As fallout from crypto collapse spreads, concerns grow over financial stability

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Further cracks are opening in the global financial system, both in expected and unexpected places, amid continued warnings about its overall stability.

In the crypto world, the collapse of the currency trader FTX has sent out shock waves with a number of companies on the skids because of their exposure to Sam Bankman-Fried's essentially Ponzi scheme operation, the viability of which depended on the continual inflow of money.

On Wednesday, the crypto broker Genesis Trading announced it was halting trading at its lending unit, blaming the "unprecedented market turmoil" set off by the demise of FTX.

It said it had decided to suspend redemptions and halt new loan applications because of "abnormal withdrawal requests which have exceeded our current liquidity." In other words, there was a run on the company it was unable to meet.

Genesis had already been hard hit because it was heavily connected to the Singapore-based crypto hedge fund company Three Arrows Capital, which filed for bankruptcy in July. It has been revealed that Genesis lent Three Arrows $2.4 billion that is now probably lost.

Crypto firms BlockFi and Voyager Digital are also reported to be under pressure. According to a report in the *Wall Street Journal*, BlockFi, which said it has "significant exposure" to FTX, is preparing to file for bankruptcy.

Bloomberg reported that Voyager was now "twisting in the wind" because Bankman-Fried was going to rescue it in a $1.4 billion deal, and it is now trying to find a replacement buyer for its assets.

The full extent of the fallout from the collapse of FTX has yet to be determined, but there are certain to be other firms that will go under because of the extent of Bankman-Fried's operations.

The crypto crisis has its own peculiarities and, to borrow from Tolstoy's famous quote regarding families, each crypto firm is "unhappy in its own way." But whatever the circumstance of each firm, there is an underlying cause.

While money was pouring into the financial system from the US Federal Reserve and other central banks, the crypto families were "happy in the same way" as money was made hand over fist.

But the financial environment has completely changed because of the tight monetary policies of the world's central banks as they seek to crush the global wages movement of the working class in response to the highest inflation in four decades.

The problems that have erupted in the crypto world are developing in all areas of the financial system as set out in the financial stability reports of the world's major central banks—the latest being that of the European Central Bank issued on Wednesday.

Summarising the report, the *Financial Times* said it warned that the "toxic combination of recession, soaring inflation, rising funding costs and lower liquidity is threatening to trigger financial market turmoil in the euro area."

The report noted that the turmoil in the long-term UK bond market (gilts), when the movement in yields occurred at a historically unprecedented pace, revealed the vulnerability to sharp shifts in market prices that could spark a broader crisis.

The inherent instability in financial markets was set out as follows:

"Uncertainty around the outlook for inflation and interest rates has heightened the risk of disorderly asset price adjustments in financial markets, notwithstanding recent corrections. Many investment funds remain heavily exposed to further valuation and credit losses. Those with large structural mismatches and low cash buffer are particularly vulnerable to market dislocation and the outflow of funding."

It is not only the major financial firms that are facing problems but governments as well.

The ECB reported that prolonged high budget deficits in a number of countries, together with rising funding costs, because of interest rate rises, "may not only limit the fiscal space available to shelter the economy from future shocks, but may also put debt dynamics on a less favourable trajectory, especially in countries with higher levels of debt."

The meaning of these words was spelled out by ECB Vice President Luis de Guindos in presenting the report. He said government measures to deal with the energy crisis and its devastating impact on the population had to be targeted and temporary.

"It cannot be the same 'whatever its takes' fiscal policy approach that we have seen during the pandemic," he said.

Like the events in Britain, when former Prime Minister Liz Truss' mini budget set off a financial crisis, an incident in South Korea illustrates the inherent fragility of the financial system.

South Korean bond markets have been plunged into turmoil because the newly elected right-wing governor of the Gangwon province, Kim Jin-tae, refused to honour debt commitments incurred in the building of a Legoland Korea theme park.

The theme park, which opened on May 5, was intended to boost the depressed economy of the province but failed to generate sufficient revenue to pay the debt used to construct it. On September 28, Kim announced he would not honour the commitment made by the previous province administration.

The South Korean bond market, the total value of which is more than $2 trillion and already under stress because of the interest rates emanating from the US, was thrown into turmoil. As an article in *Foreign Policy* put it, "Kim's declaration all but threw a match" into what was a "dry winter forest."

The withdrawal of support for a supposed government-backed project cast a dark shadow over the riskier corporate bond market.

It noted that one of the safest bonds in South Korea, that issued by the Korea Electric Power Corp, saw the yield on its three-year debt climb from around 2.2 percent at the start of the year to 5.8 percent and its latest issuance, worth about $146 million, could not find a buyer.

In response to the turmoil the government and financial authorities have had to intervene. The government has provided a liquidity facility of more than 50 trillion won, equivalent to $35 billion.

The Bank of Korea has injected the equivalent of $67 billion into the short-term bond market, and South Korea's five largest banks have stepped in to pledge $67 billion in liquidity.

As the *Foreign Policy* report noted, there is an "absurdist" quality to these measures.

On the one hand, following the interest rate hikes initiated by the US Fed, the Bank of Korea has been "aggressively raising the benchmark rate to curb inflation by reducing liquidity, but on the other hand, the South Korean government is injecting liquidity to the market to stave off a total economic collapse."

The old saying "those whom the gods would destroy they must first make mad" comes to mind.

Drawing a parallel with the UK crisis, which saw the demise of Liz Truss, and the crisis sparked by the actions of Kim, it concluded that "electing bad politicians leads to a bad economy."

That may well be the case. But the deeper meaning of both events is that, as in the case of war, where even seemingly minor incidents can spark a full-scale military conflict, such is the brittle nature of the financial system everywhere that what might be viewed as accidents can trigger a major crisis.