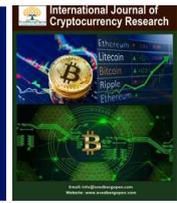




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Stablecoins and National Security: Implications for Nigeria's Regulatory Landscape

Agama Emomotimi^{1*} ¹Securities & Exchange Commission, Central Business District, Abuja, Nigeria. E-mail: eagama@sec.gov.ng

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Abstract

Stablecoins have become a critical element of the cryptocurrency ecosystem, offering benefits such as value stability, efficient cross-border transactions, and enhanced access to Decentralized Finance (DeFi) and everyday payment systems. Their increasing adoption demonstrates their capacity to transform financial processes by enabling faster transactions, reducing fees through blockchain technology, and expanding financial inclusion for unbanked populations. However, these advantages come with significant national security concerns, including the risks of illicit financial activities, gaps in regulatory oversight, and potential disruptions to monetary policy. This article explores the implications of stablecoins for Nigeria's national security, focusing on their usage, regulatory challenges, and associated risks. It highlights vulnerabilities such as the potential for market manipulation, exploitation by criminal networks, and the use of stablecoins for money laundering, cyberattacks, and other illicit financial activities. The article also examines how these risks could undermine financial stability and national security, particularly in a context of limited regulatory capacity. By drawing lessons from global regulatory frameworks, the study stresses the urgent need for Nigeria to develop robust regulatory measures to address these risks and ensure financial stability. It calls for a balanced approach that promotes innovation while safeguarding the integrity of the financial system.

Keywords: Cryptocurrencies, Stablecoins, National security, Nigeria

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1. Introduction

Stablecoins stand out among other cryptocurrencies in payment transactions, in their ability to often maintain a consistent value relative to another asset. This is because they are pegged to a stable asset, often the US dollar, meaning their value remains relatively constant. This stability makes them more like traditional money and

* Corresponding author: Agama Emomotimi, PhD, Securities & Exchange Commission, Central Business District, Abuja, Nigeria. E-mail: eagama@sec.gov.ng

allows for quicker and easier cross-border transfers without relying on banks (Fiedler and Ante, 2023; Lêt *et al.*, 2023; Massad, 2024).

The increasing prevalence of stablecoins in overall transactional activity underscores their significant usefulness among cryptocurrency users. They not only make it easier to buy and sell things, but they also provide a reliable way to store value. Additionally, they act as a bridge between traditional currencies and cryptocurrencies. Notably, they are widely used in DeFi for various financial activities such as lending, borrowing, and earning interest on crypto holdings (Veloso, 2023). Stablecoins, if well-regulated, could become a faster, cheaper, and more accessible payment option for everyday use (FDIC, 2021). Notwithstanding its potential, there are projections of a potentially turbulent future for the stablecoin ecosystem (Oxford Analytica, 2022).

So far Policymakers have focused on financial stability and consumer protection risks posed by cryptocurrencies. However, the emergence of stablecoins poses multifaceted challenges to national security (Massad, 2024). While they offer promise in terms of financial innovation and facilitating cross-border transactions, their convenience and potential for anonymity raise concerns regarding their susceptibility to exploitation for activities contrary to national security interests. The opaque nature of the stablecoin market, coupled with limited regulatory oversight, creates vulnerabilities to manipulation and cyberattacks, which could disrupt financial systems and compromise sensitive data, thereby undermining confidence in digital assets and posing significant risks to national security (Massad, 2024).

Without effective regulation, stablecoins could become favoured instruments for illicit financial transactions, thereby posing a threat to national security interests. In nations grappling with currency volatility, stablecoins present a potential hedge against devaluation and inflation. However, their widespread adoption could impede governmental control over monetary policy and destabilize domestic currencies. The use of stablecoins for remittances may circumvent formal banking channels, bypassing regulatory oversight and potentially facilitating money laundering and illicit financial flows. Transactions conducted through Crypto platforms and exchanges may operate within a regulatory grey area, raising concerns about investor protection, financial stability, and compliance with anti-money laundering and counter-terrorism financing regulations. Moreover, the widespread adoption of stablecoins as a hedge against currency crises could exacerbate capital flight, further compromising the government's ability to manage monetary policy effectively and aggravating existing crises (Syed, 2023).

The rise of stablecoins necessitates reinforced regulation to safeguard national security interests. Failure to address these issues may weaken the effectiveness of sanctions, disrupt economic stability, and provide opportunities for terrorist organizations and criminal networks to exploit the anonymity and global reach of stablecoin transactions for illicit activities. Recent incidents, such as the alleged use of Tether by Russian smugglers to evade sanctions, underscore the urgency of implementing robust regulations to mitigate the potential misuse of stablecoins for activities contrary to national security objectives.

This study explores the possible influence of stablecoins on Nigeria's security. Following this introduction, Section 2 reviews previous research on stablecoins. Section 3 provides an overview of the current landscape of stablecoin usage. Section 4 investigates the diverse regulatory approaches taken by different countries while the study concludes in Section 5.

2. Literature Review

Stablecoins, cryptocurrencies pegged to a stable asset, hold promise for the future of finance according to Bains *et al.* (2022). They offer potential benefits like reduced costs for sending money internationally, improved payment infrastructure, increased competition in the payments space, and greater efficiency for large transactions between regulated institutions. However, this potential comes with significant risks in the absence of proper regulations. Unregulated stablecoins could pose threats to consumers, financial markets, and even the entire financial system, especially if the assets backing them are complex, difficult to sell quickly, or lack transparency. Additionally, a lack of regulation for key players like wallets and exchanges, coupled with limited recourse for consumers in case of issues, further amplifies these risks.

According to Ahmed, Aldasoro and Duley (2024), while Stablecoins were designed to provide a stable unit of account within the crypto universe. Yet despite the various strategies used to defend their promise of par convertibility to the sovereign unit of account, that promise has been broken on multiple occasions

Watsky *et al.* (2024) highlighted that Stablecoins are gaining traction in DeFi and crypto markets, but their peg to the dollar raises concerns. The authors noted that even though they have been designed to be stable even during market swings, some stablecoins have lost their peg under pressure. Different designs seem to have different vulnerabilities, with each market crash revealing new risks.

A 2023 report by the International Organization of Securities Commissions (IOSCO) titled “Policy Recommendations for Crypto and Digital Asset Markets” raises concerns about the unique risks posed by stablecoins compared to other cryptocurrencies. While stablecoins advertise a peg to a stable asset like the US dollar, IOSCO highlights that this very characteristic creates new challenges. One major concern is the lack of transparency surrounding some stablecoins. It can be difficult to verify if the claimed reserves actually exist, raising doubts about the true stability of these assets. Additionally, stablecoins are susceptible to “bank runs” where a mass withdrawal of funds could overwhelm the system and cause a collapse. Furthermore, IOSCO warns that the perceived stability of stablecoins makes them attractive to money launderers and criminals seeking to bypass traditional financial regulations. Compared to the volatility of other cryptocurrencies, stablecoins offer a seemingly less risky avenue for laundering illicit funds. This perceived stability also extends to scams, with fraudsters specifically targeting victims by requesting payments in stablecoins to capitalize on their perceived lower risk of price fluctuations.

Similarly, Syed (2023) highlighted that the increasing traction of stablecoins underscores the critical need for the establishment of robust regulatory frameworks. These frameworks would be instrumental in ensuring consumer protection, safeguarding financial stability, and mitigating the inherent risks associated with these digital currencies. Clearly defined regulations foster a sense of trust and confidence within the market, thereby encouraging wider adoption by both businesses and individual users. Additionally, regulations serve to address potential concerns surrounding money laundering, fraudulent activities, and market manipulation, which could pose significant threats in the absence of appropriate oversight. According to Syed, the global stablecoin market exhibits significant growth and dynamism, with over 200 crypto assets vying to maintain a stable value against established fiat currencies. On the Ethereum blockchain alone, on-chain stablecoin transactions are projected to exceed \$7.5 trillion in 2022. However, the current landscape is heavily influenced by US dollar-pegged stablecoins issued by prominent entities such as Circle (USDC) and Tether (USDT). As of October 12, 2023, these two stablecoins held a combined market dominance of approximately 87% relative to the total market capitalization of \$123.4 bn.

Kaldewei and Spiege (2022) observe that Stablecoins, unlike traditional bank deposits insured by government programs, lack a safety net. Their stability depends on investor confidence and the quality of the assets backing them. These assets can range from highly liquid and safe options like cash or government bonds to potentially riskier combinations including corporate bonds or commodities, similar to pre-2008 money market funds. A key vulnerability for all stablecoins is the potential for runs. When investor confidence wanes, they may rush to redeem their holdings, triggering a domino effect of rapid asset sales and price drops in the underlying assets. This scenario according to the authors played out in May 2022 with the collapse of TerraUSD, a top-five stablecoin at the time. TerraUSD relied on an algorithmic peg to the US dollar, linked to another cryptoasset (Luna). When investors lost faith in Luna, the consortium behind both tokens attempted to maintain the peg by selling over \$1.5 bn in Bitcoin, causing a freefall in both TerraUSD and Luna (Figure 1). Tether, the largest stablecoin, also experienced temporary de-pegging during this event, highlighting the potential for broader market instability. They noted that While Tether eventually recovered its peg due to its asset backing, even such coins are not without risk. A large-scale run on a fully asset-backed stablecoin could lead to rapid asset sales, devaluing the underlying assets and potentially spilling over into traditional financial markets.

3. Stablecoin Usage/Adoption

Even though popular cryptocurrencies like Bitcoin and Ethereum have attracted all the attention, stablecoins have quietly become the most used type of cryptocurrency. In fact, transactions involving stablecoins have

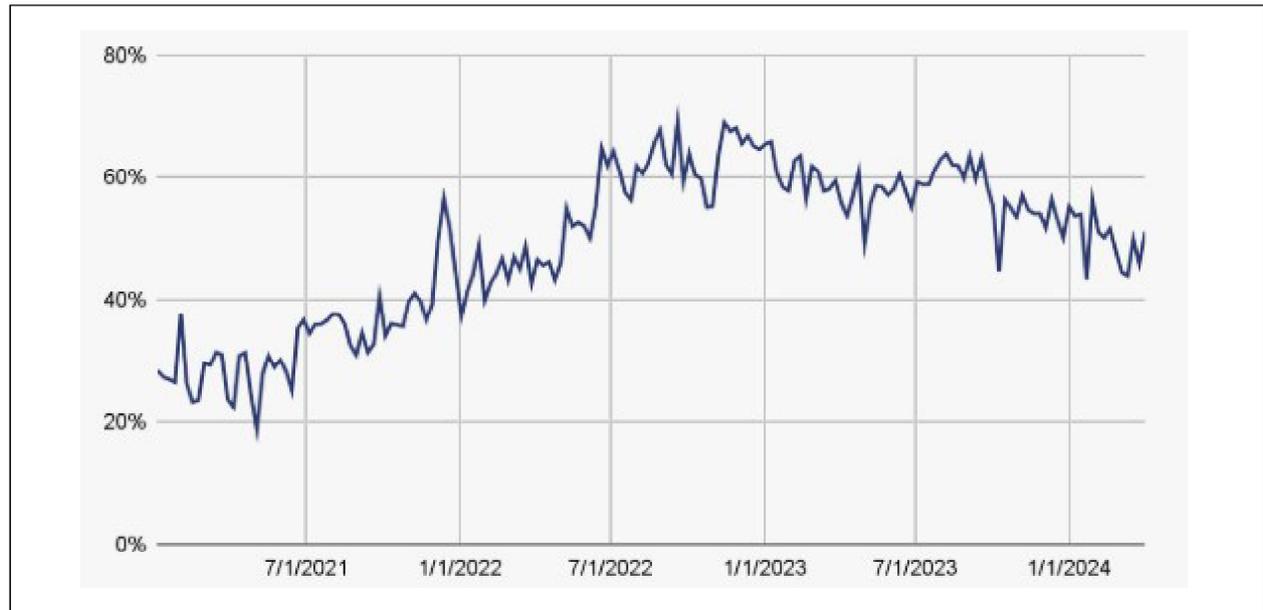


Figure 1: Stablecoins’ Share of All Transaction Volume On-Chain January 2021-March 2024

Source: Chainalysis (2024)

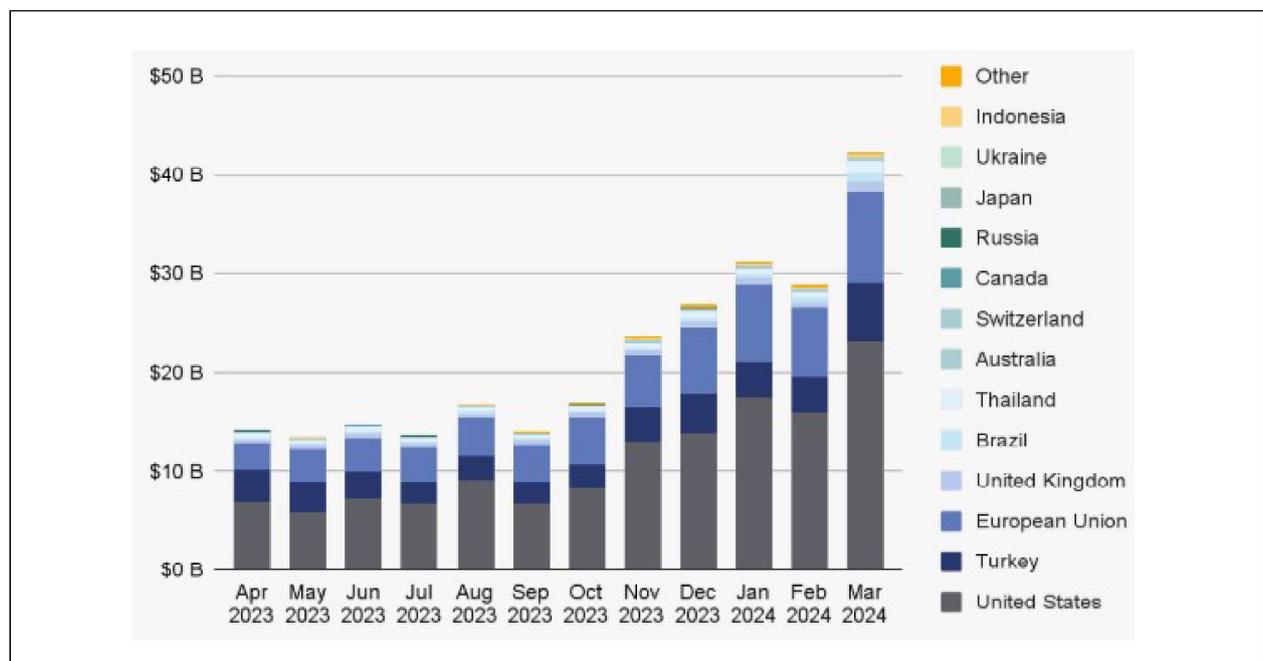


Figure 2: Fiat Purchases of Stablecoins April 2023-March 2024

Source: Chainalysis (2024)

made up more than half of all crypto activity lately. The increasing prevalence of stablecoins in overall transactional activity indicates the significant utility that this asset category has attained among cryptocurrency users. Stablecoins have been instrumental in facilitating the broader acceptance of cryptocurrency for everyday transactions beyond trading (Chainalysis, 2024).

Figure 2 presents the acquisition of stablecoins using fiat currency across different countries and indicates that stablecoins are emerging as a universally recognized asset. Although the United States consistently dominates in stablecoin purchases, there’s a noticeable surge in global demand. In March 2024 alone, purchases exceeded \$40 bn, with various nations and regions making significant contributions (Chainalysis, 2024).

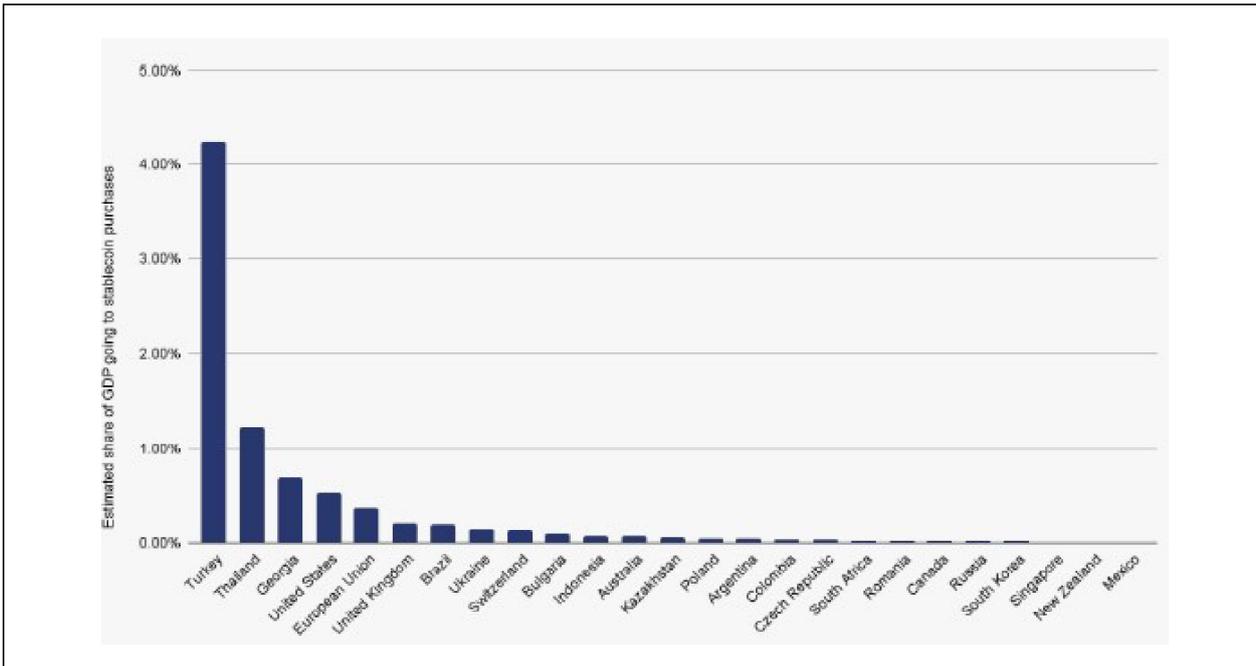


Figure 3: Stablecoin Purchasing as a Share of GDP by Country April 2023-March 2024

Source: Chainalysis (2024)

Despite Nigeria’s prominent position as a global leader in Bitcoin trading, it surprisingly does not rank among the top 10 countries in terms of stablecoin acquisition. From Figure 3 we can observe that although the United States and the EU maintain their presence, emerging economies such as Turkey, Thailand, and Brazil are taking the lead in stablecoin acquisition relative to their national GDP, with Turkey particularly standing out. The global interest signifies a widespread and increasing dependence on USDT across diverse geographical regions. Interestingly, countries grappling with currency instability and devaluation, such as Turkey and Georgia, are prominently engaged in USDT purchases.

Figure 4 reveals a significant trend from August 2021 to July 2023, Nigerian exchanges received a larger share of stablecoin volume compared to Bitcoin, mirroring similar patterns observed in other geographical regions where stablecoin transactions dominate the majority of exchanges.

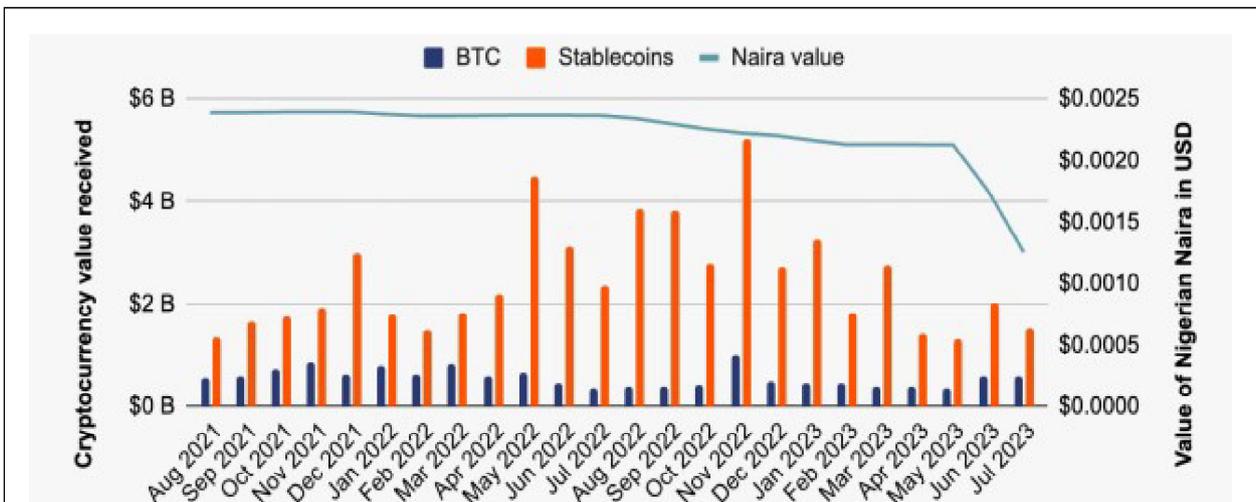


Figure 4: Bitcoin and Stablecoin Volume Received by Nigerian Exchanges vs. Naira Value April 2021-July 2023

Source: Chainalysis (2023)

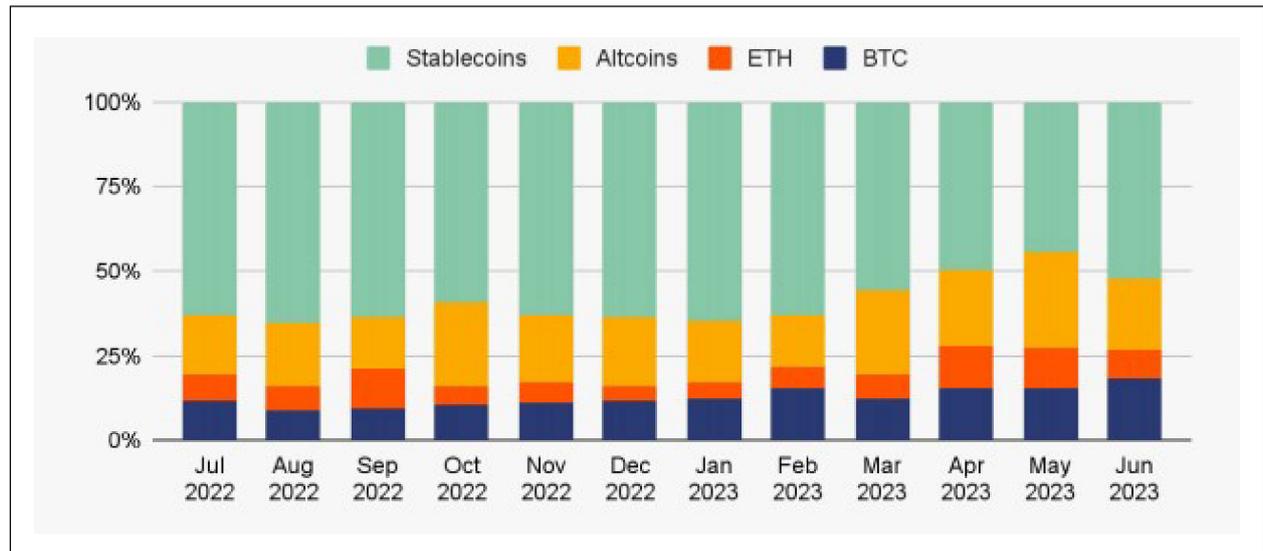


Figure 5: Share of Monthly Cryptocurrency Value Sent by Sub-Saharan Africa by Asset Type July 2022-June 2023

Source: Chainalysis (2023)

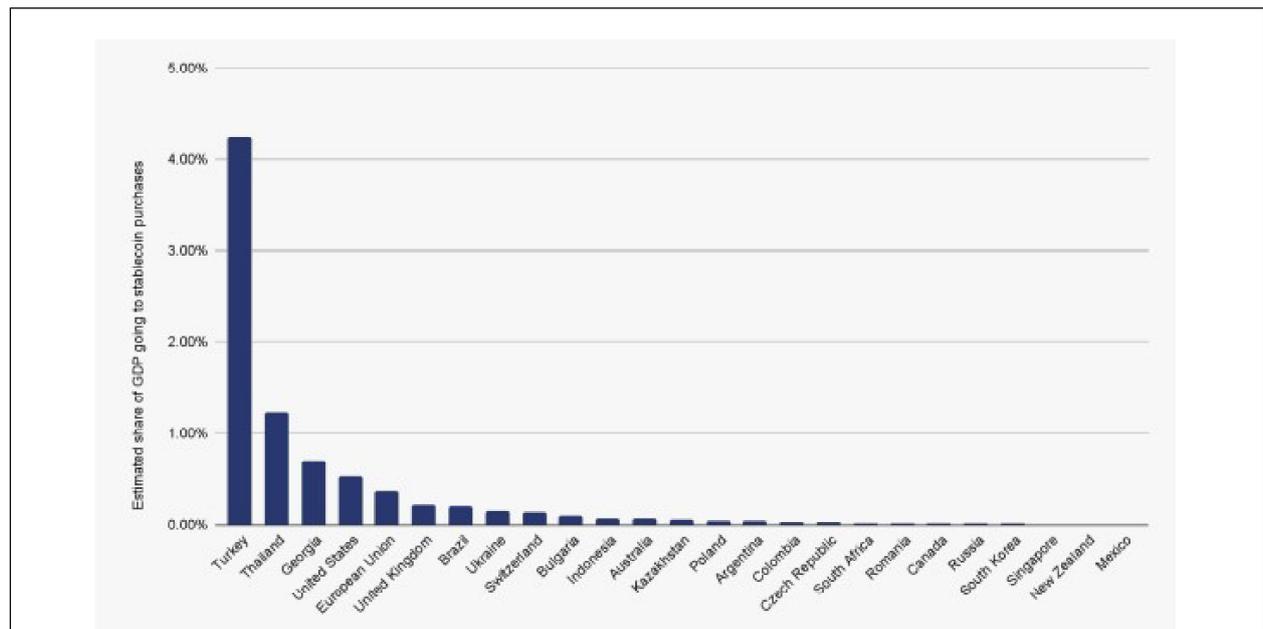


Figure 6: Stablecoin Purchasing as a Share of GDP by Country April 2023-March 2024

Examining stablecoin adoption it can be observed from Figure 6 that while the United States and the European Union remain prominent players, a compelling trend emerges in emerging markets. Countries like Turkey, Thailand, and Brazil demonstrate a strikingly high ratio of stablecoin purchases compared to their national GDPs. Turkey, in particular, stands out as a frontrunner in this space.

3.1. Stablecoin Regulations around the world

The world of cryptocurrency is rapidly evolving, and governments are struggling to keep pace. As stablecoins gain traction, regulators are working to establish frameworks that manage risks and protect consumers. According to Syed (2023) Central banks are wrestling with how to regulate stablecoins, a new digital currency gaining traction. The challenge lies in balancing innovation with financial stability. Stablecoins, pegged to traditional currencies, could disrupt central banks’ control over money supply. Regulations aim to ensure

stablecoins don't undermine monetary policy or enable illegal activities. Additionally, central banks prioritize the stability of the coins themselves, advocating for strong backing by reliable assets and transparent practices by issuers. Consumer protection is another key focus, with regulations defining rights and responsibilities to safeguard users from fraud and ensure secure transactions. By establishing these safeguards, central banks hope to foster trust in stablecoins as a legitimate digital payment method.

Deposit-backed stablecoins are generally considered less risky. They are pegged to a traditional asset, like the US dollar, and are backed by reserves of that asset held by the issuer. Algorithmic stablecoins, on the other hand, use complex algorithms to maintain their peg. This can raise concerns about stability, and some countries have taken a more cautious approach towards them (Veloso, 2023).

The regulation of stablecoins is a global trend. The European Union's Markets in Crypto Assets (MiCA) regulation sets a framework for how member states approach stablecoins. This includes requiring issuers to meet certain prudential standards, such as holding sufficient reserves. Several countries, like Japan and Singapore, are also developing their own bespoke regulatory frameworks specific to stablecoins. Collaboration between international regulators is crucial to ensure a consistent and effective approach to managing stablecoin risks.

The regulatory landscape for stablecoins in Canada is still evolving. Both deposit-backed and algorithmic stablecoins are currently legal, but there is no formal distinction between the two yet.

El Salvador stands out as the first country to adopt bitcoin as legal tender. It also allows both deposit-backed and algorithmic stablecoins, and even plans to launch its own national stablecoin pegged to the US dollar. France and Germany fall under the EU's MiCA framework, which means deposit-backed stablecoins are legal, while algorithmic ones are not.

Japan has taken a nuanced approach. Deposit-backed stablecoins are legal and have a specific regulatory framework in place. Algorithmic stablecoins, however, are treated the same as regular tokens and face restrictions on advertising and risk presentation. While Mexico has taken a stricter stance, banning both deposit-backed and algorithmic stablecoins altogether.

Similar to Japan, Russia allows deposit-backed stablecoins but effectively bans algorithmic ones due to stringent liquidity requirements. Singapore allows both types of stablecoins, but is considering future regulations specifically tailored to the unique characteristics and risks associated with stablecoins. South Africa, South Korea, Spain, Switzerland, and UK: These countries are all at various stages of developing regulations for stablecoins. The legal status of algorithmic stablecoins is particularly unclear in some cases, with discussions ongoing about potential restrictions.

4. Conclusion

The increased adoption of Stablecoins necessitates a reevaluation of their impact on national security. The very features that make stablecoins attractive—ease of use, anonymity, and potential for cross-border transactions—also raise national security concerns. The lack of transparency and oversight in the stablecoin market creates vulnerabilities.

Malicious actors could exploit these vulnerabilities to manipulate markets, attack currencies, launch cyberattacks that disrupt financial systems, or erode trust in digital assets. Furthermore, the potential for stablecoins to be used for illicit financial activities, bypass monetary controls, and circumvent Anti-Money Laundering (AML) regulations poses a significant threat.

Stablecoins present various challenges for public policy, oversight, and regulation, including legal certainty, governance, AML/CFT compliance, operational resilience (including cybersecurity), consumer/investor protection, data security, and tax compliance.

The shift in the cryptocurrency landscape demands a closer look at the national security implications of stablecoins. Robust regulations and international cooperation are crucial to mitigate the risks associated with these digital assets and ensure their responsible development as well as rein in clandestine activities.

Nigeria must establish comprehensive regulatory measures to effectively address these risks and maintain financial stability. Such measures should strike a careful balance between fostering innovation and protecting the integrity of the financial system.

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