Fueled by hope and fear, cryptocurrency markets are primed for contagion

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Credit: AI-generated image (disclaimer)

Financial contagions can be triggered easily, if conditions are right. First one financial institution falls and then others follow, like a chain of falling dominoes.

The cinder that sparked the global financial crisis in 2007 is considered by many to have been a March 14 briefing by executives of the Lehman Brothers' investment bank.

Under intense questioning from financial analysts, the executives admitted the bank had overstated the value of billions of dollars in subprime mortgages.

This news saw Lehman Brothers' stock price crash, and led to investors losing faith in the entire edifice of complex financial deals that had been so profitable for banks and brokers.

As share prices fell, more investors scrambled to sell their stock, driving prices even lower. The contagion spread through global share, property and derivative markets.

Of course, it was a crisis waiting to happen. It took years to create the rickety system that collapsed under pressure. It was going to happen sooner or later. But it still needed a trigger.

We're at a similar point in cryptocurrency markets.

2022's major collapses

This year has seen several major crypto-related collapses.

In May the Terra/Luna cryptocurrency, considered a reputable stablecoin with a total market cap of US$31 billion in April, was wiped out.

In July the US-based cryptocurrency lender Celsius, with assets valued at US$12 billion in May, went bankrupt.

Then in November, FTX—one of the world's biggest cryptocurrency exchanges, valued at $US32 billion at the beginning of 2022—collapsed, taking with it the assets of 1.2 million customers.

Binance fears

Crypto owners are spooked, waiting for the next exchange to drop.

Last week it looked as if that might be the world's biggest cryptocurrency exchange, Binance, after customers withdrew US$1.9 billion of assets in 24 hours.

To put that in perspective, that's just 3.5% of the US$55 billion in assets Binance reported it was holding on December 18. Binance says withdrawals have settled down.

But the panic was real enough—apparently triggered by some large depositors interpreting a trading halt for one of Binance's listed coins as signifying something more serious.

Centralized exchanges are a risk

In any market crisis there's always an underlying problem that provides the fuel for a cinder to spark.

In this case the problem is that Binance and other other centralized crypto exchanges (known as CEX) are riskier than other ways to store crypto assets.

There are good reasons for any crypto owner, after seeing what happened with FTX, another centralized exchange, to withdraw their assets.

The lesson from FTX is that if you don't have self-custody of your crypto assets, you have no real control.

Centralized cryptocurrency exchanges are more like banks than exchanges. They act as custodians, holding customers' crypto or fiat currency, similar to holding money in a bank account.

But banks are regulated—in part to minimize the disastrous "bank runs" that occurred regularly in the past.

This includes a global regulatory framework known as the Basel prudential guidelines, introduced in 1988 to ensure every bank holds enough capital and sufficient liquidity to meet withdrawals. It also requires banks to report financial information on a regular basis.

We take all this for granted. But it didn't happen magically. It's a function of careful planning based on strict minimum liquidity and capital requirements imposed by banking regulators.

Containing the next crisis

Banks are closely supervised because they hold most of the money in the economy. For the economy to function it is vital that people can store money safely and securely, and accessed when required.

We need the same oversight of cryptocurrency.

Every centralized crypto exchange is in danger if customers' withdrawals exceed its liquid assets. If it can't cover withdrawals, it must freeze customers' accounts. At that point the end is nigh. This is what happened with FTX—albeit the person making the most problematic withdrawals was founder Sam Bankman-Fried.

The next big crypto collapse is not a question of "if" but "when"—and whether governments can work quickly enough to build the regulatory buffers to stop collapse leading to contagion.

It may not be possible to avert a crisis, but it can be contained.

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