The Fragility of Contemporary Capitalism*

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While the world remains preoccupied with the geopolitical and humanitarian fallout of the Russian invasion of Ukraine, its economic consequences are increasingly a matter for concern. Though the two countries at war account for less than two and one half per cent of the world's population, it emerges that the damage to production within their boundaries and the suspension of their trading relationship with rest of the world threatens a crisis in multiple markets, not least in the markets for food and oil where shortage abound and prices are rising. This is are typical illustrations of the entangled fate of nations in a globalised world economy.

But there is more that the war in Ukraine is showing up. Events in unusual corners of the global economic system illustrate how centralised and financialised markets for goods and services have increased the fragility of contemporary capitalism. A telling example is the market for nickel and nickel futures. Nickel is a metal that enters into the production of stainless steel and has gained in importance because of being an in input into batteries that fuel the world's booming electric vehicle industry. It is not normally the centre of attention in economic discussions. But matters changed on March 8, 2022 when the London Metal Exchange (LME), which describes itself as "the world centre for industrial metals pricing, hedging and trading", suspended trade in nickel.

That should not be too much cause for concern some may say. But the suspension was a rare and almost unprecedented event in the history of the LME's nickel market that provides the reference price for the metal for all those exposed to it along global value chains. The suspension was triggered by extraordinary price trends. In a single day nickel prices doubled to exceed $100,000 a tonne and nickel futures saw their prices rise by 175 per cent over a two day period.

The trigger for the price explosion was the Ukraine war and sanctions, that threatened to shut out Russia, which accounts for around 11 per cent of global nickel output, from world markets. But as noted earlier, Russia and Ukraine seem to be important in multiple markets, such as wheat, oil and fertiliser. All of them have seen price increases, but none of a kind (as yet) that led up to a decision to halt trading in the commodity. There must have been more happening in the nickel market.

There indeed was. It emerges that the unusual exposure to nickel of one player through its agents was turning what should have been a price spike into a price explosion. That player is China's Tsingshan Holding Group, the world's biggest producer of nickel and stainless steel, led by one more of China's rags to riches tycoons, Xiang Guangda. The group controls large nickel producing capacities in Indonesia which supply the metal to its stainless steel plants or to Chinese producers of electric vehicle batteries.

Xiang, being a metals tycoon, was obviously exposed to the market for metal futures, especially nickel futures. Futures are seen as sensible hedging instruments that help protect those exposed to markets for commodities from suffering losses if prices move in directions that were not expected. For example, if production decisions are taken assuming the price of nickel would rule at $40,000 a tonne, say, but prices fall

to $35,000 a tonne by the time the product reaches the market, the supplier would suffer significant losses. So, paying a premium for a futures trade in which you tie in some buyers willing to commit in advance to pay $40,000 is a way of insuring against losses. If the price does not fall you lose only the premium. If it does, you cut your losses and protect profits.

But futures markets are not populated only by hedgers engaged in production but also by speculators who, convinced of their expectations of how markets would move, place bets to reap profits from trading. A typical example of such a bet is a "short". Traders convinced that prices of some commodity would fall, borrow that commodity to sell at today's high price, with the plan to buy back at a lower price on a later date to return the commodity to the lender and close the deal. The spread between the selling and buying price, after allowing for costs, delivers a profit. Even if you are not a nickel producer that is a legitimate and potentially lucrative activity to engage in.

Xiang was, of course, different. He was a major producer of nickel and steel. But that possibly convinced him that he had more knowledge and a better idea than most on how the markets would move. And he believed that nickel prices would fall significantly given likely trends in demand and supply. That persuaded him not to stop at hedging. He chose to accumulate large short positions, financed with debt, or place bets that would allow him to benefit from that expected fall in price and reap huge profits. Some of those bets were not even in exchange traded futures, but in over-the-counter derivatives partly issued by banks. But the Russian invasion of Ukraine tripped him up. Prices rose and, caught in a "short squeeze", he was losing massively on those deals. Those losses are estimated to have totalled about $8 billion or more in an extremely short time span.

When that happens brokers and creditors demand more "margin" money to cover those losses. If forced to make those payments the speculator could run short of cash to pay or face a liquidity crunch. Xiang would also have to consider buying the commodity—in this case nickel—before prices rise further, to deliver the physical metal against futures contracts and cut losses when closing deals. That needs money too. But it also increases demand for the physical commodity, both from the short seller and other steel and battery producers using the raw material, resulting in further price increases, since supply is short. That explains the explosion in nickel and nickel futures prices. It did not help that Tsingshan's own production of nickel was not of the Class 1 type (99.8 per cent purity), needed for delivery against an LME contract. So it could not divert its own production to close the deals it had entered into.

An event like this roils financial markets as well. In this instance the LME had to halt trading and find ways of closing out a large proportion of the short positions to stabilise markets. What angered some money managers is that, realising that some brokers would default on margin calls that the price spike entailed, the Exchange cancelled around 5,000 trades that had been concluded, when the price had risen but before the suspension of trading. This was clearly penalising those who would have profited from the trade to save the brokers who had entered into those deals voluntarily. Those brokers were members acting on behalf of buyers wanting the physical commodity for production, while the speculators who gained were largely electronic traders making speculative bets. The action may have prevented many defaults but is a violation of market principles. But a spokesperson for the LME reportedly justified the action stating: "In the interests of systemic stability and

market integrity, we suspended the market as soon as we could and cancelled trades from the point at which the LME no longer believed that prices reflected the underlying physical market." That position is unlikely to go unchallenged.

The banks supporting Tsingshan's speculation, were hit as well. If they closed its positions or insisted on margin calls, Tsingshan and Xiang could default. To prevent that they had to roll over or extend more credit. The likes of JPMorgan Chase, Standard Chartered and BNP Paribas were reportedly owed billions by Tsingshan and had to negotiate a deal postponing repayments and offering more credit. China Construction Bank also obliged with new credit lines and the Chinese government has reportedly advised banks to lend a helping hand. But uncertainty still haunts the market and those exposed to it.

These ripple effects of the Ukranian invasion across the world's economy and financial system point to how the transformation of capitalism in the last three decades and more has rendered it fragile. A shock can damage the world's economic and financial system through multiple routes. Not only will the war in Ukraine have catastrophic military and humanitarian consequences if no resolution is found, but its effects on inflation and on unexpected segments of a financialised world economy mired in speculation could precipitate another global economic crisis.

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