

WTF is Tokenomics

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TLDR

Tokenomics is a term used to describe the economics of a token in a decentralized ecosystem. Tokenomics refers to the quality of a token, its attributes, production, distribution, supply and demand, as well as its incentive and burn mechanisms. Understanding tokenomics is important when making decisions on which cryptocurrencies and/or NFT projects to invest in.

Attributes

Broadly speaking, a token is a digital unit built on top of a blockchain. Tokens can standalone or be paired as NFT's to a variety of things like digital art assets. They can be used as memberships to clubs like Proof Collective or serve as voting rights in DAO's. Similarly Rob McElhenney's Adimverse uses their tokens to design characters and advance creative proposals in their NFT gated community. Point being, tokens can be used to fulfill a lot of roles in a decentralized ecosystem. This is what makes tokens interesting. They are not limited to one specific attribute on the blockchain. Furthermore because tokens do not require massive amounts of capital to scale, builders can tinker around and innovate.

There are fundamentals to tokenomics builders and investors need to consider. In order to keep an ecosystem sustainable, participatory and growing, understanding what affects the supply and demand of a token is crucial for its success.

Supply

There are many qualities to a token that can predict its value and behavior. The first quality to consider is the amount of tokens circulating in supply. The amount of circulating supply can drive the value of a token. In a vibrant ecosystem when demand exceeds supply, prices tend to rise. These are basic market forces. Vice Versa, if demand is low and supply is high, the value of a token will decrease.

Supply of a token can either be inflationary or deflationary. An inflationary token is a token that continues to be generated. Tokens are produced for several reasons including mining in the protocol, issuance schedules, incentives to reward investors, and/or payment for developers. Generally inflationary tokens will decrease in value over time unless the overall increase of value of the ecosystem outpaces new token generation. There must be demand for users to keep on buying.

Deflationary tokens on the other hand mean tokens will be fixed, taken out of circulation or potentially burned. Assuming there are no changes in the market, these tokens usually go up in value when the ecosystem is healthy and stable. If there are less tokens to buy and the demand remains unchanged, the token value

increases.

There are sophisticated projects out there that do have deflationary and/or burn mechanisms in their protocol to reduce supply in order to support the token's value. For instance WOW Pixie's DAO has incorporated a Pixie Market into the NFT project. WOW Pixies is a social DAO supporting women artists on the blockchain. Users can auction off their WOW Pixies tokens for digital assets stored in the Pixie vault. When a trade-in occurs, the WOW Pixies tokens are taken out of circulation. This benefits holders because theoretically with the reduction in supply of Pixies, the value of the other tokens in the Pixie ecosystem will increase.

Demand and Distribution

Distribution is another key term in tokenomics as it refers to the allocation of the token. Distribution details who receives the tokens, the amount given, and when the tokens are issued. Understanding the distribution of the token is important to investors because if certain holders have an abundance of tokens and choose to sell them at a certain time it can crash the token market ecosystem. Consequently, builders need to be careful in their considerations of token distribution if they want to keep their project sustainable and investors engaged. Having issuance schedules and vesting structures helps to provide predictability and security for token holders. Quality projects will be transparent, list their supply as well as distribution dynamics on their website or in their white paper

Supply tends to be easier to analyze and interpret than demand. CoinGecko and Messari have data and charts that aggregate data. These sites research reports and aim to inform investor's analysis. Alternatively demand often comes down to human behavior which is more difficult to predict. Frequently demand is driven by how investors think the market is doing and how influencers are engaging with the token. Sentiment can quickly shift based on a single tweet. Always be skeptical of influencer pumps. This past week we saw Kim Kardashian settling with the SEC for \$1.26 million promoting a token called EthereumMax (EMAX). She failed to disclose the \$250,000 payment she received for her endorsement on her Instagram account of EMAX. It is well known that in the current crypto market influencers can drive sentiment. When looking at an influencer's endorsement, look for ways they are acting responsibly and ethically.

Utility and Incentive Mechanisms

Determining the utility of a token coupled with market sentiment are key features when analyzing demand. A token's utility refers to the product or service it holds. If a token solves a problem or offers a service, users will continue to adopt it. However if there are no real use cases chances are the demand for the token will abate.

Market sentiment is the attitude investors have towards sectors of the economy. Are investors putting in time and capital into the space? Despite bear or bullish attitudes, decentralized economic markets are new and can be fickle. Therefore it can be difficult at times to predict precisely if and where the demand is occurring.

Due to the temperamental nature of the decentralized economy some builders have built in mechanisms to incentivize users to stay engaged with the token. For example there are mechanisms like staking which locks up tokens. Locking up tokens prevents investors from selling which helps tokens retain their value when

markets are dropping. These mechanisms aim to keep projects whole. By locking up tokens investors are rewarded with yields, prizes, IRL events, access points. Examples of these mechanisms include staking Eth coins, nesting in the Moonbirds, or collecting seeds in FlowerGirls. Holding or locking up the tokens signals to the world users are committed. In turn this gives investors reasons to be confident in the tokens sustainability and potential growth.

Tokenomics is important to understand when either designing or investing in projects or protocols. It is a broad concept that includes a variety of components. Such components include the add value a business creates, how a token might be tied to it, allocation, supply and demand, distribution and incentive mechanisms. It is a new category for all of us to watch, play with, and learn.

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