What are Some Takeaways that We Can Get from Terra Luna Crash?

Original:
https://www.btcc.com/en-US/academy/research-analysis/what-are-some-takeaways-that-we-can-get-from-terra-luna-crash

Gytis Trilikauskis of MEV Capital says that Terra's LUNA/UST death spiral was perfectly anticipated, and that it functioned as a stress test for better-designed stablecoins.

When Terra's LUNA/UST failed, it brought the crypto market to a screeching halt, wiping out billions of dollars in value in a matter of days. This failure will almost certainly lead to more stringent stablecoin regulation in the near future.

Stablecoins are digital assets whose value is tied to a certain currency, the U.S. dollar, such as TerraUSD or UST. Blockchain smart contracts known as "protocols" ensure that algo-stablecoins remain stable by requiring collateral in the form of other digital assets to be deposited into the system before they can be issued.

A third-party organization is not needed to control supply and maintain necessary reserves in algorithmic stablecoins, unlike reserve-backed stablecoins, which rely on traditional assets such as U.S. Treasury bonds or cash equivalents to keep sufficient reserves.

UST's vulnerability to a bank run was due to the fact that UST obligations were mostly backed by LUNA, a cryptocurrency native to the Terra blockchain. Every time a UST emission was produced, a corresponding amount of LUNA was depleted from circulation (burned). Every time UST was destroyed, LUNA tokens were minted (produced).

Terra's Economics: the LUNA-UST Connection

LUNA, Terra's reserve currency, and its algorithmic stablecoin both functioned in an organized and symbiotic way. Was it a Ponzi scam in any way? Take a look at the built-in rewards.

The Anchor protocol, a Terra blockchain-native decentralized protocol, began giving 18-23% interest rates on UST deposits as early as March 2021, and naturally it began drawing a large number of depositors to it. Anyone who could get their hands on some UST and deposit it into the Anchor protocol would get a 20% or so return on the dollar.

The stablecoin's circulation increased in tandem with the rise in UST demand, which necessitated the burning of LUNA tokens, as previously mentioned. LUNA's price soared from US$6.50 to a high of US$116 in just over 13 months, a 16-fold rise. This pressured up the price for several months. The interest obligations of the Terra blockchain, on the other hand, increased in absolute value as a result of the increase of stakers on the Anchor protocol.

It was necessary for the Luna Foundation Guard, a non-profit based in Singapore that was established to aid Terra's ecology, to regularly inject funds into the Anchor protocol in order to satisfy liabilities and pay out yield to depositors.

Even if the underlying asset was volatile and poorly constructed, there was theoretically enough collateral as long as UST adoption was accompanied by an increase in the price of LUNA.

But when the price of LUNA began to fall, the true mayhem started. Everything that happened after that may be summed up as follows:

- This cycle repeats itself again and over as panic and uncertainty spreads throughout the Terra environment.
- A "bank run" occurs when a large enough number of people get entangled in this cycle, causing UST liabilities to outweigh its assets.
- Speculators in the market also play a role at this point. As a result of the trembling system, they decide to add fuel to the fire by shorting both UST and LUNA in the Terra environment. At some time in the future, UST will begin to depreciate against the US dollar.

Spiraling Towards Death

The dreaded death spiral is arrived. The interlaced mint/burn process of the UST is being exploited by arbitragers. One UST can be exchanged for one LUNA at any time, regardless of LUNA's current value, because of the link between the two digital assets.

For example, when you redeem US$1 in UST for US$1 in LUNA, you can then immediately sell the LUNA to complete the arbitrage. That is, of course, exactly what occurred. It drained the system of all collateral, destroyed the LUNA price, and drained the Anchor protocol of the vast bulk of deposits. There was a 93% decline in the quantity of UST deposits between May 6 and May 19, from around 14 billion to 1 billion. It was a hurricane of biblical proportions, no doubt about it.

This means that as the price drops, more LUNA is placed into circulation to keep the asset/liability balance of UST in check. In this particular situation, however, the price decrease was so severe and swift that the elasticity turned out to be a defect rather than a feature and utterly destroyed the value and recovery capacity of the underlying LUNA.

In light of the UST de-peg, the circulation supply of LUNA coins has risen from 345 million to 6.5 trillion (yep trillion). Terra Classic, or LUNC, formerly known as LUNA, is presently trading for less than US$0.0001, according to CoinMarketCap.

Could the Terra Luna Crash Have been Foreseen?

Is the LUNA/UST problem something that should have been foreseen? Yes, without a doubt. With the blockchain and algorithmic stablecoins, anyone curious enough can see and understand the circulating supply model, the mint/burn cycle, and the collateralization processes. Although there were many whistleblowers warning of the impending calamity, human psychology prevailed in the end.

As time went on, even though you were dubious at first, you began to discount the red signs and focus on the benefits, possibly unintentionally. At the very least, till everything went to hell.

Some Takeaways

Rather than showing that "no such thing as low-risk in crypto," the tragic case of Terra demonstrates that the market is still in its developing stage and what we've seen may be classified as a crypto market's adaptation to changing environment. This could be the single biggest destruction of wealth in the crypto market.

That this experiment failed so miserably is due in large part to the fact that TerraUSD is a unique and shoddy stablecoin. Market pressure has since been applied to other stablecoins and their collateralization schemes. As of May 12, even the most popular centralized stablecoin, Tether (USDT), was de-pegged 6 percent for around four hours.

Some stablecoins were fully #rekt, while others, like USDC or DAI, temporarily lost their peg. The takeaway here is that during the recent market downturn, fundamentally good systems prevailed and served as safe haven assets. Confidence in the company will only rise as a result of it..

Every newcomer will have to prove itself worthy of a position in the stablecoin hall of fame. They'll be put to the test, as they should be, and only the strongest and most elegantly made ones will make it to the end of the line.