2 June 2022

Could Luna's crash be good for the crypto market?

Comparing virtual assets to a Ponzi scheme ignores that no one guarantees a return from investment into cryptocurrencies, often the defining feature of such schemes, argues **Wojciech Kozlowski, Business Development Director at Q Securities.**

How did the Luna crash happen?

Wojciech Kozlowski: The mechanisms behind this crash are no different from those in traditional financial markets. In short, whenever there's massive selling, the price of an asset drops.

In the case of Luna, we should not exclude that someone was playing short, meaning the event might have been orchestrated by some market players seeing the opportunity and the "gap" in the Terra ecosystem.

The crash is nothing unusual, just to recall the bitcoin and several price drops from the past, ranging from 20-30% and more of its value (March 2018, end of 2018, March 2020, May 2021). Although it happens more often than in the traditional finance world, one still needs to remember that the crypto ecosystem is a young one and, therefore, riskier.

Recent events may even be viewed as positive in the long term as the crypto space rids itself of solutions, which are susceptible to events such as the recent crash.

Why the sudden loss in value?

Luna invests in UST and loses money as the demand for UST increases. UST stablecoin was one of the network's foundations in the Terra ecosystem, and it stopped working as purposely designed. Market participants using UST were incentivised for Luna to keep a one-to-one peg with the dollar. The triggered selling hit UST, so it started to lose its peg to USD, which began to hit Luna heavily and led to the decline.

Consequently, when UST began trading significantly below its dollar peg, market participants started to exchange UST for other stablecoins, triggering the UST to decrease deeply. The price of Luna, the collateral for UST, dropped because of short selling. It led to a situation where Terra was forced to mint more Luna to reduce the negative price pressure, which we know didn't help at all. Finally, it led to crypto exchanges delisting Luna from trading, and now Luna and UST are "dead".

Would more stringent regulation help contain the crash?

The regulator in Luxembourg has already underlined before the Luna decline – and rightly so - that the virtual asset class should be at this point reserved for institutional and professional investors. In principle, any regulation bringing rules/duties/responsibilities usually has a positive effect on the professional clients – ensuring security, putting a framework, and raising risk awareness. And this is what we see with the recently expanded crypto regulation introduced by the CSSF.

Because of the Luna/UST narrative, market participants have become more mature regarding stablecoin recognition and distinguishing between asset-backed stablecoins vs algorithmic stablecoins. As a result, the attention given to crypto, in general, increases, which is a good thing. However, investors will undoubtedly become more cautious about different stablecoin operations and their reserves.

Some news outlets made references to a Ponzi scheme.

Comparing virtual assets to a Ponzi scheme overlooks that no one guarantees a return from investment into cryptocurrencies, which is usually the defining feature of such schemes. Some commentators tend to conflate volatility and high risk - typical for the virtual assets space - with fraud, which seems a step too far while assessing the recent events.

What’s the outlook for crypto assets?

Volatility is embedded in crypto investment, but the long-term market perspective stays bullish. Further massive price declines are not expected in the short term.

Two weeks after the Luna / UST crash, we already see the crypto-ecosystem stabilise. However, there is always a psychological effect in the trading space in general. Either investors will withstand the shocks (if their investment is long-term) or enter the stop-loss strategy to minimise their losses.

Having said that, one should not mix individual and institutional investors’ perspectives, as their expectations towards the investment differ, and so is the market behaviour.

The crypto market users – based on supply-demand driven behaviour – are creating crypto market swings. From a volatility standpoint, crypto assets do not significantly differ from traditional assets available in the regulated world of finance. Similarly to stock, commodity, or forex market shocks from the past, markets eventually stabilised and bounced back with time.