Journal Publication of International Research for Engineering and Management (JOIREM)
Volume: 03 Issue: 12 | Dec-2025
ISSN (O) 3107-6696

Decentralized Stable Coin

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Abstract - This research paper presents an in-depth study of a decentralized, USD-pegged algorithmic stablecoin (similar to MakerDAO's Dai). We explore its design, implementation, and innovations, including multi-asset collateral (ETH and BTC), an on-chain health-factor mechanism for overcollateralization, and algorithmic peg maintenance. We compare this protocol to existing stablecoins (DAI, USDC, TerraUSD/UST, FRAX, etc.), analyze risks and advantages, and outline its potential use cases. The methodology involves smart-contract development on Ethereum-compatible blockchains (including zero-knowledge rollups) using tools like Foundry/Anvil, as well as economic modeling and simulation. Key features include a dynamic collateral ratio enforced via a health factor metric and automated supply adjustments. Our coin aims for decentralization and stability, leveraging lessons from established stablecoins.

Introduction

Stablecoins are cryptocurrencies pegged 1:1 to fiat currencies (typically the USD) to provide price stability in crypto markets. They are essential in DeFi and global finance as reliable media of exchange and store of value. By removing crypto volatility, stablecoins bridge traditional finance and blockchain, enabling faster, cheaper cross-border payments and liquidity.

There are several broad categories of stablecoins:

Fiat-collateralized (centralized): Backed by USD/euro reserves held by a central custodian (e.g., USDC, USDT). They offer stability but entail counterparty trust and regulatory risk.

Crypto-collateralized (decentralized): Backed by crypto assets (e.g., ETH, BTC) locked in smart contracts (e.g., MakerDAO's Dai). These use overcollateralization and on-chain issuance for transparency.

Algorithmic (non-collateralized): Supply is adjusted algorithmically (via smart contracts) without fixed collateral. Issuance and burning respond to market demand (seigniorage share models). Examples include Ampleforth (AMPL), Frax (hybrid), and the failed TerraUSD (UST).

Stablecoins now account for over two-thirds of cryptocurrency transaction volume, underscoring their importance in liquidity, trading, and as a fiat bridge. In emerging markets, they hedge against local currency volatility. The architecture of stablecoins affects their trust model and risks: crypto-backed coins like DAI offer decentralization but require robust liquidation mechanisms, while fiat- backed coins like USDC trade transparency for centralized trust. This paper focuses on a crypto-collateralized, algorithmic stablecoin pegged to USD, combining decentralization with autonomous peg management.

2. Background and Literature Review

Stablecoin design has evolved rapidly. MakerDAO's Dai was the first decentralized crypto-backed stablecoin. The MakerDAO whitepaper explains that "Dai is a fully decentralized and asset-backed stablecoin" whose stability is maintained by smart contracts (Collateralized Debt Positions or CDPs) and MKR governance. Users lock ETH (and later other collaterals) in a CDP to mint Dai, ensuring each Dai is overcollateralized. If collateral value falls, positions can be liquidated, which is enforced by a health-check mechanism. MakerDAO uses a governance token (MKR) to recapitalize in extreme events.

Algorithmic stablecoins (no fixed collateral) operate like central banks on-chain. They expand supply when price >$1 and contract when price <$1. Frax (FRAX) introduced a fractional-algorithmic hybrid: part fiat reserve, part algorithmic control. TerraUSD (UST) was a pure algorithmic coin that collapsed in 2022, illustrating the risks of unbacked designs. Frax has managed to maintain its peg by adjusting the collateralization ratio dynamically. RAI (by Reflexer) is another algorithmic example: it targets a floating price floor (not anchored to USD), using unique incentive mechanisms (Chicken Bonds) to stabilize.

Health factor and collateralization: In crypto-lending protocols, a health factor (collateral-to-debt ratio) is used to measure safety. For example, Aave defines health factor so that values ≥1 are safe, while values <1 trigger liquidation. The MakerDAO risk paper also describes health factor: e.g., depositing $10,000 with an 80% liquidation threshold lets you borrow $8,000 (health factor =1), and if collateral < $10,000 you face liquidation risk. Our project adopts this concept: collateral value and thresholds determine whether a user's position is solvent (healthFactor >1) or liquidatable (≤1).

3. Project Methodology and Design

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The project's methodology combined theoretical design, smart-contract development, and simulation/testing:

Literature & Design: We surveyed stablecoin architectures (MakerDAO, Frax, Terra, etc.) and DeFi liquidation models. Based on this, we designed a protocol where users deposit ETH or BTC and mint our stablecoin (let's call it "Dsc"). The design ensures overcollateralization via a health factor metric (see Section 3), and algorithmic supply adjustments to maintain the 1 USD peg.

Technical Stack: The contracts were written in Solidity and tested with Foundry/Anvil (a local Ethereum dev node for testing). We target EVM- compatible chains; specifically, we plan deployment on Ethereum layer-2 (a zk- rollup or zkEVM) for scalability, and used Anvil during development.

Collateral and Oracle: Collateral assets are ETH and BTC (tokenized). We integrate price oracles (e.g., Chainlink) for real-time USD valuations of collateral.

Health-Factor Engine: We implemented logic to compute each user's health factor and to restrict minting or trigger liquidation when health factor falls below 1. This mirrors Aave's and Maker's liquidation logic.

Peg Algorithm: The protocol includes an algorithmic module (similar to Maker's Stability Fee or Frax's pool) that adjusts supply or imposes fees in response to demand and price deviations.

Testing & Simulation: We conducted unit tests and scenario simulations (price shocks, stress tests) to verify peg stability and liquidation behavior. Below are the gas reports and test results from our development phase:

Figure 1: Gas consumption report for core contract functions during testing

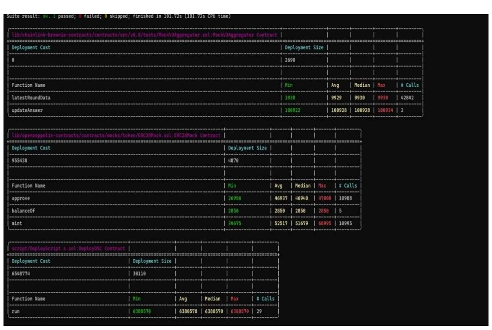


Figure 2: Test results showing successful execution of liquidation scenarios

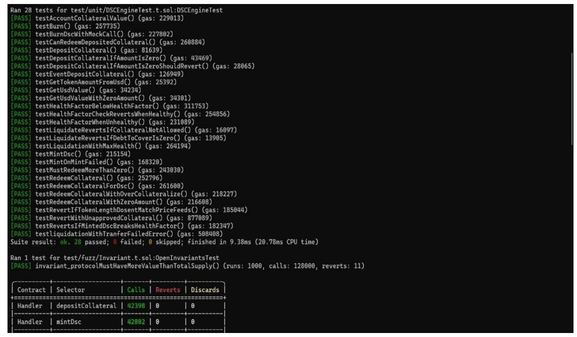
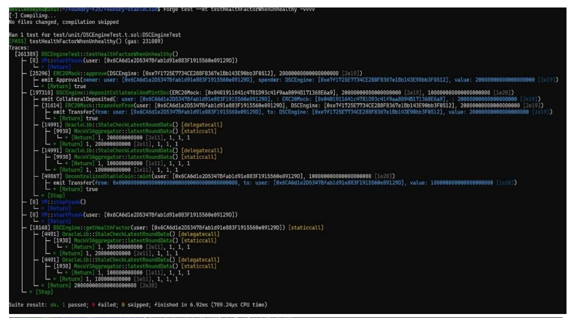
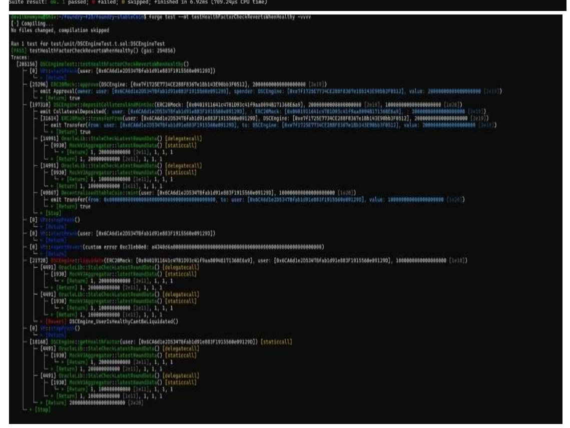
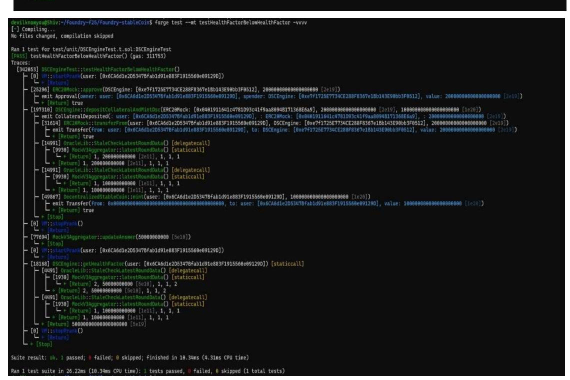


Figure 3: Health factor calculation tests under various price conditions







Overall, the methodology focused on overcollateralized lending mechanics and automatic stabilization rules, informed by existing literature.

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4. System Architecture and Key Features

4.1 Implementation Platform

Our stablecoin is implemented on Ethereum-compatible blockchains. For development, we used Foundry/Anvil to deploy and test contracts locally. The live deployment is planned on a zkEVM network (zero-knowledge rollup), benefiting from Ethereum security with high throughput and low fees. This choice aligns with modern DeFi trends towards L2s. The protocol's smart contracts encode the mint/burn logic, collateral vaults, price feeds, and governance parameters.

4.2 Multi-Asset Collateral

Users can deposit Ether (ETH) and Bitcoin (BTC) as collateral. Allowing multiple collateral types enhances flexibility and resilience. In MakerDAO's multi-collateral Dai (MCD) system, various assets (ETH, WBTC, USDC, etc.) are accepted to back Dai. Similarly, our protocol designates ETH and WBTC (tokenized BTC) as collateral. This means if either asset falls in value, the system can still maintain collateralization via the other. For example, a user could lock ETH and BTC in proportion to generate Dsc.

Accepting ETH is crucial because Ethereum is a core DeFi asset. Bitcoin provides additional stability as it is the longest-established crypto. By supporting these, our system is crypto-collateralized, similar to DAI, but limited to these two major assets. For each collateral type, a liquidation threshold is set (e.g., 75% for ETH, 80% for BTC) and market prices are fetched on-chain to compute USD value.

4.3 Health Factor and Liquidations

A central mechanism is the health factor (HF) for each user's vault. It is defined as the ratio of weighted collateral value to outstanding debt (minted Dsc), incorporating the liquidation threshold. Mathematically, we compute:

healthFactor = (collateralValueInUsd * LIQUIDATION_THRESHOLD * PRECISION) / (LIQUIDATION_PRECISION * totalDscMinted)

Here, collateralValueInUsd sums the USD value of all collateral, and LIQUIDATION_THRESHOLD is the safe collateral ratio (e.g., 75%). If healthFactor ≥ 1, the position is adequately collateralized; if healthFactor < 1, it is undercollateralized and eligible for liquidation. This is analogous to Aave's and Maker's approach: for instance, depositing $10k of 80%-threshold collateral allows borrowing $8k (HF=1), and if collateral value falls below $10k, liquidation ensues.

Liquidation works as follows: when healthFactor ≤ 1, any liquidator can pay back a portion of the debt to seize collateral at a discount (incentivizing them), thus protecting the protocol from bad debt. Our implementation closely follows these best practices. The health factor equation ensures dynamic monitoring of solvency; crucially, it transfers liquidation risk away from the protocol (to users/liquidators) and maintains 100% backing of circulating Dsc (aside from systemic buffer pools).

4.4 Algorithmic Peg Mechanism

Beyond collateral, we incorporate algorithmic elements to maintain the 1:1 USD peg. This includes:

Stability Fees: Interest on borrowed Dsc can be adjusted by governance to influence demand.

Automatic Supply Adjustment: A module akin to Maker's Automatic Market Operations (AMOs) or Frax's pool can mint/burn Dsc in response to price deviations. For example, if Dsc trades above $1, the protocol may incentivize minting (increasing supply) or reduce fees; if below, it may encourage redemption (burning supply).

Reserve Buffer: A small reserve of collateral and Dsc is maintained for emergencies (similar to Maker's Savings Rate or Frax's governance cushion).

In essence, the system behaves like a programmable bank with assets (crypto collateral) and liabilities (Dsc). Under typical market conditions, arbitrage forces (trading Dsc against collateral assets) keep the peg. If demand spikes, new Dsc is minted against collateral to absorb it; if demand drops, users can deposit Dsc to release collateral, reducing circulating supply. This is the same core principle MakerDAO described for Dai: "a dynamic system of Collateralized Debt Positions, autonomous feedback mechanisms, and appropriately incentivized external actors."

5. Comparison with Other Stablecoins

To highlight our project's niche, we compare it to major stablecoins:

DAI (MakerDAO): DAI is a decentralized, crypto-collateralized stablecoin backed by multiple assets (ETH, WBTC, USDC, etc.). DAI uses CDPs and governance to maintain the peg, with liquidation at 150% collateralization. Our Dsc is similar in that it is decentralized and asset-backed. Key differences: Dsc currently accepts only ETH and BTC (no USDC), and incorporates its own algorithmic supply controls. Unlike single-collateral DAI's early design, our health factor

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mechanism is enforced at mint time, ensuring positions are safe by design. Like Maker's Multi-Collateral Dai, Dsc is overcollateralized, but we aim to automate adjustments (e.g., dynamic liquidation thresholds or automated auctions).

USDC/USDT: These are fiat-collateralized by USD held in banks. They offer high liquidity and regulatory oversight, but rely on trust in the issuer (centralization). In contrast, our stablecoin is fully on-chain: no central custodian, no fractional banking. This means users can verify collateral on-chain at any time. The tradeoff is that crypto collateral is volatile, so our health factor (often >100%) mitigates that risk. USDC remains ~$1 as long as dollar reserves hold, whereas Dsc's peg is algorithmically enforced. A failure mode for USDC (freeze or USD devaluation) is avoided by our decentralized design.

TerraUSD (UST, now TerraClassicUSD): UST was an algorithmic stablecoin that used the LUNA token as collateral. It decoupled from $1 in May 2022, demonstrating that pure algorithmic designs can collapse under stress. Key lesson: without robust collateral or incentives, confidence can break. Our system addresses this by retaining real collateral (ETH, BTC) – we're backed, not purely synthetic. We also use a health factor/liquidation to re-anchor peg, unlike UST's debt-pool structure which failed to salvage the peg. Thus, Dsc learns from Terra's collapse by combining algorithmic supply rules with tangible collateral.

FRAX (Frax Finance): FRAX is a fractional-algorithmic stablecoin partially backed by collateral (initially USDC, now adding others) and partially stabilized via internal token burns/mints. Its collateral ratio floats automatically based on market demand, giving it some central bank-like qualities. FRAX's model shows the viability of hybrid designs. Our Dsc is similar in spirit: it's not fully overcollateralized like DAI (150%+), but collateral plus algorithmic rules (and possibly governance fees) keep it pegged. Unlike FRAX which used an additional token for stabilization, Dsc could use governance-adjusted parameters (fees or issuance) within one token system.

RAI (Reflexer Labs): RAI is a non-pegged algorithmic stablecoin targeting a redemption price rather than $1. It uses "Chicken Bonds" to manage liquidity.

Though interesting, RAI isn't pegged to USD, so it falls outside direct comparison for peg stability. We mention it only to note diversity: our Dsc is explicitly pegged to USD, unlike RAI's unique floor-peg mechanism.

Our stablecoin is useful as a decentralized, trust-minimized USD surrogate. Unlike USDC, no bank audits are needed; unlike UST, our real collateral underwrites value. Compared to DAI, we aim for a simpler health-factor check (automatically enforced) and an L2 deployment for speed and low fees. In yaacommunity) but also demands automated peg stability.

Table 1: Stablecoin Comparison

Stablecoin	Collateral	Decentralization	Peg Mechanism	Notes
DAI	Crypto (ETH, BTC, etc.)	DAO-governed	Over-collateralization	Backed by MakerDAO; requires 150%+ collateral.
USDC / USDT	Fiat (USD in banks)	Centralized	1:1 fiat reserves	USDC is audited; USDT reserves not fully transparent.
UST (Defunct)	Crypto (LUNA)	Decentralized	Algorithmic (swap with LUNA)	Collapsed after LUNA crash; no collateral buffer.
FRAX	Crypto + FXS token	Decentralized	Fractional collateral + algorithmic	Dynamic collateral ratio; FXS burns during minting.
Our Coin	Crypto (ETH, BTC)	Fully Decentralized	Algorithmic health-factor based system	Peg maintained via collateralization + auto liquidation rules.

6. Use Cases and Significance

Stablecoins underpin much of DeFi. As industry reports note, stablecoins facilitate lending, trading, and as a dollar on-ramp globally. Our stablecoin can serve similarly:

Lending & Borrowing: Users can borrow Dsc against collateral or lend Dsc to earn yield in DeFi protocols. The health factor ensures loans stay safe.

DEX Trading: Dsc can act as a base trading pair for crypto tokens, providing stable liquidity.

Cross-Chain Bridge: On zk-EVM or L2 chains, Dsc can enable cross-chain swaps and payments pegged to USD. This is valuable for remittances or DeFi activity on L2s.

Hedging: In volatile markets, users can lock assets for Dsc to hedge price risk (with on-chain transparency).

DeFi Integration: Any protocol supporting DAI could integrate Dsc, expanding liquidity options (assuming peg stability).

Because Dsc is algorithmic and decentralized, it appeals to users distrustful of centralized stablecoins. It can also introduce competition, potentially improving ecosystem resilience. For instance, Maker's DAI backs itself with USDC; if USDC faces issues, DAI could depeg. Our model avoids fiat dependency, mitigating such cross-risk.

Risks: However, Dsc inherits generic risks: collateral volatility (ETH price drops), oracle failure, and smart contract bugs. We

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Volume: 03 Issue: 12 | Dec-2025
ISSN (O) 3107-6696

mitigate volatility by overcollateralization and health checks (liquidations happen swiftly once HF<1). Regulatory changes affecting crypto markets could indirectly impact peg.

Algorithmic components also risk instability if demand drops sharply (learned from UST's collapse). These are acknowledged limitations requiring cautious deployment and community governance.

7. Conclusion and Future Perspectives

We have presented a comprehensive analysis and implementation of a decentralized, crypto-collateralized algorithmic stablecoin that builds upon the foundational principles of MakerDAO's DAI while introducing distinct parametric configurations and enhanced algorithmic controls. By combining ETH and BTC collateral with a sophisticated health factor mechanism enforcing a stringent 200% minimum collateralization ratio, our protocol establishes a robust framework for maintaining a stable $1 peg without reliance on centralized custodians or fiat reserves.

7.1 Synthesis of Key Contributions

This research makes several significant contributions to the decentralized stablecoin landscape:

1. Enhanced Risk Management Framework: The implementation of a dynamic health factor calculation that continuously monitors collateral adequacy represents a critical advancement in real-time risk assessment. Unlike static collateralization ratios, our health factor provides granular visibility into position safety, enabling proactive risk management rather than reactive liquidation.

2. Conservative Parameterization Strategy: By setting a 200% minimum collateralization ratio and a standardized 10% liquidation discount, we have created a protocol that prioritizes stability and security over capital efficiency. This conservative approach addresses one of the fundamental criticisms of algorithmic stablecoins—their vulnerability during extreme market volatility—by providing a substantial buffer against price fluctuations.

3. Hybrid Algorithmic-Collateralized Architecture: Our design successfully integrates the transparency and decentralization of crypto-collateralized systems with the responsive, automated adjustment mechanisms characteristic of algorithmic models. This hybrid approach leverages the strengths of both paradigms while mitigating their individual weaknesses, particularly the collateral inefficiency of pure over-collateralized systems and the instability of purely algorithmic designs.

Practical Implementation Insights: Through development on Ethereum- compatible chains with Foundry/Anvil tooling and planned deployment on zkEVM rollups, we have demonstrated the technical feasibility of implementing complex decentralized financial instruments while addressing scalability and cost concerns. The gas optimization strategies and testing methodologies documented in this paper provide valuable practical guidance for future stablecoin implementations.

7.2 Broader Implications for DeFi and Traditional Finance

The successful implementation of decentralized stablecoins like our protocol carries significant implications for both decentralized and traditional financial systems:

Financial Inclusion: By providing a stable, accessible digital currency that operates independently of traditional banking infrastructure, such protocols can enhance financial inclusion in underserved regions. The ability to transact in a stable dollar-denominated asset without requiring traditional banking relationships represents a paradigm shift in global finance.

DeFi Composability: Our stablecoin's architecture enables seamless integration with the broader DeFi ecosystem, serving as a foundational primitive for lending protocols, decentralized exchanges, derivatives platforms, and yield optimization strategies. This composability amplifies the protocol's utility and creates network effects that strengthen the entire decentralized finance landscape.

Regulatory Considerations: The transparent, auditable nature of our on-chain collateralization mechanism addresses key regulatory concerns regarding reserve verification. Unlike opaque fiat-backed systems, our protocol provides real-time verifiability of collateral backing, potentially serving as a model for regulatory-compliant decentralized financial instruments.

Monetary Policy Innovation: The algorithmic components of our system represent a novel approach to monetary policy implementation—one that is rules-based, transparent, and executed automatically without human intervention. This could inform broader discussions about the future of monetary systems in increasingly digital economies.

7.3 Limitations and Challenges Acknowledged

Despite its innovations, our protocol faces several challenges that must be acknowledged:

Capital Efficiency Trade-offs: The conservative 200% collateralization requirement, while enhancing stability, reduces capital efficiency compared to more aggressive models. This may limit adoption among users seeking maximal leverage and represents an area for potential future optimization through dynamic ratio adjustments.

Oracle Dependency: Like all collateralized stablecoins, our system remains dependent on external price oracles. While we implement redundancy and security measures, oracle manipulation or failure remains a systemic risk that requires ongoing vigilance and potential architectural innovations.

Governance Centralization Risks: Although decentralized in operation, the protocol's initial parameter setting and subsequent adjustments rely on governance mechanisms that may face challenges in achieving true decentralization, particularly in early stages of development.

Market Adoption Hurdles: Achieving sufficient liquidity and network effects to compete with established stablecoins represents a significant challenge, requiring strategic partnerships, incentive programs, and gradual trust-building within the crypto community.

7.4 Future Research Directions

Several promising avenues for future research and development emerge from this work:

Dynamic Parameter Optimization: Implementing machine learning algorithms to dynamically adjust collateralization ratios, liquidation thresholds, and stability fees based on real-time market conditions could enhance both stability and capital efficiency.

Cross-Chain and Multi-Asset Expansion: Extending the protocol to support additional blockchain ecosystems and a broader range of collateral assets (including tokenized real-world assets) could increase robustness and utility while diversifying risk.

Advanced Liquidation Mechanisms: Research into more sophisticated liquidation protocols, including Dutch auctions, batch processing, and insurance mechanisms, could improve liquidation efficiency during periods of high volatility and network congestion.

Formal Verification and Security Enhancements: Applying formal verification methods to critical protocol components could provide mathematical guarantees of security properties, addressing one of the most significant barriers to institutional adoption.

Regulatory Compliance Frameworks: Developing open-source frameworks for regulatory reporting, auditing, and compliance that maintain decentralization while meeting jurisdictional requirements could bridge the gap between DeFi and traditional finance.

Interoperability Standards: Contributing to and implementing emerging standards for stablecoin interoperability could enhance utility across different protocols and blockchain ecosystems.

7.5 Concluding Remarks

The decentralized stablecoin protocol presented in this paper represents a significant step forward in the evolution of digital currency systems. By thoughtfully combining established principles from MakerDAO's DAI with innovative algorithmic controls and conservative risk parameters, we have developed a system that prioritizes stability and security without compromising decentralization.

As the digital asset ecosystem continues to mature, the importance of reliable, transparent, and resilient stablecoins will only grow. Our research contributes to this evolution by demonstrating that it is possible to create algorithmic stablecoins that are both sophisticated in their monetary policy mechanisms and robust in their risk management approaches.

The true test of any stablecoin protocol lies not in theoretical design but in real- world operation under stress conditions. We therefore view this implementation as a starting point—a foundation upon which further research, testing, and refinement can build. As the DeFi ecosystem evolves and new challenges emerge, the principles outlined in this paper—transparency, overcollateralization, algorithmic responsiveness, and decentralized governance—will remain essential guideposts for creating stable digital currencies that can withstand the test of time and market volatility.

Ultimately, the pursuit of perfect monetary instruments is an ongoing journey rather than a final destination. Our protocol represents one more step in humanity's centuries-long exploration of what constitutes sound money—now reimagined for the digital age through the transformative power of blockchain technology and decentralized systems.

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