

I'm not a bot



The Terra Protocol's ecosystem has been at the center of attention in recent times due to some significant developments that have affected both its algorithmic stablecoin LUNA and cryptocurrency LUNA. The current situation of these two assets is quite dire, with UST dropping to around \$0.30 and LUNA plummeting by over 90% within a short span. This article aims to break down what has transpired with these cryptocurrencies and why it's proving to be challenging for them to bounce back from this situation. To understand the current state of affairs, it's crucial to delve into how UST's algorithmic stablecoin works. The Terra Protocol is based on two primary tokens: Terra (UST) and Luna (LUNA). Users can mint UST by burning LUNA at the Terra Station portal, which is made possible through the protocol's algorithmic market module that incentivizes such actions. This mechanism is different from traditional stablecoins like USDT or USDC, which are backed by fiat or equivalents. In simpler terms, imagine the Terra economy as two pools: one for Terra and one for Luna. The price of Terra is maintained by adding to or subtracting from its supply pool based on market conditions. Users can swap LUNA for UST at a 1:1 ratio using the Terra Station's swap feature, profiting from small discrepancies in the exchange rate. However, if the peg is lost and UST trades below \$1, users can burn UST to mint LUNA, selling it at a profit. Unfortunately, this theoretical scenario became reality when UST's price dropped significantly, causing LUNA's value to plummet by over 90%. This cascade of issues was triggered by unforeseen events that led to the disappearance of UST's peg and the subsequent decline in LUNA's price. The past few days have been particularly tumultuous for the Terra ecosystem, with UST's market cap failing to surpass that of LUNA, a scenario that could lead to financial instability. Speculations are rife about what might be causing this crisis, with Do Kwon, Terra's CEO, yet to provide a clear explanation. The immediate challenge is to find a way out of this situation and stabilize the Terra Protocol's ecosystem. However, Do Kwon explained on May 9th that the Luna Foundation Guard Council voted to deploy \$1.5 billion in capital, comprising \$0.75 billion in BTC and \$0.75 billion in UST, to defend the peg. 1/ The LFG Council just voted to deploy 1.5B in capital (0.75B in BTC, 0.75B in UST) to allay market concerns around UST. Some more context on why and how: — Do Kwon O (@stablekwon) May 9, 2022 Two days later, with increased volatility, UST is trading at 50% of its peg value while LUNA continues to crash. The problem persists as long as the price of UST remains below its peg, creating an arbitrage opportunity for users to burn UST and mint LUNA. Do Kwon mentioned a recovery plan but nothing official has been announced yet. Close to announcing a recovery plan for \$UST. Hang tight. — Do Kwon O (@stablekwon) May 10, 2022 ****Terra's Stablecoin UST: Unlocking Algorithmic Stability**** Among various assets, including commodities and fiat currencies, Terra's UST (TerraUSD) stands out as the most popular, closely tracking the US dollar with a token value hovering around \$1. This stability is achieved through its symbiotic relationship with LUNA, another ecosystem token. ****LUNA plays a crucial role in maintaining Terra stablecoins' price stability and reducing market volatility****. ****LUNA's Astronomical Rise****: From \$0.66 in 2021 to an all-time high of \$104.58 on March 9, 2022, LUNA's value skyrocketed, defying the downward trend of global cryptocurrencies during the Ukrainian invasion crisis. ****UST's Emergence****: Surpassing \$15 billion in market capitalization, UST has become the fourth-largest stablecoin, trailing behind USDT, USDC, and BUSD. ****What sets Terra's stablecoins apart is their algorithmic stabilization method****, diverging from traditional reserve asset-based approaches used by USDC and USDT. ****The Algorithm at Work****: Instead of relying on reserves, UST employs a smart contract-based algorithm to maintain its \$1 peg. This involves ****burning LUNA tokens to mint new UST tokens****, leveraging arbitrage in a unique way. Users can swap LUNA for UST (and vice versa) at a guaranteed \$1 rate, regardless of market prices. ****Arbitrage Dynamics****: - ****Rising Demand****: If UST's price exceeds \$1, LUNA holders can profit by swapping \$1 of LUNA for a more valuable UST token. The swap process burns a percentage of LUNA, increasing its scarcity and value. - ****Low Demand****: Conversely, if UST's price falls below \$1, UST holders can exchange their tokens for more valuable LUNA at a 1:1 ratio, again profiting from the arbitrage. ****The Outcome****: Burning LUNA reduces its circulation, increasing its value, while minting more UST dilutes existing tokens, bringing the price back to \$1. This intricate balance sustains the stability of Terra's ecosystem, solidifying UST's position in the cryptocurrency market. There is a variety of stablecoins available pegged to different fiat currencies such as CNY, EUR, BGF, JPY and KWR. TerraSDR, the International Monetary Fund's special unit of account, is unique as it cannot be used by everyday users but is instead an international reserve asset calculated from various fiat currencies. Terra utilizes TerraSDR for its transaction fees, rewards, and stimulus grants on the blockchain, aiming to minimize price volatility among different state-issued currencies. This is achieved through diversifying risk, which is essential for determining stable fee rates and rewards. The Terra smart contract platform was built on the Cosmos SDK, allowing interoperability between chains. It also features bridges to other blockchains such as Ethereum, Binance Smart Chain, Harmony, and Osmosis, facilitating data and token transfer between non-native ecosystems. Terra employs the Delegated Proof-of-Stake consensus protocol known as "Tendermint," where token holders can delegate their funds to certified validators. These individuals or groups propose new blocks, secure transactions, and add value to the blockchain. This system is similar to a House of Representatives, with LUNA token holders delegating coins to validators who then vote on proposals to develop the network. Validators use Terra Core software to validate transactions, stabilize the price of stablecoins through arbitrage, and participate in governance decisions. Validators' voting power is weighted according to their total coin stake, allowing those with larger stakes to have a higher chance of adding new blocks in exchange for rewards from transaction fees. LUNA coins can exist in three statuses: Bonded, Unbonded, or Unbonding, each with its own characteristics and restrictions. Terra blockchain offers cheaper transaction fees than most credit card companies and payment processors, making it popular among South Korean e-commerce platforms. The platform's algorithmic stablecoins incur a computational fee that goes to validators as rewards, making transactions seamless for users and cost-effective for merchants. Terra has expanded beyond payments to include lending, borrowing, insurance, investing, and charitable causes. Some notable applications built on the Terra blockchain include Anchor, a decentralized money market offering industry-leading yields, Chai, a payment rail with lower transaction fees and a debit card that rewards users, and The Mirror Protocol, a DeFi platform allowing users to create and trade "mirrored assets" tied to stock prices. Other notable apps include Ozone, Pylon, and Valkyrie. However, algorithmic stablecoins have faced scrutiny over their design flaws, which can lead to de-pegging, as seen in the rocky launch of Fei. The lack of collateral by design raises concerns about the value of these coins. The Luna Foundation Guard, a Singapore-based nonprofit focused on developing the Terra ecosystem, intervened by adding \$1 billion worth of bitcoin as backing for their stablecoins. This move was aimed at alleviating concerns about the coin's potential drop without a safety net. However, it's crucial to note that both stablecoins and decentralized finance are largely unregulated globally, with varying regulatory approaches posing risks to investments in LUNA or UST. Notably, the Terra CEO Do Kwon is facing scrutiny from the U.S. Securities and Exchange Commission regarding the Mirror Protocol's offering of stock derivatives, such as those for Apple (AAPL) and Tesla (TSLA). The company has opted to challenge this action in court.

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