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A DEFINITIVE GUIDE ON ALGORITHMIC STABLECOINS

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What Are Stablecoins?

Stablecoins are a type of cryptocurrency that maintains a stable value under any circumstances. Typically, the prices of cryptocurrencies are highly volatile.

To ensure that cryptocurrencies are a probable alternative to paper-based currencies, these coins ensure their stable pricing for proper utilization.

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What Are Algorithmic Stablecoins?

Algorithmic stablecoins are a type of stablecoins that does not have any collateral backing them up.

You may also know them as non-collateralized stablecoins. These stablecoins can offer more stability compared to other types of stablecoins.

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Working of Algorithmic Stablecoin

An algorithm maintains the value of the stablecoin. Typically, this algorithm follows specific rules for the supply and demand of the coin. To maintain the stable state of the coin, the platform mints, and burns tokens when necessary.

When the prices start to increase, the algorithm mints some coins to stabilize it. When it starts to decrease, it burns some coins.

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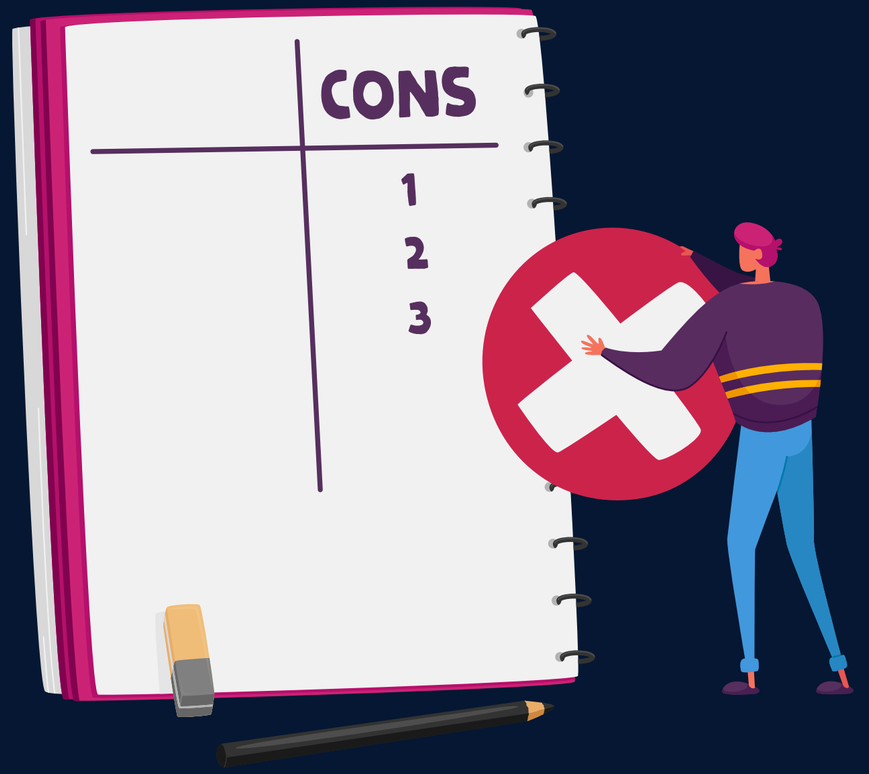
What Are the Advantages?

- Algorithmic stablecoins are fully decentralized as there is no third party or authoritative party involved.
- It does not have any collateral backing up the coins; therefore, price fluctuations of the collateral will not affect the prices.
- It can offer very stable pricing if the algorithm works perfectly.

Major Drawbacks

- The algorithm itself is very difficult to implement, especially for developers, as you may have to predict a lot of circumstances.
- The process is very complex, and many times it results in unsuccessful projects.
- It does not offer the necessary security for business usage needed within enterprise companies.



Types of Algorithmic Stablecoin

- Single Token Model
- Multi-token Model

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Key Elements for an Efficient Algorithmic Stablecoins Infrastructure

- Governance
- Incentives
- Token Adoption
- Accuracy

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Governance

Algorithmic stablecoins can feature a DAO-like structure as the governance of the system. A functioning smart contract-based governance model is a good choice in ensuring the proper management of proposals.

However, the stakeholders or participants need to have a fair offering to ensure the proper distribution of the token.

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Incentives

Offering incentives to the users for modifying their tokens is a key element in algorithmic stablecoins.

Many of the stablecoin platforms tend to use incentives to encourage their users to take part in maintaining the stability of the currency.

Token Adoption

Typically, major projects are adopted by only a small number of users or developers on the market.

Automated Market Makers don't need approval; therefore, they are excluded from adoption. Thus, it affects negatively because of limitations for new users.

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Accuracy

Algorithmic stablecoins can have issues regarding maintaining the value at all times. In many cases, protocols may malfunction and fall in a “death loop.”

There needs to be another protocol that will ensure that even if a protocol falls in a loop, this new protocol will help it to move out of the loop.

Risks of Algorithmic Stablecoins

- Increasing Supply
- Reducing Supply
- Oracles
- Broken Pegs

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Increasing Supply

When a stablecoin's price increases above the threshold, the algorithm will mint new tokens. Typically, these tokens are given to shareholders, but the shareholders may need to pay the bondholders to get the tokens.

The whole process determines the value of shares. So, if the demand for stablecoin does not increase or increases slower, there is no need to mint new tokens. This will result in the loss of value for the shares.

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Reducing Supply

Just like increasing supply issues, reducing supply can also lead to problems. Typically, the blockchain platform will offer Bond tokens at lower pricing than the stable value.

Users need to buy these bond tokens with their stablecoins in hopes of getting more stablecoins in the future. But if the demand is low, there will be no new stablecoins, and the users will not get paid for their investment.

Oracles

Oracles within a stablecoin are responsible for feeding live price data about the stablecoins pricing. With this data, the algorithm can adjust the supply to keep the value stable.

Unfortunately, oracle contracts are highly susceptible to cyber attacks, which increases the vulnerability of the platform.

Broken Pegs

Broken pegs are the worst-case scenario for any stablecoin. As the stablecoin operates on market confidence, if the value goes below the stable price, there is no certainty that users will not rush to sell all of their tokens.

In those cases, it gets harder for algorithmic stablecoins to recover as they don't have any collateral backing them up and giving users confidence to not sell the token.

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Learn More About Algorithmic Stablecoins

Stablecoin Fundamentals Masterclass

https://academy.101blockchains.com/courses/stablecoin-masterclass

Blockchain in Finance Masterclass

https://academy.101blockchains.com/courses/blockchain-in-finance

Central Bank Digital Currency (CBDC) Masterclass

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Introduction to DeFi Course

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