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Cryptocurrency Contagion

Losses and uncertainty are no cause for celebration.

By Carl Tannenbaum

I am pretty even-keeled; I have to be, given the range of thorny economic issues I am asked to discuss and the sharp elbows of today's political discourse.

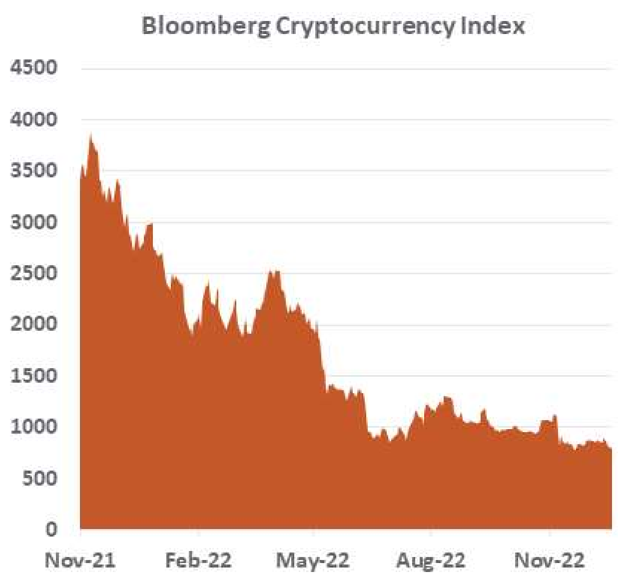
But for some reason, my partners here at Northern Trust enjoy planting questions within audiences to see if they can get a rise out of me. A flat tax? Modern monetary theory? Brexit? Banning the University of Chicago? All have been tried, but none have caused me to lose my cool.

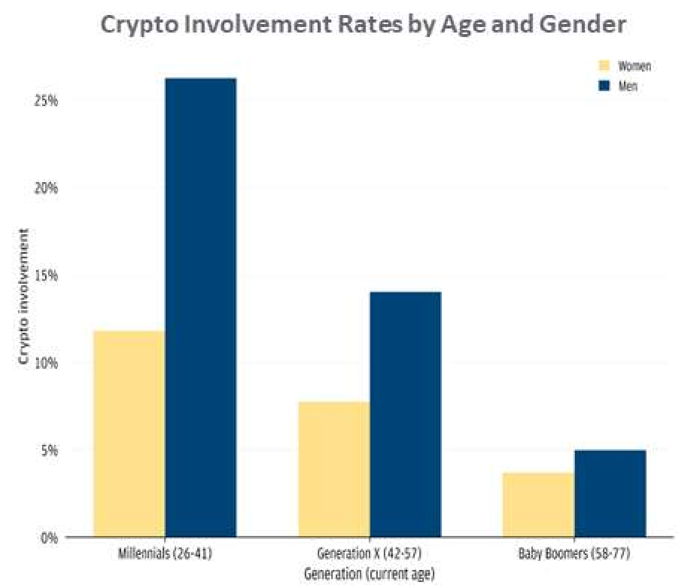
And then, a few years ago, a partner in San Francisco discovered my kryptonite: cryptocurrencies. When the topic is raised, you are guaranteed to get a rant of at least five minutes. Our 2021 piece entitled "Lacking Currency" does a good job of summing up our skepticism.

So you might expect me to be indulging in a little *schadenfreude* at the recent meltdown of FTX, the cryptocurrency exchange operated by the now-jailed Sam Bankman-Fried. But the situation has resulted in a substantial loss of wealth for investors which could impair consumption. And there is some modest risk of contagion to other areas of the financial system.

To be fair, cryptocurrencies weren't the only cause of trouble at FTX. More traditional elements were at play: fraud, self dealing, lax controls and inadequate disclosure are just a few of the old-fashioned faults that sank the exchange. The opacity of the asset class and the public's mania around it are also not new: these ingredients can be found in financial panics across centuries.

At the time of its bankruptcy, FTX had about 1 million creditors who were owed about $8 billion. Its failure accelerated losses in cryptocurrencies, which now total more than $2 trillion over the past 12 months. These numbers are small relative to the wealth held by U.S. households, so a chain reaction of bankruptcies is unlikely.





Sources: Bloomberg, JP Morgan Chase

But according to a study by JP Morgan Chase, an estimated 15% of Americans had conducted transactions into crypto accounts by the middle of 2022. (As shown in the chart, this activity skews toward younger cohorts.) The loss of wealth will curtail spending; estimates indicate a reduction of 0.5% in U.S. consumption over the next year. This is an unwelcome development for an economy trying to avoid a recession.

Even those who did not own cryptocurrencies could be affected by the FTX collapse.

FTX had a stake in a small bank, whose failure would probably not cause big ripples through the financial system. What we don't know is how readily assets traded on FTX (or shares of the company itself) were used as collateral for leverage that will unwind hastily in the wake of the exchange's failure. Surveillance is especially active on this front. Calls for additional regulation of the sector were present prior to the FTX debacle, and have increased in volume since then.

The irony of manias and panics is that they can come to affect those who were wise enough to avoid direct participation. I hate having to care about cryptocurrencies, but so I must.

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Carl Tannenbaum is the Chief Economist for Northern Trust. In this role, he briefs clients and colleagues on the economy and business conditions, prepares the bank's official economic outlook and participates in forecast surveys. He is a member of Northern Trust's investment policy committee, its capital committee, and its asset/liability management committee.