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Original:

<https://www.btcc.com/en-US/academy/crypto-basics/what-is-tokenomics-in-crypto-and-why-it-matters>

What is Tokenomics in Crypto and Why It Matters?

A large part of the success of crypto projects can be attributed to their tokenomics. But what does the term exactly mean and why it is so important?

A portmanteau of “token” and “economics,” tokenomics is a catch-all for the elements that make a particular cryptocurrency valuable and interesting to investors. That includes everything from a token’s supply and how it’s issued to things like what utility it has.

Tokenomics is an important concept to consider when making an investment decision because ultimately a project that has smart and well-designed incentives to buy and hold tokens for the long haul is more likely to outlast and do better than a project that hasn’t built an ecosystem around its token. A well-built platform often translates into higher demand over time as new investors flock to the project, which, in turn, boosts prices.

Likewise, when launching a project, founding members and developers need to consider the tokenomics of their native cryptocurrency carefully if their project is to attract investment and be successful.

Tokenomics main features

The structure of a cryptocurrency’s economy determines the incentives that encourage investors to buy and hold a specific coin or token. Just like how fiat currencies are all different, each cryptocurrency has its own monetary policy.

Tokenomics determine two things about a crypto economy - the incentives that set out how the token will be distributed and the utility of the tokens that influence its demand. Supply and demand has a huge impact on price, and projects that get the incentives right can surge in value.

Here are the main variables that developers change that affect tokenomics:

- **Mining and staking**- For base layer [blockchains](#), like Ethereum 1.0 and Bitcoin, [mining](#) is the core incentive for a decentralized network of computers to validate transactions. Here, new tokens are given to those who devote their computing power to discovering new blocks, filling them with data and adding them to the blockchain. [Staking](#) rewards those who fulfil a similar role but by locking away a number of coins in a smart contract instead - this is how blockchains like Tezos operate, and it's the model that Ethereum's moving toward with its 0 upgrade.
- **Yields**- Decentralized finance platforms offer high yields to incentivize people to buy and stake tokens. Tokens are staked in liquidity pools - huge pools of cryptocurrencies that power things like decentralized exchanges and lending platforms. These yields are paid out in the form of new tokens.
- **Token burns**- Some blockchains or protocols "burn" tokens - permanently remove them from circulation - to reduce the supply of coins in circulation. According to the laws of supply and demand, reducing a token's supply should help to support its price as the remaining tokens in circulation become more scarce. In August 2021, Ethereum started to burn a portion of tokens sent as transaction fees instead of sending them to miners.
- **Limited vs unlimited supplies**- Tokenomics determines a token's maximum supply. Bitcoin's tokenomics, for instance, dictates that no more than 21 million coins can ever be mined, with the last coin expected to enter circulation around the year 2140. Ethereum, by contrast, has no maximum limit, although its issuance each year is capped. [Non-fungible token](#) (NFT) projects take scarcity to the extreme; some collections might mint only a single NFT for a piece of art.
- **Token allocations and vesting periods**- Some crypto projects account for a detailed distribution of tokens. Often, a certain number of tokens are reserved for venture capitalists or developers, but the catch is that they can sell those tokens only after a certain time. That naturally has an effect on the circulating supply of the coin over time. Ideally, a project's team will have implemented a system where tokens are distributed in such a way that it reduces the impact to the circulating supply and a token's price as much as possible.

What Determines the Tokenomics?

All of these decisions are made at the protocol level, and most tokenomics are baked into a particular cryptocurrency's computer code by its founding developers.

Before a cryptocurrency is released, its tokenomics are often outlined in a corresponding white paper, which is an in-depth document that explains what the proposed cryptocurrency will do as well as how it and any underlying technology will work.

For instance, take the tokenomics of the [Terra](#) ecosystem, described in a 2019 white paper. The

project describes itself as a network of stablecoins - a type of crypto token that maintains a stable value using either a reserve of assets or a clever algorithm.

One of the main stablecoins in Terra's ecosystem, called TerraUSD ([UST](#)), relies on a complicated network of arbitrageurs, who swap UST with another of Terra's tokens [LUNA](#), to keep the price of UST as close to \$1 as possible at all times. This complex tokenomics system is appealing to investors because it creates easy opportunities to make low-risk gains through arbitrage trading. Not to mention, the UST [stablecoin](#) can be used across various trading platforms to lock in U.S. dollar-denominated gains during volatile market conditions.

Game Theory

The list above lays out the groundwork for tokenomics, but that's just the start. Cryptocurrencies are essentially a free pass to introduce any type of game theory the creators would like.

Many tokens are so-called utility tokens, meaning that they have a specific purpose within a particular ecosystem - AMP, for instance, is used for a decentralized escrow system, and Index Coop's DeFi Pulse Index token powers a decentralized index fund for top DeFi tokens.

Game theory is an economic concept that assumes that traders are rational actors, and given certain incentives will eventually settle on the optimal choice (like staking [ETH](#) to earn high returns, mining bitcoin and so on). Compare, for instance, two wildly different tokenomic schedules: that of Olympus DAO, the contentious decentralized reserve currency project, and that of Loot, the NFT character sheet game created by entrepreneur and computer programmer Dom Hofmann, who co-founded the video-hosting service Vine.

In the past few years, token holders have been able to vote on rules that define a cryptocurrency's economy by voting using tokens through decentralized autonomous organizations, or DAOs. A DAO might vote, for instance, to change the number of tokens issued to stakers - those who pledge tokens to validate transactions.

Olympus DAO, for instance, operated a kind of huge decentralized money-market fund, where those who wanted to create a reliable reserve currency benefited from additional funds joining the pool. According to the project's game theory model (popularized by the meme (3,3)), the most rational choice was to stake OHM into the protocol's auto-compounding protocol.

This was due to the tokenomics of the protocol; by staking OHM, you would strengthen the decentralized reserve currency and allow people to buy more bonds. If everyone sold OHM, that would hurt the price of the protocol and all holders would get hit. So, you can see how the protocol's

tokenomics incentivized people to buy and stake the token.

Tokenomics don't always go to plan. Eventually, lots of people did sell OHM, after investors using an OHM liquidity pool on a third-party platform were liquidated. That caused the price to fall dramatically, scaring other investors away from the token.

Loot, on the other hand, is an NFT project created by Hofmann. Its tokenomics let anyone buy Loot as soon as it launched; the 10,000 character sheets, which listed items that characters in an as-yet-to-be-created game would use, sold out almost instantly. The tokenomics of Hofmann's game revolved around scarcity; because there were only 10,000 character sheets and were hyped up on Twitter, they became immensely valuable.

Token Governance Plays An Important Role

Governance plays a huge role in tokenomics these days. Lots of tokens function as so-called governance tokens, meaning that holders are granted voting rights to influence the future rules and decisions of a project. This is all in the name of decentralization; instead of a centralized group of developers calling the shots, token holders can vote on how the platform should be run.

Think of governance tokens like stock in a public company, albeit one without a CEO.

[DeFi](#) platforms operate through DAOs - the name given to a governance system that relies on token governance. Holders can vote on anything: As of this writing, for instance, Uniswap's DAO is discussing whether to deploy Uniswap V3 to Polygon's proof-of-stake chain and Gnosis Chain.

Tokenomics are crucial to the success of a project; just as a reckless CEO can run a company into the ground, poor governance decisions can kill off top DeFi projects.

If all else goes wrong, it is always possible to impose a new tokenomic schedule by "hard forking" a cryptocurrency - a process of copying a blockchain codebase, making some non-backward-compatible changes and migrating the old crypto and verifiers to the new network.