

Cryptocurrencies and Their Impact on Financial Systems

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Abstract. Cryptocurrencies have emerged as a novel force in the financial landscape, challenging traditional systems with their decentralized nature and blockchain technology. This essay explores the dynamic landscape of cryptocurrencies and anticipates their future implications on financial systems. It further delves into both the potential benefits and risks associated with cryptocurrencies, including financial inclusion, improved efficiency and transparency, alongside concerns regarding volatility, security risks, and potential misuse for illicit activities. By examining these various dimensions, the paper aims to provide a comprehensive understanding of the multifaceted future of cryptocurrencies and their intricate influence on financial systems.

Keywords: Cryptocurrency, financial system, market capitalization

1 Introduction

The financial landscape is undergoing a significant transformation driven by the emergence of cryptocurrencies. These digital assets, different from traditional government-backed currencies, have captured the imagination of investors, entrepreneurs, and even central banks worldwide. By definition, cryptocurrencies are digital or virtual currencies that utilize cryptographic techniques to secure transactions and control the creation of new units [1]. They operate on a decentralized network, meaning no single entity controls their creation or distribution. This decentralization is achieved through a technology called blockchain, a distributed ledger that transparently records all transactions [2].

Cryptocurrencies boast several unique characteristics. Firstly, as mentioned above, cryptocurrencies operate on a distributed ledger (blockchain) that is maintained by a network of nodes rather than being controlled by a central authority [3]. Secondly, cryptocurrencies use cryptographic techniques to secure transactions and ensure the integrity of the network. Once recorded on the blockchain, transaction data cannot be altered, ensuring a permanent and verifiable record [4]. Thirdly, the identities of the parties involved are often pseudonymous, providing a degree of privacy and anonymity. Lastly, cryptocurrencies can be accessed and transacted from anywhere in the world with an internet connection, enabling borderless transactions and financial inclusion.

The evolution of cryptocurrencies over time has been a dynamic journey marked by significant technological advancements, regulatory developments, adoption trends, and

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shifts in market dynamics. It all began with the genesis of Bitcoin in 2009, introduced by an anonymous entity known as Satoshi Nakamoto. Bitcoin's whitepaper introduced the concept of "a decentralized peer-to-peer digital currency", laying the foundation for a revolutionary new financial system [5]. With the rise of Ethereum in 2015, the concept of smart contracts emerged, enabling the creation of decentralized applications (dApps) and programmable tokens. The subsequent ICO boom of 2017 brought about a surge in new blockchain projects raising funds through token sales, while also seeing the tokenization of real-world assets [6]. The cryptocurrency ecosystem continued to mature, with improvements in infrastructure and increasing institutional adoption. In recent years, decentralized finance (DeFi) has emerged as a dominant force, offering decentralized lending, borrowing, trading, and yield farming, and challenging traditional financial intermediaries. Similarly, non-fungible tokens (NFTs) have gained traction as unique digital assets representing ownership of digital art, collectibles, and virtual real estate.

While the current state of the cryptocurrency market is still evolving, it is clear that these digital currencies are here to stay and will continue to impact financial systems in the future. This paper will delve deeper into the multifaceted nature of cryptocurrencies, examine their impact on financial systems, and explore the opportunities and challenges they present in shaping the future of finance.

2 Overview of Cryptocurrencies Market

The current state of the cryptocurrency market is characterized by rapid growth, innovation, and volatility. With thousands of cryptocurrencies in existence, Bitcoin and Ethereum stand as the frontrunners, commanding the highest market capitalization and trading volume. The market's exponential expansion has attracted a diverse array of participants, including retail investors, institutional players, and technology innovators.

2.1 Market Capitalization and Trends

The total market capitalization of cryptocurrencies has experienced significant growth over the years, reaching hundreds of billions to trillions of dollars [7]. Bitcoin alone boasts a market capitalization of over a trillion dollars, with Ethereum not far behind. The trends in cryptocurrency market capitalization have been highly dynamic, reflecting the ebbs and flows of investor sentiment, technological advancements, regulatory management, and macroeconomic factors. Therefore, the total market capitalization of crypto is the real-time calculation of all coins and tokens listed by crypto price tracking websites [8]. Assets such as NFTs and metaverse land are not currently included in the calculations of any major crypto price services. Despite occasional periods of volatility and corrections, the overall trend has been upward (as shown in Figure 1), reflecting growing adoption and interest from both retail and institutional investors.

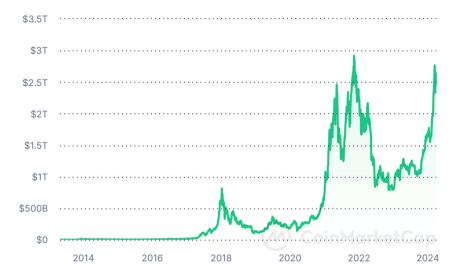


Fig. 1. Global Cryptocurrencies Market Capitalization 2010-2024 (in bln \$)

2.2 Major Cryptocurrencies and Key Players

The market now comprises thousands of cryptocurrencies, each with its unique value proposition and use case. At the forefront of the cryptocurrency market is Bitcoin (BTC), often referred to as digital gold. Launched in 2009, Bitcoin remains the largest cryptocurrency by market capitalization and is widely regarded as a store of value and a hedge against inflation [9]. Ethereum (ETH) holds the second position, offering a platform for developers to build decentralized applications (dApps) and deploy smart contracts. Other prominent cryptocurrencies include Binance Coin (BNB), Cardano (ADA), Solana (SOL), and Ripple's XRP, each catering to specific use cases such as decentralized finance (DeFi), non-fungible tokens (NFTs), and cross-border payments.(as shown in Figure 2 and Figure 3)

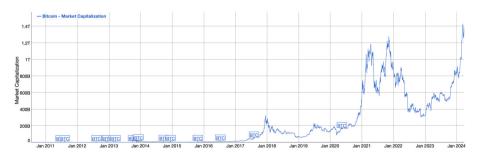


Fig. 2. Bitcoin Market Capitalization 2010-2024 (in bln \$)

Cryptocurrency	Market Cap (USD)	Calculating Supply	Price (USD)
Bitcoin	\$1,387,023,685,082	19,665,256	\$70,531.69

Ethereum	\$434,069,667,563	120,074,016	\$3,615.02
BNB	\$87,412,478,795	149,536,704	\$584.56
Solana	\$85,266,959 391	444,310,731	\$191.91
XRP	\$34,805,418 341	54,884,241,878	\$0.6342
Dogecoin	\$26,212,073,707	143,632,396,384	\$0.1825
Cardano	\$23,798,384,834	35,578,768,641	\$0.6689
Avalanche	\$21,288,514,607	377,416,536	\$56.41
Toncoin	\$17,523,469,268	3,470,267,820	\$5.05
Polkadot	\$13,913,973,054	1,426,404,583	\$9.75

Fig. 3. Characteristics of the main cryptocurrencies (as of Mar 20, 2024)

Furthermore, institutional involvement in the crypto space is growing. Cryptocurrency exchanges serve as central hubs for trading digital assets, with platforms like Coinbase, Binance, and Kraken offering users access to a wide range of cryptocurrencies and trading pairs. Wallet providers such as Ledger, Trezor, and MetaMask offer secure storage solutions, enabling users to store, send, and receive digital assets with confidence. Miners, both individual and collective through mining pools like AntPool and F2Pool, validate transactions and secure blockchain networks, ensuring the integrity and decentralization of cryptocurrencies. Developers are instrumental in driving innovation and maintaining the underlying technology of cryptocurrencies and blockchain networks, with projects like Ethereum, Cardano, and Solana attracting large developer communities. Institutional investors, including hedge funds, asset managers, and family offices, bring capital and legitimacy to the market, while regulators and governments establish policies and regulations to ensure compliance, consumer protection, and market integrity. Currently, central banks worldwide are exploring the potential issuance of central bank digital currencies (CBDCs) to enhance payment efficiency, reduce transaction costs, and promote financial inclusion, further shaping the evolving landscape of the cryptocurrency market [10].

3 The Impact of Cryptocurrencies on Financial Systems

Despite the ongoing evolution of the cryptocurrency market, one fact remains unmistakable: these digital currencies have firmly established their presence and are poised to exert a lasting impact on financial systems worldwide. It becomes increasingly evident that cryptocurrencies are not merely a passing trend but a fundamental force shaping the future of finance.

3.1 Positive Impact

Financial Inclusion. It refers to the accessibility and availability of financial services to all individuals and businesses, particularly those who are marginalized or underserved by traditional banking systems [11]. It entails providing easy access to affordable and useful financial products and services, such as payments, savings, credit, and

insurance, and has the potential to significantly boost the economies of developing countries. Traditionally, initiatives aimed at fostering financial inclusion have been spearheaded by governments, institutions, and banks. But the rise in popularity of internet-based open-source technology, coupled with increased investments in cryptocurrencies, public blockchain networks, and protocols, suggests the emergence of a technological framework for an alternative, open, and inclusive financial system. Statistically, this trend suggests a potential \$3.7 trillion annual GDP increase across all emerging economies. Two-thirds of this growth is expected to come from improved efficiency across businesses and governments due to digital payments [12]. Additionally, wider adoption of digital finance could create up to 95 million new jobs across various sectors [13].

Efficiency and Speed. Cryptocurrencies facilitate faster and more efficient transactions compared to traditional financial systems. Traditional cross-border payments can take several days to settle due to the involvement of multiple intermediaries and clearing houses. However, cryptocurrencies operate on a decentralized network and thus eliminate the need for intermediaries, which significantly reduces settlement times. Meanwhile, international wire transfers through banks often involve high fees, including currency conversion fees and intermediary fees. In contrast, cryptocurrency transactions may only involve minimal network fees, which are typically lower than traditional banking fees. For instance, according to Dune Analytics, decentralized exchanges processed over \$76 billion in trading volume in January 2022 alone, highlighting the growing popularity and adoption of decentralized trading platforms [14].

Decentralization. DeFi refers to a peer-to-peer financial ecosystem built on public blockchains. It bypasses traditional financial intermediaries like banks, offering a range of services [7]. DeFi platforms enable the creation and trading of synthetic assets and derivatives, allowing users to gain exposure to various financial instruments without owning the underlying assets. Projects like Synthetix and Mirror Protocol allow users to mint synthetic assets that track the value of real-world assets such as stocks, commodities, and fiat currencies. These synthetic assets can be traded on decentralized exchanges and used as collateral for lending and borrowing.

3.2 Negative Impact

Volatility and Price Fluctuations. Cryptocurrency markets are known for their extreme price fluctuations, with prices often experiencing rapid and unpredictable swings within short periods. For example, Bitcoin, the largest cryptocurrency by market capitalization, experienced a price increase of over 300% in 2017, followed by a sharp correction of nearly 80% in 2018. Similarly, Ethereum, the second-largest cryptocurrency, saw its price surge by over 1,300% in 2017 before experiencing significant volatility in subsequent years. These price fluctuations can lead to significant gains or losses for

investors and undermine the stability of financial markets. Moreover, the lack of investor protections and recourse mechanisms in cryptocurrency markets can exacerbate the impact of volatility on individual investors.[16]

Regulatory Uncertainty. Cryptocurrencies are a relatively new asset class with unique characteristics that don't neatly fit into existing regulatory frameworks. This makes it difficult for regulators to categorize and apply appropriate regulations. A 2022 survey by the International Organization of Securities Commissions (IOSCO) found that over 90% of its members reported having regulatory concerns regarding crypto-assets [15]. Furthermore, regulators may issue conflicting guidance or take divergent approaches to regulating cryptocurrencies, further complicating compliance efforts for businesses and investors. For example, China has banned cryptocurrency trading and initial coin offerings (ICOs), while countries like Switzerland and Singapore have adopted more crypto-friendly regulatory approaches. These different regulatory responses contribute to regulatory uncertainty and create compliance challenges for businesses operating in multiple jurisdictions.

Security Risks. While cryptographic security is strong, cryptocurrency exchanges and wallets can be vulnerable to hacking and scams. Cryptocurrency exchanges, where users buy, sell, and store their digital assets, are frequent targets for hackers due to the large sums of money involved. One notable example is the Mt. Gox hack in 2014, where approximately 850,000 bitcoins, worth over \$450 million at the time, were stolen from the exchange¹. Meanwhile, cryptocurrency wallets, which are used to store private keys and access funds, are also susceptible to security breaches. Malicious actors may target individual users' wallets through phishing attacks, malware, or social engineering tactics.

4 Conclusions

Overall, the impact of cryptocurrencies on financial systems is profound and ongoing, reshaping traditional financial paradigms, fostering innovation, and challenging regulatory frameworks. It is clear that the future of cryptocurrencies, as a revolutionary technology, holds both promise and challenges for the financial landscape. On the one hand, from decentralized exchanges and lending platforms to tokenization of assets and decentralized autonomous organizations, cryptocurrencies have introduced new paradigms for accessing and interacting with financial markets. However, the complexities and risks associated with cryptocurrencies remain a major concern, including volatility, regulatory uncertainty, and security vulnerabilities. These challenges underscore the need for policymakers, regulators, industry stakeholders, and researchers to collaborate in developing clear and balanced regulatory frameworks, implementing robust security measures, and promoting responsible innovation in the cryptocurrency ecosystem.

¹ https://www.wired.com/2014/03/bitcoin-exchange/

Under this context, this essay provides readers with a deep understanding of the complex dynamics surrounding cryptocurrencies by delving into various aspects such as their key features, evolution, market landscape, positive and negative impacts, and shedding light on future research directions. As cryptocurrencies continue to evolve and gain broader acceptance, there are several avenues for future exploration in the field of cryptocurrencies and their impact on financial systems. Firstly, research efforts should focus on understanding the macroeconomic implications of widespread cryptocurrency adoption, including its effects on monetary policy, financial stability, and international capital flows. Secondly, there is a need for further research into the regulatory challenges and opportunities associated with cryptocurrencies, particularly in addressing issues such as investor protection, market integrity, and systemic risk. Thirdly, ongoing research is needed to enhance the security and resilience of cryptocurrency networks and infrastructure, including mitigating risks related to cyberattacks, smart contract vulnerabilities, and 51% attacks. Moreover, analyzing the potential applications of blockchain technology beyond cryptocurrencies, such as supply chain management, identity verification, and decentralized governance, can provide valuable insights into the broader impact of decentralized technologies on various sectors of the economy.

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