Cryptocurrency market in turmoil

Nick Beams
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The cryptocurrency market was thrown into turmoil last week as the market value of bitcoin, the most widely used cryptocurrency, continued to fall and so-called “stablecoins” are collapsing.

The use of stablecoins has increased over the past two years because they are supposed to provide some protection against the wild swings in the cryptocurrency markets, above all for bitcoin, which has experienced several plunges in its history.

Stablecoins have been likened to chips in a gambling casino. They can be used to buy cryptocurrencies without the use of government-backed currencies, principally the US dollar, enabling the user to make more rapid transactions. Deals involving regular currencies often take days to complete.

Stablecoins are supposed to provide a degree of security because they can be cashed in, like a chip in the casino, at their face value, dollar for dollar.

There are two types of stablecoin: those that are backed by holdings of financial assets, including cash, government bonds, or corporate debt, and those that seek to maintain their dollar-for-dollar peg through financial engineering based on the use of algorithms.

But last week one of the latter type, TerraUSD and its associated stablecoin, Luna, collapsed. According to the *Wall Street Journal* (WSJ) their demise “saddled investors with billions of dollars in losses and ricocheted back into other cryptocurrencies.”

Seven days ago, Luna was trading at $81. It is now worthless, and Terra has been delisted from major exchanges meaning it is effectively finished after once being valued at $40 billion.

The *Financial Times* (FT) reported that, according to the research firm, CryptoCompare, the Luna episode was “the largest destruction in this amount of time in a single project in crypto’s history.”

Another trader and enthusiastic supporter of crypto told the FT Luna’s failure was “one of the greatest catastrophes crypto has ever seen” and a “real wake-up call” that it is possible crypto prices can fall to zero.

The FT commented that while Terra’s demise was not systemic to the broader crypto market, it had far-reaching implications.

“What matters more is that the episode has renewed concerns potential cracks in other stablecoins, including the biggest of them all, Tether, calling into question the foundations behind the crypto industry.”

These cracks became evident when Tether, which is regarded as crucial to the functioning of the crypto market, “broke the buck” for a period and was at one stage trading at 95.11 cents, well below the $1 peg. It recalled a key episode in the 2008 financial crisis when a mutual fund went the same way.

Tether operates on a different basis from Terra. It claims to maintain the dollar peg by holding reserves of traditional financial assets such as government and corporate bonds. It is the biggest player in the $180 billion stablecoin market and is supposedly worth $80 billion.

But money flowed out last week.

“We had pretty much $3 billion [in] redemptions, and they were liquidated pretty quickly through our banking channels,” Tether’s chief technology officer Pail Ardiono revealed in a live audio Twitter conversation on Thursday. Redemption requests ranged from $100,000 to as much as $600 million.

In an interview with the FT, Ardiono committed to maintain the dollar peg and claimed the company had bought a “ton” of US government debt which it could sell to meet that objective. But he refused to give details of the holdings of government bonds because he did not “want to give out our secret sauce.”

He said Tether was not a public company and would keep that information to itself “but we are working with many big institutions in the traditional financial space.”

The FT report noted that last year the US Commodity

Futures Trading Commission fined Tether $41 million because it said the company had made “untrue or misleading” statements about its reserves.

The fall of Terra and the failure of Tether to maintain dollar parity, even if only for a short period, has sent a shock wave through the crypto markets, raising major concerns.

“Cash is supposed to be cash. When it’s not, like when money markets froze during the financial crisis, sheer panic ensures,” Andree Beer of the US investment firm Dynamic Beta told the FT.

And because Tether and other stablecoin firms have large holdings in the short-term credit market, efforts to maintain dollar parity by selling their assets could have spillover effects.

Last year the rating agency Fitch warned that if Tether holders were to seek to turn their tokens into cash, it could destabilise short-term credit markets where the company holds much of its assets.

“The rapid growth of stablecoin issuance could, in time, have implications for the functioning of short-term credit markets,” it said, pointing to the “potential contagion risks linked to the liquidation of stable coin reserve holdings.”

Since that warning was issued, credit markets have become more fragile because of the rise in interest rates by the US Federal Reserve and the prospect that further significant rises are to come.

If Tether were forced to unload a significant portion of its holdings of $24 billion worth of commercial paper, its $35 billion of Treasury bonds or $4 billion worth of corporate bonds it could cause reverberations in these markets.

Calling for increased regulation of the crypto market, an FT editorial noted that if Tether did have $80 billion of assets this would place it among the world’s biggest hedge funds.

“If a fire sale of these assets ensues as Tether tries to retain its dollar peg, or faces a wave of redemptions, the sheer size of such moves could make already jittery financial markets even more volatile,” it said.

The crypto crisis also attracted the attention of US Treasury Secretary Janet Yellen. Testifying at a Senate hearing last week, she pointed to the run on TerraUSD.

“I think that simply illustrates that this is a rapidly growing product and that there are risks to financial stability.

“I wouldn’t characterize it at this scale as a real threat to financial stability but they’re growing very rapidly. They present the same kind of risks that we have known for centuries in connection with bank runs.”

FT journalist Katie Martin warned that while the stablecoins TerraUSD and Tether did not operate in the same way the differences were small.

“Either these things can maintain the one-for-one peg with the dollar or they can’t. If they can’t, then the belief system underpinning crypto is in trouble.”

The fall in the main cryptocurrency, bitcoin has been dramatic. After reaching a record high of almost $69,000 last November, it went down to as low as $25,000 last week before moving up again slightly. The decline means that anyone who got into the market after the end of 2020 and stayed there is now under water and the losses could extend to hedge funds.

According to the WSJ over the past six weeks at least $1 trillion in supposed crypto currency value has simply evaporated.

It remains to be seen how the crypto turbulence will play out this week and in the coming period. But whatever ups and downs may take place, it is yet another indication of the deepening crisis of the financial system as the massive inflow of trillions of dollars from the Fed and other central banks over the past decade has promoted new and ever more arcane forms of speculation and outright swindling and criminality in some cases.