The Race to Dominate Stablecoins

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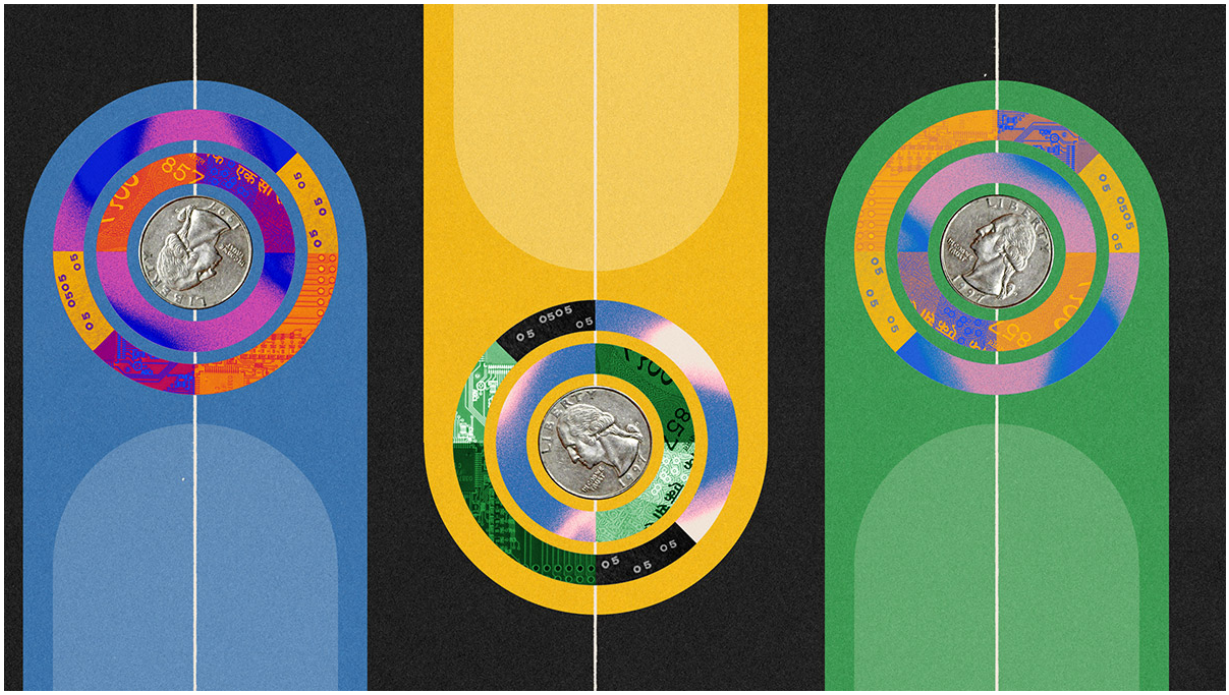

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Summary. Stablecoins — cryptocurrencies pegged to an external currency — have the potential to rewire the global financial system, and expose banking and finance to new digital competition. Now, there is intensifying competition among stablecoin issuers,...

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Stablecoins, a novel form of interoperable and programmable money, have the potential to rewire the global financial system. In doing so, they could allow software to eat banking and financial services — sectors left relatively untouched by the internet. They could displace legacy payment and credit card networks such as SWIFT, Visa, and Mastercard, accelerate the unbundling of financial institutions, and expand access to dollars to countries where it is heavily restricted, including because of sanctions.

They also promise to change the balance of power in these industries. The companies that control the stablecoin market will wield substantial influence over the future of money.

Given these high stakes, we are witnessing intensifying competition among stablecoin issuers, prominent digital wallet providers, and traditional banks, each racing to establish their platform as the dominant one. In this article, we delve into the strategies of both incumbents and challengers, the role regulators will play, and ultimately predict how the market will shake out. The outcome will be consequential not only for financial institutions but for any company and digital platform that relies on money movement at scale.

Towards an Operating System for Money?

Platform wars, in which proponents of competing views of the future fiercely compete for market dominance, are some of the loudest and most turbulent moments in business, bringing out the best and worst of business strategy.

Some turn into trench warfare, like the endless skirmishes and (at times questionable) growth hacks Uber deployed in its city-by-city fight against Lyft. Or when Didi leveraged its home-field advantage to poach drivers, gather counterintelligence, and outmaneuver Uber with Chinese regulators.

Others start quietly with technical discussions within standard setting organizations — like HD-DVD vs Blu-Ray — before turning ugly when competitors drive prices to the bottom to tip adoption to their side. Because these markets exhibit winner-take-all dynamics, CEOs will stop at nothing to gain an early advantage.

Usually the actual technology matters much less than people think. While experts endlessly debate the technical merits of each solution, in the end, winning is about execution. The classic but dated example is the ’80s battle between VHS and Betamax, where JVC beat Sony despite having fewer resources and a lower quality product. JVC understood that having more content — what we would call “applications” today — mattered far more than perfect video.

The same has been unfolding in the world of blockchains: More than a decade into the Bitcoin experiment, countless teams raised billions to displace Bitcoin’s limited design. Yet Bitcoin persists, with stronger network effects and institutional adoption than the alternatives. While engineers obsess about metrics such as transactions per second, energy consumption or dimensions of scalability and decentralization, the world moves on.

The conclusion of a platform war is always the same: A dominant design emerges, everyone switches over, and the conflict is done. The losing side has no second chance until a completely new technological paradigm emerges: Think Mac vs PC, where Apple only got a re-do with the iPhone; or Meta aggressively pursuing AR/VR because it is currently hostage to iOS and Android on mobile.

When it comes to blockchain infrastructure, Bitcoin and Ethereum are already dominant designs, and more activity will converge onto them (though some prefer to ignore this fact).

But while the blockchains war might be over, the one for stablecoin dominance is just beginning. While the former matters for developers, the latter will decide what we use every day. The reason is simple: Stablecoins are the bridge between cryptocurrencies and traditional finance. Without stablecoins, crypto applications have to wrestle with volatility, and volatility makes financial contracts expensive.

The Past and the Future of Money

Regulators appear to understand the relevance of stablecoins — and what's at stake. Without stablecoins, blockchains are uncompetitive. But in their current form, stablecoins challenge banks, are used to circumvent capital and anti-money laundering controls, and can ignite or accelerate a banking crisis.

The run on Silicon Valley Bank was a small preview of what can happen: because Circle's USDC had about 8% of its reserve at risk, it rapidly depegged and withdrew $3 billion from the struggling bank. While it is easy to avoid this with proper reserve design, the risks are real.

Back in 2019, when Facebook announced Libra — a project one of us designed — central bankers likely knew the currency would have never become a new unit of account. It took years for the Euro to establish itself, and that was with top-down enforcement by every government involved. Even so, Libra was a credible threat to the status quo and saw sharp criticism from financial incumbents, legislative proposals to ban it, and stonewalling from regulators. In 2022, the project wound down.

But stopping the consortium behind Libra only bought incumbents time, and things are heating up again.

Incumbents are threatened by stablecoins becoming the new operating system for money, doing to the existing system what the internet did to Barnes & Noble. As a result, they are determined to embrace, extend and extinguish. Financial giants like JPMorgan Chase have developed their own proprietary blockchain and launched their programmable dollars on top of it. And while in the '90s Microsoft deployed a similar strategy against Netscape, which eventually proved ineffective, financial services are different. Regulation gives incumbents a chance to leverage their distribution and lobbying to slow things down to a halt while building a counteroffensive. This is what killed Libra, and others may face the same fate soon.

The last serious attempt at reforming the financial system did not use a blockchain. It was Elon Musk's original version of X.com, before the merger with Peter Thiel's PayPal. Musk was ahead of his time, and wanted to build a universal financial services app. Thiel was more pragmatic and focused on ensuring backward-compatibility with card networks and banks. That solidified PayPal's growth in the short term, but ultimately doomed its chances of truly changing the system. Two decades later, the card networks are a comfortable oligopoly and banking is untouched by the internet.

Reform or Status Quo?

Stablecoins present a second chance at reforming the financial system. But whether they will be able to do so depends on the stablecoin wars — and whether regulators tip the scales in favor or against innovation. By narrowly scripting design choices, they can limit the viable business models and foreclose entry to anyone but the banks. And if that

happens, the pro-competitive elements of the technology will be lost once more. While this would please incumbents, it would come at a high cost to consumers and businesses.

Irrespective of the unpredictable level of regulatory interference in the stablecoin wars, the most important question is whether we will end with one or two global players leading, or with a swarm of commoditized issuers. The technology can support either outcome, so where we land will depend on how different players execute on their strategy.

The first group of contestants are the crypto-natives Tether and Circle. Tether introduced the first stablecoin for trading 10 years ago, and dominates the market with $114 billion in USDT in circulation. USDT is issued offshore, and while there have been also questions about its reserve, its core challenge is its ability to evolve into a properly regulated entity. While Tether has repeatedly stated that it promptly responds to law enforcement requests, reports from the UN and JPMorgan have raised questions about the company's compliance and suggest more work is needed. Tether's competitive advantage comes from its scale, integration with market makers, and strong product market fit among segments that otherwise cannot hold U.S. dollars. The last item is also Tether's biggest liability.

With $33 billion in USDC, Circle is Tether's closest competitor. While Circle operates under the same U.S. state money transmitter licensing regime as PayPal, the federal government has made it clear stablecoins should be a federal matter, since risks arising from managing a stablecoin reserve are more bank-like relative to simply operating a digital wallet. As a result, the big open question for Circle — which has been trying to IPO for several years — is whether it can make the transition to a federal charter, given that it does not impose know-your-customer (KYC) rules on USDC holders. Depending on future regulation, Circle could be in pole position or dealing with a messy transformation into a bank. Banking supervision would also drastically limit Circle's revenue levers, as the Fed rightly wants issuers to be safe and boring.

For both Tether and Circle, we believe the strategy is simple: Adapt to tighter compliance and consumer protection standards without losing the ability to monetize the stablecoin ecosystem. This is a delicate balancing act, as stricter regulation will inevitably limit how issuers create and capture value.

Among the crypto-natives, Paxos, founded in 2012 to scale blockchain infrastructure, is interesting because of its unique strategy. Rather than scaling its own stablecoin, Paxos is betting on a world with many stablecoins. By positioning itself as a stablecoin infrastructure provider, Paxos helps others issue branded stablecoins. This has been so effective that when PayPal decided to enter crypto, it partnered with Paxos. While PayPal's PYUSD only has $350 million in circulation, market cap is the wrong metric if you care about payments rather than crypto trading and decentralized finance (DeFi). For stablecoins that want to compete with the card companies, total payments volume (TPV) will be a better metric, and that's where PayPal could rapidly overtake USDC thanks to its existing merchant business.

If Paxos can replicate this with additional, large consumer brands that do not want to become financially regulated companies, a proliferation of stablecoins would flood the market. Like branded reward credit cards, where consumers pick an airline, hotel chain, or retailer, stablecoins may fade into the background and turn into loyalty points. Starbucks already holds over $1 billion of customers' money in its app, and one could easily imagine Walmart or Amazon entering the fray. Target's extremely successful RedCard program could be replicated with a stablecoin by anyone with a loyal customer base, driving revenues away from the card companies.

Because stablecoins live on open networks, they would all be interoperable. Furthermore, if regulation makes them similarly safe, a key dimension of differentiation would disappear. Consumers and businesses would hold digital and programmable dollars, and perceive them similar to commercial bank deposits today. This is the doomsday scenario for Tether and Circle, as they would struggle to differentiate themselves in a sea of competitors with a distribution advantage.

Banks are already pushing behind the scenes for a world with many stablecoins. It's what they're familiar with today where dollars at different banks are perceived as fungible by consumers, even though they are made so only by central bank clearing. It also preserves the banks' role in a way that the rise of a large stablecoin company does not. By pushing network effects back to the dollar rather than a stablecoin, the banks can fend off the creation of a competitor more powerful than the card networks. Furthermore, this would not prevent JPMorgan Chase from dominating institutional use cases, or Bank of America to do the same in the retail market, preserving the pecking order.

While Visa and Mastercard would retain more of their competitive advantage by issuing their stablecoins, this is fraught with antitrust risk and would strain their relationship with the banks. As a result, the multiple stablecoins world is one the card networks will also embrace: It does not change their role, and they can add stablecoins just like new currencies. A slightly more risky bet would be for the card companies to collaborate with the banks to design a stablecoin with distributed reserves across them — but this is likely too ambitious and similar to Libra.

This leaves the big tech companies as wildcards. The reality is that they have all learned the lesson from Libra to make too loud of an entry into financial services. There is strong political opposition to it, and they are better off partnering with banks than fighting. They could also never operate their core business under federal banking laws and supervision. Last, since they control the distribution, nothing prevents them from leveraging their network effects to capture value, irrespective of the stablecoin being used. While neobanks such as Revolut or Nubank may have bigger ambitions than the tech giants, they will also struggle with scope as they further encroach on traditional banking territory.

So will only pure-play issuers such as Tether and Circle push for a winner-take-all scenario? After all, the market is very concentrated today, and network effects seem to matter. Stablecoin liquidity has been important so far in ensuring lower cost conversions to and from fiat, and this will only increase in relevance with mainstream adoption.

But the reality is that incumbency is unlikely to automatically translate to non-crypto use cases, and as banks are allowed to enter, traditional distribution channels will matter more. So while Tether and Circle have dominated the crypto era, graduating from this niche, unregulated market to billions of consumers and businesses is a fundamentally different game.

That said, leading crypto exchanges such as Coinbase and Binance could also enter and scale as pure-play issuers, and they would have the users, technical talent, and regulatory experience to compete. Both companies have built networks for payments and financial applications (Base and BSC respectively), will have to become more bank-like as they grow, and are deeply familiar with the technology — likely more than Circle or Tether.

Disruption Wanted

The stablecoin wars, like the battle for home video, will not be decided by better tech or incumbency, but by the applications. While regulators can make it significantly harder for innovators to compete, they will not be able to stop them forever. In the end, the most likely outcome is one with many stablecoins that fade into the background and deliver lower-cost, faster payments to the world. That would be a victory for consumers and businesses alike, even if not for the existing stablecoin issuers — which may be acquired by banks.

When that happens, it will not end the battle for the control of our digital wallets. The same companies will all still fiercely compete to own the “pay with” experience. Credit card companies will fight hard to retain the pay with Visa or Mastercard flow, which might be fine with the banks. So it will be up to the leading neobanks and crypto exchanges to try something truly novel, and they may be the ones that actually succeed at changing the game.