Proceedings of ICEMGD 2025 Symposium: The 4th International Conference on Applied Economics and Policy Studies
DOI: 10.54254/2754-1169/2025.BJ25108

The Risk Impact of Virtual Currencies on Financial Market Stability and Preventive Strategies

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Abstract. The rapid proliferation of virtual currencies (cryptocurrencies and related digital assets) over the past decade has raised questions about their potential effects on financial market stability. This study reviews recent developments in virtual currency markets, analyzes risk channels (including volatility, contagion, regulatory gaps, and monetary policy disruption), and examines notable cases from 2017-2022 (crypto market crashes, stablecoin failures, and emerging market adoption). This paper uses case analysis to assess how extreme price swings and linkages can propagate stress to broader markets, and it finds that cryptocurrency volatility and opaque structures have led to episodes of market turmoil and systemic concern (e.g., TerraUSD's collapse). Preventive measures are outlined, such as robust regulation ("same risk, same activity"), improved institutional risk management, central bank digital currencies (CBDCs) as safer alternatives, and greater transparency and investor education. This research highlights the need for coordinated policy action to balance innovation with stability.

Keywords: virtual currency, financial stability, systemic risk, regulation, Central Bank Digital Currency (CBDC)

1. Introduction

Virtual currencies, epitomized by Bitcoin's 2009 debut, have grown from niche experiments into a sizable asset class [1]. By late 2021 the aggregate value of all cryptocurrencies approached roughly $2.9 trillion. Such exponential growth has prompted scrutiny of possible systemic effects. Unlike traditional assets, cryptocurrencies operate on decentralized ledgers without central-bank backing, leading to extreme price swings and regulatory uncertainty. This creates novel channels by which digital-asset turmoil could spill into conventional markets or undermine monetary policy. The literature to date suggests that while global financial stability risks have been limited so far, they could intensify as market participation broadens. This paper investigates the impact of virtual currencies on market stability through four risk lenses (volatility, contagion, regulatory gaps, and policy disruption) and uses recent episodes (2017–2022 crashes and stablecoin failures) to illustrate vulnerabilities. A review of official reports (IMF, BIS, FSB, ECB) and academic analyses forms the basis of our assessment [2-5]. The goal is to identify concrete preventive strategies, from regulation and risk management to CBDC [6] deployment and transparency measures, that can mitigate potential threats while preserving the benefits of blockchain innovation.

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2. Overview of virtual currencies and financial stability

2.1. Definition and kinds of virtual currencies

Virtual currencies, also known as cryptocurrencies or crypto-assets, are digital representations of value that rely on a network of computers that use cryptographic techniques. They include established tokens (Bitcoin [1], Ether), countless altcoins, stable coins that are pegged to fiat money and new asset classes such as nonfungible tokens (NFTs). As of 2022, the crypto universe includes more than 16,000 different assets, but the vast majority of these have relatively small market capitalizations. These assets have different designs: stablecoins should hold a stable value with fiat backing or algorithms, and utility / DeFi tokens have other network uses. This variety is what allows the term “virtual currency” to encompass a wide range of different electronic tokens used as a medium of exchange or store of value in lieu of traditional banking systems. The architecture is inherently borderless and frequently opaque, with transactions posted in public ledgers but user identities cloaked in pseudonyms. This contrast with regulated financial infrastructure is at the root of many stability questions.

2.2. Financial stability

Financial stability, which is often regarded as a broadly inclusive state in which financial systems are capable of carrying out their functions.Financial stability is further defined as the ability of the financial system to withstand shocks and to continue to provide funding to the real economy. Well-functioning financial markets allocate capital smoothly without too many bubbles, runs on liquidity or systemic crises. Stability can be interrupted by swift movements in asset prices, the collapse of critical financial institutions, or widespread contagion within markets. In the context of this discussion, evaluating the potential impact of virtual currencies on stability means looking at the possibility that crypto-fueled strain could harm banks, investors or the general economy. Risk gauges are looking at volatility, stock market capitalization as a percentage of GDP and “links” with the mainstream of finance [1].

2.3. Growth and market dynamics

Virtual currencies have surged in popularity — and value — over the past decade. Market capitalizations have ballooned from near nothing to several trillion $$$ at highs. The crypto market grew by about seven times from 2020 through late 2021, peaking at about €2.5 trillion. As of last November, some of the biggest coins, like Bitcoin and Ether, were among the world’s largest assets by market value [1]. Second, new segments (stablecoins, DeFi protocols) also had rapid growth, and indicated expanding usage beyond currency like function. But volatility was still intense. For instance, the realized volatility of Bitcoin has always far exceeded that of stock or government bond indices [1]. Throughout 2021, even as crypto prices moved higher, the market was susceptible to steep reversals. By mid-2022, broad-risk aversion caused the majority of major cryptocurrencies to lose more than HALF their value. These developments highlight a market that is still growing up and subject to speculative ups and downs, emphasizing why their interaction with financial stability deserves close examination.

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3. Risks arising from virtual currencies

3.1. Market stability and price volatility

Price volatility is a characteristic of virtual currency markets. The price of digital assets can rise or fall by double-digit percentages in a single day. The high volatility prevents these assets from being considered a stable store of value and, thus, financial instability occurs. Empirical studies and the analyses of central banks also confirm that crypto volatility is much higher than that of leading stock or bond indices. For example, the ECB points out that, despite reducing from early highs, bitcoin's volatility is still far in excess of that of traditional assets such as gold or silver [2]. This volatility has real-world implications: Wild price fluctuations have wiped out trillions of dollars in market value during corrections, and delivered losses to retail and institutional investors alike. For instance, the crypto market cap fell from nearly $2.9 trillion in late 2021 to less than $1 trillion by June 2022 under crash-like conditions [1]. These big moves can splash into other markets when leveraged positions are unwound or when crypto is used as collateral. In addition, they also create a high degree of uncertainly for financial institutions that carry digital assets on their balance sheets which could impact their risk management capabilities. All in all, virtual currencies are a manifestly disruptive influence with a rising price volatility and they are indeed a clearly destabilizing factor should it become even more transmitted to the broader financial sector.

3.2. The contagion and the systemic risk

And beyond isolated volatility, cryptocurrencies can cause contagion. Links between crypto and the traditional market have developed – common investors, exchanges and financial instruments (like futures, and ETFs). When a major crypto entity fails, it can immediately spill over to others. The Financial Stability Board (FSB [7]) says events in 2022 showed the failure of a large crypto service (like Terra's algorithmic stablecoin or a leading exchange) can "transmit risks to other parts" of the ecosystem. Plus ECB staff caution that if banks or other financial firms are more involved in crypto-assets, the risk of spillovers to the wider financial system would rise [2]. So far, the size of the global financial system in crypto-assets is less than 1% and systemic effects have been limited. But even limited links can count: the fall of crypto lenders such as Celsius and exchanges such as FTX in 2022 induced a broader market anxiety. Stress seen in crypto markets also dripped into risk sentiment – steep Bitcoin selloffs, for instance, fueled broader equities and tech stocks selloffs [1]. In sum, the risk of contagion exists when crypto-market shocks are transmitted through institutional and investor connectivity which destabilizes beyond the crypto bubble.

3.3. Regulatory and integrity issues

Another dimension of risk is ambiguous regulation and illicit use in crypto markets. Virtual currencies frequently operate in holes in between jurisdictions and regulatory regimes. Inconsistent regulations create opportunity for regulatory arbitrage where players take advantage of poor supervision to bypass financial oversight. Some popular stablecoins have even been recognized as a tool for money laundering and the financing of terrorism on account of loose regulation. This subverts the integrity of the market and heightens its legal risks: banks and markets players that trade in crypto-assets must figure out greyish compliance schemes, or face their wrath as soon as unsanctioned flows are triggered. The fragmented regulatory environment has also led to an inconsistent application of protections for consumers and investors, raising the risk that market

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abuse or fraud would flourish. For instance, until 2022 there was no truly regulated stablecoin similar to fiat-backed money-market funds. The lack of clear, consistent rules makes it hard for officials to monitor exposures. This uncertainty is a risk in itself — companies can get over-leveraged assuming there will be no immediate oversight, only to see a sudden clampdown (a la Russia's 2017/18 crypto boom). In other words, regulatory vacuums and AML/CFT weaknesses in virtual currency markets generate systemic risk through the intensification of confidence shocks and illicit flows [8].

3.4. Monetary policy disruption and currency substitution

A more indirect risk is the potential disruption to monetary policy and capital controls, especially in emerging markets. When virtual currencies are widely used as alternatives to domestic money, central bank control of liquidity and interest rates can be undermined. BIS researchers describe "cryptoisation", a modern form of currency substitution, where economic agents hold crypto-assets as hedges against local currency devaluation [4]. In some developing economies, users turn to unbacked crypto (or foreign-backed stablecoins) to preserve purchasing power, bypassing inflationary fiat. This can weaken demand for the domestic currency and complicate exchange rate policies. For instance, Bitcoin's use in countries experiencing inflation may reduce the effectiveness of monetary tightening (fewer people hold on-balance-sheet money) [1]. In the extreme, if crypto became a recognized "reserve asset," it could challenge the dominance of major fiat currencies in emerging markets. Such scenarios would force central banks to adjust policies in response to flows that occur outside traditional banking channels. Thus, widespread crypto adoption can indirectly threaten financial stability by diluting monetary transmission and circumventing capital flow management, making economic policy less effective.

4. Case studies

4.1. Crypto market crashes (2017–2022)

Historical episodes illustrate virtual currencies' instability. In late 2017 Bitcoin's price surged to nearly $20,000, only to crash below $7,000 by early 2018 (a drop of over 60%). After several years of recovery, the market reached new peaks in 2021: by November 2021 the total crypto market capitalization had climbed to roughly $2.9 trillion [1]. However, this rally was followed by a sharp reversal. In the first half of 2022, rising inflation and tighter monetary policy triggered a broad sell-off: by June 2022, the crypto market had lost over $1 trillion in value and briefly fell below $1 trillion total. Bitcoin itself fell from around $47,000 in January 2022 to under $24,000 by June [1]. Such crashes have ripple effects; they wipe out investments, trigger liquidations of leveraged positions, and dampen broader risk appetite. Notably, an ECB study observes that crypto prices "trended upwards" in 2021 and then "more than halved" for major crypto-assets after early November, emphasizing the link between market sentiment and crypto fortunes [2]. These boom–bust cycles underscore how quickly crypto can turn from exuberance to crisis, causing abrupt losses for market participants. The 2017–2018 and 2021–2022 crashes did not cause large-scale financial institution failures, but they revealed the system's fragility: even if crypto remains small relative to global finance now, the experience confirms that a "crypto winter" can occur when confidence collapses, validating concerns about volatility-induced instability.

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4.2. Stablecoin crises (e.g., terra-luna)

Stablecoins, digital tokens meant to maintain a fixed value, were designed to reduce crypto volatility, but crises have shown they can magnify systemic risk. The most dramatic example occurred in May 2022 with TerraUSD (UST), an algorithmic stablecoin. UST's mechanism failed and the coin de-pegged from $1, causing its market value to collapse by orders of magnitude within days [2]. This event wiped out an estimated $60+ billion of crypto value and triggered a chain reaction across decentralized finance (DeFi) platforms and crypto lending protocols. The European Central Bank notes that TerraUSD's crash, along with a Tether de-peg incident, revealed that stablecoins "are not as stable as their name suggests" [2]. These failures have broad implications: many financial products and strategies had relied on stablecoins for liquidity or collateral. For instance, the TerraUSD collapse led to losses at centralized lenders (e.g., Celsius) and exchanges (e.g., FTX in Nov 2022) that had exposure to the fallen stablecoin [2]. In sum, stablecoin crises demonstrate a new contagion channel: runs and confidence crashes in seemingly "safe" crypto instruments can cascade through the digital-asset ecosystem, raising systemic risk. This has prompted regulators globally to call for stricter reserve requirements and oversight of stablecoin issuers.

4.3. Emerging market adoption

Some emerging and developing countries have embraced virtual currencies in ways that test financial stability. The clearest case is El Salvador, which adopted Bitcoin as legal tender in September 2021 [1]. This experiment created fiscal and policy risks: businesses were obliged to accept Bitcoin [1], and the government offered a digital wallet incentive. BIS analysis highlights the dangers: since Bitcoin is highly volatile, its legal-tender status in El Salvador "implies large risks" for financial stability and fiscal health [1,4]. In practice, uptake was low – by one year in, only about 20% of the population was actively using the state-backed Bitcoin wallet. Meanwhile, the government purchased over $100 million worth of Bitcoin, which by late 2022 had depreciated to under $50 million, realizing a sovereign loss [1]. This illustrates the combined market and policy risk: the state was directly exposed to crypto volatility. Other emerging markets show subtler adoption: for example, use of stablecoins and crypto wallets can surge when local currencies weaken (as noted in parts of Asia, Latin America, and Africa). The BIS warns that rapid crypto adoption in EMEs could transmit instability across borders, for instance by facilitating remittances or circumventing capital controls [4]. Thus, while cryptocurrency use can enhance financial inclusion in underserved areas, it also poses a channel for stability shocks: local currency substitution for crypto in high-inflation contexts might undermine monetary frameworks if unchecked (Table 1).

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Table 1: Major events in virtual currency markets (2017–2022)

Year	Event	Impact
2017	Bitcoin price peaks ~$19,000 (Dec) then crashes	Triggered bubble concerns; early adopters suffered steep losses
2021	Crypto market cap ~$2.9 trillion (Nov)	Regulatory attention increased; fueled speculative boom
2022	TerraUSD stablecoin collapses (May); FTX fails (Nov)	Massive investor losses and liquidity crunch in crypto markets
2022	Crypto market cap falls below $1 trillion (Jun)	Reflects broad sell-off amid risk-off environment

5. Preventive strategies

Based on the risks identified, a number of approaches can help reduce stability risks associated with virtual currencies.

5.1. Regulation and supervision

One important recommendation from international organizations is that a uniform global regulatory regime for crypto-asset transactions should be created. The FSB's July 2023 framework cements "same activity, same risk, same regulation" for crypto and stablecoin activities [5]. That would effectively bring crypto platforms and issuers under bank-like protections: stringent custody rules, capital buffers and consumer safeguards. The FSB emphasizes coordination among standard-setters and national regulators to avoid gaps [5]. Similarly, the IMF advises a comprehensive policy framework aiming to achieve financial stability, consumer protection, and integrity [3]. For stablecoins specifically, many jurisdictions are adopting strict reserve and transparency rules. For example, regulators now require issuers to maintain high-quality liquid assets and publish proof of reserves. Overall, a proactive regulatory posture, including licensing of crypto institutions and enforcement of AML/KYC, can reduce the chance of unchecked growth or fraud. Cross-border cooperation (e.g., G20 and BIS initiatives) further helps ensure that virtual currencies cannot simply migrate to unregulated jurisdictions [4].

5.2. Risk management by financial institutions

Financial firms must also prepare for crypto-related stress. Banks and asset managers can implement internal limits on cryptocurrency exposures and conduct regular stress tests that include crypto-market shocks. Supervisors have encouraged institutions to enhance risk modeling of digital assets. Current evidence suggests that crypto is still a small share of banking assets, but it is growing in some portfolios. The ECB notes that as crypto engagement rises, so will stability risks [2]. Therefore, banks should adopt robust due diligence, collateral requirements, and scenario analyses (e.g., run scenarios on crypto loans). Central banks and regulators can mandate that crypto-related businesses (such as crypto custody or lending) be ring-fenced or given separate capital treatment. In addition, aligning fintech innovation with banking safety, for instance by subjecting crypto-exchanges to oversight, helps contain systemic risk. Through such institutional risk management measures, the financial sector can cushion potential crypto shocks before they spill over.

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5.3. Central Bank Digital Currencies (CBDCs)

Central banks around the world are exploring CBDCs, government-backed digital currencies – as a stable alternative to unregulated crypto [6]. A well-designed CBDC could satisfy the demand for digital money without forfeiting policy control [6]. BIS research highlights that a CBDC could improve payment system resilience and financial inclusion [4,6]. However, it also warns of risks: a CBDC that promises attractive yields or easy access might draw large retail deposits away from commercial banks, potentially triggering bank runs under stress [6]. Consequently, policymakers are discussing design features (cap on balances, tiered remuneration) to offset this. Still, if done properly, CBDCs might head off some crypto risks [6]. One possibility is for regulated financial institutions to issue stablecoins on blockchains backed by reserves of a central bank digital currency (CBDC), which would mitigate the necessity for private stablecoins [6]. In short, promoting CBDCs as safe digital money is an attractive strategy to reduce the demand for unstable private crypto instruments, as long as there are safeguards for protecting banks and payment systems [6].

5.4. Transparency, AML/CFT, and human capacity development

Another requirement is more market transparency and financial literacy. The authorities need to make K.Y.C. (know your customer) and anti-money-laundering regulations stringent for the providers of crypto services. 36 And this will include mandating that exchanges — and custodians — need to record transactions and wallet exposures, and making it more difficult for nefarious flows to hide in blockchain transactions. Enhancing AML is exactly designed to deal with the financial integrity risks mentioned above. Alongside regulation, investor education is vital. Many crypto traders underestimate the risks; authorities can launch public campaigns on crypto volatility and fraud prevention. For instance, awareness of past failures (Luna/Terra run, FTX fraud) can discourage reckless speculative lending. Exchanges themselves should provide risk warnings and ensure clear disclosure of product designs. In short, transparency and user protection measures, similar to those in traditional finance, can reduce panic-driven runs. By improving information, markets become less opaque and participants are better equipped to manage crypto exposures (Table 2).

Table 2: Risk impacts of virtual currencies and preventive measures

Risk/Challenge	Implication	Preventive Measure
High price volatility	Abrupt wealth losses; market instability	Position limits; stress testing by firms; risk warnings
Cross-market contagion	Spillovers to traditional assets if linkages grow	Restrict bank/insurer exposures; global regulatory coordination
Regulatory/AML gaps	Illegal finance and regulatory arbitrage	Harmonize regulations; strengthen KYC/AML
Monetary policy disruption	Reduced control of currency demand	Deploy CBDC; enforce capital flow controls

6. Conclusion

Virtual currencies present a paradox for financial markets: on one hand they promise innovation in payments and finance; on the other hand, their instability and lack of oversight pose new risks. This paper has reviewed how cryptocurrencies and stablecoins can endanger market stability through their hallmark volatility, contagion channels, regulatory gaps, and potential to undermine policy.

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Recent cases (from the 2018 and 2022 crypto crashes to the TerraUSD debacle and El Salvador's Bitcoin experiment) provide sobering evidence that these risks are real [1,2,4]. While global crypto assets are still small relative to the entire financial system, official analyses warn that growth and financialization could change that calculus. In response, stakeholders are deploying a variety of strategies. Regulatory bodies (G20/FSB/IMF) are moving to create consistent global frameworks so that crypto activities face "same risk, same regulation" as similar financial activities [3,5]. Financial institutions and supervisors must likewise upgrade risk management practices to account for crypto-induced shocks. Additionally, central banks are exploring CBDCs to provide a safer digital-money alternative, though this solution also requires careful design to avoid unintended bank run dynamics [6]. Finally, enhancing transparency and enforcing AML/CFT rules will help ensure that crypto markets are less opaque and less prone to illicit use, thereby improving overall stability [8]. In sum, maintaining financial stability in the era of virtual currencies will depend on a balanced approach: encouraging beneficial financial innovation while proactively addressing the vulnerabilities that decentralized digital assets create. Ongoing monitoring of crypto trends and adaptive policy measures will be essential as this dynamic landscape evolves.

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