

Market convulsions could spark financial crisis

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Somewhere along the way, more likely sooner than later, a major speculative investor or financial institution could take a significant hit because of the gyrations in markets, with far-reaching consequences ripping through the global financial system.

Even before the Russian invasion of Ukraine, financial markets were their most fragile since March 2020, at the start of the pandemic, due to fears of what interest rate increases and a tightening of monetary policy by the US Fed and other central banks would produce.

The sanctions imposed on the Russian banking and financial system by the US and NATO along with the bans on Russian oil by the US have sent commodity prices soaring—not only for oil and natural gas, but wheat and other grains together with industrial metals.

Oil has gone as high as \$139 a barrel. Gas prices in Europe at one stage hit €345 a megawatt hour before falling back to €241. One year ago, the price was €16.

The financial flow-on effects of the escalation of commodity prices were starkly demonstrated this week in the market for nickel, of which Russia is a major producer.

On Monday, the price of nickel on the London Metals Exchange (LME) rose by 75 percent to \$50,000 a tonne. The next day it doubled to \$100,000, then fell back to \$80,000 before the LME suspended trading in the metal.

Nickel prices usually move at most by a few percent a day and long-time traders in the LME said they had never seen in anything like it before.

The financial impact was soon revealed. Chinese billionaire Xiang Guangda, the founder of the country's leading stainless-steel producer Tsingshan Holding Group, had shorted nickel, that is, had taken out contracts based on the assumption its price would

fall.

The movement the other way left the company with paper losses totalling several billions of dollars. Initial estimates in the Chinese media were that losses could be as high as \$8 billion.

Announcing the suspension of nickel trading, which is not expected to resume before the end of this week, the LME said the decision was taken on “orderly market grounds.”

The extreme turbulence extends well beyond commodity markets and the institutions that trade in them, often making large bets based on where they consider prices will move. It also impacts on banks that have invested in Russian financial markets.

The Italian bank UniCredit, the world's 34th largest, has warned it faces losses of around €7 billion in the face of an “extreme scenario” in which its entire Russian business is wiped out. The company said yesterday it had loans of about €7.8 billion in its Russian consumer unit and cross-border exposures to companies of €4.5 billion of which about 5 percent had been hit by sanctions.

The effect of the sanctions goes far beyond the companies and financial institutions that are directly caught up in them.

In an article earlier this week, the *Wall Street Journal* cited the remarks of Christopher Smart, a former special assistant to President Obama. He said the situation facing global businesses in the wake of the sanctions was reminiscent of that which accompanied the collapse of Lehman Brothers in 2008.

“We've never seen anything this comprehensive, this powerful and this sudden imposed on an economy this size and important to the global economy,” he said.

It recalled Lehman Brothers because of uncertainty about who had exposure to Russia. “I may know that

I'm not exposed, but I'm not really sure who among my clients may be exposed, who has investments that they're ... going to have to write down," Smart commented.

The surge in commodity prices, which is already lifting the inflation rate around the world, has enormously complicated the situation facing the world's major central banks.

Before the war crisis they were on course to begin tightening monetary policy—already a delicate operation given that the financial markets have become so dependent on cheap money that even a small rise could provoke market turbulence and even a recession.

Now inflation is surging, and the financial system has become even more unstable. The first indication of how they intend to react will come today when the European Central Bank (ECB) announces the future direction of its monetary policy.

Last month the ECB's governing council said it would undertake a "gradual normalisation" of monetary policy including a possible wind-down of its asset purchasing program and a lifting of interest rates at least by the end of the year.

The indications from ECB President Christine Lagarde and ECB Chief Economist Philip Lane are that these plans may be put on hold.

As the *Financial Times* noted, Lagarde has said the bank would "take whatever action is needed" in response to the Ukraine situation. Lane said it could accept inflation above its 2 percent target when dealing with "an adverse supply shock" and the bank could consider "new policy instruments" to support financial markets.

However, such measures could widen already existing divisions in the bank's governing council. Some members may insist that the "normalisation" policy must continue under conditions where inflation hit a eurozone record of 5.8 percent in February and is expected to go to 7 percent later this year.

The FT cited one "hawk" on the governing council who said: "It is obvious that inflation will stay with us, so we have to do something. We cannot just say we will wait and see."

The Fed will determine its monetary policy next week, having already pencilled in a rise of 0.25 percent, with further rises of the same size over the course of the year as well as starting to reduce its \$9 trillion holdings

of financial assets.

The expectation of interest rate rises has already had a major impact on Wall Street with the tech-heavy NASDAQ index now down by almost 20 percent so far this year.

The shares of tech companies, many of which have yet to turn a profit, are highly sensitive to interest rate increases because their "expectations" of future profits are discounted at the prevailing interest rate to determine their present market value—the higher the rate the lower the value.

An article by Robin Wigglesworth in the FT noted: "In dollar terms, the tech-heavy market has now lost well over \$5 trillion since its November peak—more than the NASDAQ's dollar losses through the entire dotcom bubble unwinding in 2000–02."

The relatively stronger position of Big Tech companies—the well-known names such as Apple, Google and Microsoft—was obscuring the extent of the damage. But the rapid fall in the shares of Meta (the owner of Facebook) indicate that even Big Tech is not immune.

It has been estimated that almost two-thirds of the NASDAQ's 3,000 members have fallen by at least 25 percent from their 52-week highs. Almost 43 percent have lost more than half their value and a fifth had dropped by over 75 percent.

"The \$5.15 trillion that has evaporated from the NASDAQ in recent weeks is like the entire UK stock market going 'poof'," Wigglesworth wrote.

Goldman Sachs has estimated that if the Fed decides to forcefully tighten monetary policy—and it may decide to do so with inflation predicted to rise even further in the US, possibly reaching double-digit levels—the NASDAQ could fall another 17 percent.

Wigglesworth concluded that a repeat of the dotcom bust may not come but added that "the scales of the wealth destruction is already enormous" and the "wider reverberations are still unknowable, and could be significant."



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