2010
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In–Depth Analysis

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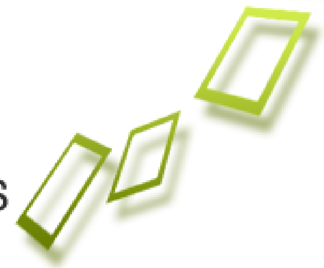

How the Greek Economic Crash Created Billions of Dollars in Forex Profits

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In this Issue:

The Greek Debt Crisis – Background.
Forex Traders – Overnight Millionaires.
Crisis Averted?
Europe's Black Debt Contagion
Fighting Debt with More Debt?
Taking Advantage of Uncertainty – Three Approaches
Conclusion.

The Greek Debt Crisis - Background

The bank stress tests in Europe, which took place earlier in July, represented only the most recent steps in understanding and evaluating the debt crisis which struck the euro zone in early 2010. That crisis appeared to materialize out of thin air following the election of a new ruling party in Greece at the end of last year.

With the election brought a new and more realistic assessment of Greece's sovereign debt situation. On 5 November 2009 the Greek government updated its budget and revealed for the first time a deficit of 12.7% of its 2009 GDP (later revealed to have actually been 13.6%), more than twice the previously disclosed estimate, and four times the 2008 estimate. Just one month later, the credit downgrades began. Immediately afterwards, however, the EUR kicked off a nose dive against its currency rivals that would not come to a halt until June.

The response from the citizens of Greece to the deficit reduction measures taken thereafter, and the international media's captivation with the corresponding demonstrations, only worsened sentiment across Europe. Among the measures taken by the Greek government were wage freezes, tax hikes, reduction of corporate bonuses, changes to the retirement age, and a number of other budget austerity measures. Labor strikes, demonstrations, and transportation freezes ensued across the country, gradually escalating, with 3 deaths in Athens occurring tragically due to rioting. But why did all this happen?

If we back up to the early 2000s we'll see that Greece was one of the fastest growing economies in the region. Due to the many investment opportunities in the small country, foreign capital was rushing in. Taking advantage of this influx, Greece allowed the rapid buildup of structural deficits in order to draw and assimilate left-leaning elements of the population back into the mainstream as part of a long-term reconciliation program, which began in 1974.

The rapid growth of the Greek economy was mirrored by record government spending, pushing the budget deficit over 100% of GDP from 1993 onward. When the financial crisis hit in 2007-2008, Greece was one of the hardest hit in the euro zone. Its economy depends on tourism and shipping, which both took a severe downturn during the recession. Greece's income dropped by 15% in 2009 as a result.

In the past, Greece had been able to tackle such economic crises with monetary measures, such as printing money to lower the value of the local currency. However, with the introduction of the euro, this option was no longer available. To remain a part of the European Monetary Union (EMU, or euro zone), Greece began to underreport its debt and conceal many of its economic realities.

Once Greece's debt problems became public knowledge, an economic witch hunt ensued. Other countries in the EMU began evaluating their debt levels during the discussions about a possible bailout for Greece, and investor confidence towards countries with high debt plummeted with haste. Those countries with high debt-per-GDP (Portugal, 9.4%; Spain, 11.2%; and, Ireland, 14.3%) were ostracized in the talks and concerns about an economic contagion rose.

Moreover, media pundits began to contemplate the possible collapse of the EMU and the death of the euro, adding more negative pressure on investor sentiment. German Chancellor Angela Merkel, along with the prime ministers of Spain and Greece, had commented that the combination of the media blitz against the region, and the role of speculators and hedge funds in selling the euro, had only added to the crisis, pushing it beyond what it should have been.

Meanwhile, the euro was still in free-fall. On 6 June 2010, the EUR/USD reached an all-time low of 1.1875; 125 pips below its 2001 opening price. To many, it looked as if the vultures were already hovering above, waiting for the euro's last breath.

Forex Traders – Overnight Millionaires

It was expected that currency speculators and hedge funds would jump into the fray and short the EUR amid the throes of crisis. The louder the media pundits shouted about economic collapse, the more sell positions entered the market and the further the euro dropped.

Making money during a recession, or any general downturn in the economy, is forever possible in the forex market by the ability of traders to short a currency whose country is in crisis. The speculation that "overnight millionaires" popped up across the currency trading world was no doubt true considering the size and duration of the Greek Debt Crisis of 2010, and coinciding freefall of the EUR. Such trading is responsible for the rise of such financial gurus as Warren Buffet, whose decision to short the British pound amid its revaluation in 1992 led to his earning over $1 billion with one trade.

Crisis Averted?

The actions of the European Union (EU) and the International Monetary Fund (IMF) in supporting a bailout loan to Greece, and a 750-billion-euro backstop for countries with a large debt-to-GDP ratio across the euro zone, helped to prevent a severe crash of the European economic system.

While the threat of resurgence is still possible, it appears that countries in the region are hard at work to check and ensure against any other economic surprises; which brings us to the recent wave of bank stress tests in July. The controversy of these stress tests, according to the same pundits who were expecting the death of the EUR, was that they were apparently not rigorous enough.

Since each country passed the stress tests with ease, there was a concern that the tests weren't performing the job they were intended to. The projections of economists and media pundits for an expectant collapse of the euro zone may have been over-inflated due to what Merkel and Co. were complaining about during the crisis. That is, the role of speculators and hedge funds, as well as the media, in worsening the crisis beyond what the authorities knew was realistic given the data.

No doubt the crisis is not yet over. Europe still faces a long-term battle with over-burdening debt, necessary financial overhauls, and various other economic and political reforms. But with the recent injection of positive news from the stress tests, as well as what appears to be steadily increasing consumer confidence and retail sales figures, the EUR is back on the rise and risk appetite is growing.

Europe's Black Debt Contagion

One of the larger concerns to arise from the debate about bailing out Greece was the fear that this debt crisis was bound to spread beyond one country and infect the entire region. The pejorative acronym for the countries at risk – P.I.I.G.S., for Portugal, Ireland, Italy, Greece and Spain – has helped market-watchers remember more easily which economies to keep an eye on, but also drives home the notion that this crisis has, and continues, to involve more than just Greece.

A common term being used among pundits for this recent crisis has come to be known as the Black Debt, in parody to the Black Death, or bubonic plague, which hit Europe in the 16th century. The implications of this labeling sound extreme, but the panic wreaking havoc on the regional economy is very real and that point is being driven home daily by media pundits.

Disagreements about the implementation of the bailout, the creation of a financial safety net for other ailing European economies, and the possibilities of Greece being unable to pay off its newly acquired debt – despite a positive first round of payments earlier this month – have only served to raise the specter of future crises.

A brief review of each country at risk may serve better to highlight the threat currently facing the euro zone's regional economy.

Portugal

Portugal was considered one of the first countries in Europe to experience a significant decline at the start of the recession of 2007-2008. Portugal was also labeled the new "sick man of Europe" in 2007 by The Economist due to its rapidly rising unemployment figures (increasing 65% from 2002 to 2007).

By 2009, Portugal had been downgraded by S&P to "negative" from "stable." Deep concerns regarding Portugal's structural weaknesses, the lesser competitiveness of Portuguese goods, and widespread political corruption were also expressed, sapping confidence from the beleaguered state.

In 2010, Portugal's unemployment rate topped 11%, and appears to still be rising today.

Ireland

According to the Central Statistics Office, Ireland was the first country in the euro zone to enter recession in 2008, marking the first time Ireland had experienced such an economic decline since the 1980s. Ireland would also enter an economic depression by 2009 after failing to see substantial economic progress in line with other global economies.

Ireland was one of many countries which fell victim to the housing bubble which formed from low interest rates and vast credit expansion throughout the late-1990s and early-2000s. By September 2008, the housing bubble had burst and economies tied up with the decade of housing and credit expansion began to feel the squeeze, Ireland included.

So far in 2010, Irish unemployment sits just above 11%; its economy was forecasted to contract 14%, but has experienced a minimal amount of growth in GDP, even while GNP continues to shrink by 1.4%.

Italy

While Italy is officially included in the group of troubled European states, it is actually in a better position than the others listed in the nefarious PIIGS acronym. One of the major causes of Italy's 2008-2010 economic slump has been a decline in auto sales and manufacturing, as well as less tourism. Italy – home to car-makers Ferrari, Lamborghini, Maserati, Fiat, and Alfa Romeo – experienced a 6.6% decline in industrial output over the past year and has had to announce various plant closures and layoffs for many auto manufacturers.

Plant layoffs and inherent structural weaknesses and corruption had pushed Italy's unemployment rate to 8.6% by mid-2010. The upside of Italy's financial crisis, however, is that the majority of its sovereign debt is domestically owned. While Greece will pay most of its debt payments to foreign holders, Italy will essentially be paying out to its own citizens. This has made fear of an Italian decline, or collapse, less severe than in other places.

Spain

Spain's economic woes sprang from the housing bubble collapse, financial defaults and bankruptcies, and a sudden corresponding spike in unemployment, which was linked mainly with an intense decline in building construction.

The lingering crisis in Spain today is the widespread unemployment, which topped 13.9% in February 2009, climbed to 17.4% by March 2010, and continues to ascend unabated, reaching over 20% by August, doubling the number of unemployed persons in just one year. Other employment figures reveal the hidden, darker side of the economic conditions of Spain. For example, a 42% unemployment rate among people aged 16-24 serves as the basic formula for future unrest and disaffection, pessimistically considered the roots of future revolution.

The positive side of Spain's economic struggles is the life-saving feature of the Spanish banking system. The conservative banking rules implemented throughout the financial structure has acted as a firm regulator of debt and borrowing. The recent wave of bank stress tests has revealed that Spain's banking system is by far the best equipped among the struggling economies to handle the recent liquidity crisis, helping to smother some of the flames over Spain's potential financial collapse.

Fighting Debt with More Debt?

Critics of the bailout plan have argued that a main cause of the recent financial crisis in the PIIGS economies has been a combination of poor investment, structural deficiencies, and corruption, and that bailing out these countries amounts to an enabling of this behavior in the future.

German Chancellor Angela Merkel has gone so far as to recommend strict budget austerity measures and high interest rates for any country taking from the €750 billion regional security fund.

Slovakia also took the step of withdrawing itself from the direct bailout of Greece, denying the struggling Greek economy of the €700 million that Slovakia was requested to put forth by the EU. Slovakia has also resisted the plans for final approval of the regional security fund, even though it has committed €4.4 billion to its coffers.

European governments have spent the last few decades constructing their current mountain of sovereign and structural debt to afford their citizens a quality of life previously unknown. This process was encouraged by private companies and investors, post-war and post-coup reconciliation efforts, a rapid market deregulation process which followed the end of the Cold War, and an unrealistic optimism which added to the recent housing bubble, including a culture which looked unfavorably on market skepticism.

Now, after the bubble popped and markets came crashing down, the solution seems to be to create a massive bailout pool which countries can access in times of need, and simply pay it off later, with interest. In other words, they can enter more debt, but to a different source. Americans know this process as paying off one credit card with another, which doesn't actually pay off the debt; it merely changes the recipient of the repayments.

The obvious critique is to point out this fact and push actively for economic and political reforms instead of bailouts, which is what countries like Slovakia and Germany are doing, much to the chagrin of PIIGS.

On the reverse side, the argument has been made, and is being pushed for by many of the struggling economies, that without such a bailout their economies will come crashing down and be pushed into default. If such an event occurs, it creates the very contagion (the Black Debt) that the euro zone wanted so desperately to prevent due to the interconnected nature of the regional economies. Once one country defaults, it can't repay loans to another that may also be at risk of default, and so on; creating, in theory, a deadly domino effect that brings the whole region down and kills the euro.

Taking Advantage of Uncertainty – Three Approaches

Currency traders sit in a unique position. Stocks and stock indices rise and fall from a wide variety of influences, often beyond the knowledge of traders. Currency markets, on the other hand, while volatile, still represent a relatively more predictable market.

If a country is in economic crisis, a trader need only look to the news and see the weight of negative sentiment pouring down on the state in question. Once an understanding has been reached that this crisis is ongoing, a trader may correlate this sentiment with a short position on the nation's currency; nine times out of ten, the trader is right.

A second approach would be to look to a specific currency pair. A trader would need only to understand which country is receiving a more positive outlook and "bet on the stronger horse."

Alternatively, there exists a third approach, which is somewhat more nuanced. Given the last three years of financial crisis, a different approach to analyzing currency trading has emerged; which may be deemed "normal vs. abnormal markets," or "gauging risk."

The former title is used to describe overall market conditions. Normal market conditions arise when the economy is not in crisis or recession; abnormal markets are the opposite. For example, right now the global economy would be considered as being in abnormal market conditions due to recession and various crises. Since we are in abnormal markets, safe-haven investments are of the utmost importance to investors.

This third approach breaks currencies into two groups as a result: safe-havens and riskier assets. The safe-haven group consists mainly of the US dollar (USD) and Japanese yen (JPY) only, with others slipping in occasionally depending on where crisis is hitting. Precious metals like Gold, Silver, and Platinum are also lumped in with safe-haven assets due to their value in times of crisis. Riskier assets include currencies with relatively higher rates of interest, such as the EUR, CAD, AUD, NZD, CHF, and the Scandinavian currencies like the Swedish, Danish, and Norwegian Kroner (SEK, DKK, and NOK, respectively).

This approach holds that when economic news is positive, regardless of location, the riskier assets will rise in relativity to the importance of the news to the country of the currency. For example, if Canada were to release a positive figure for retail sales, the riskier assets would all rise, but the CAD would rise more than the others due to its correlation with the source of the economic figures.

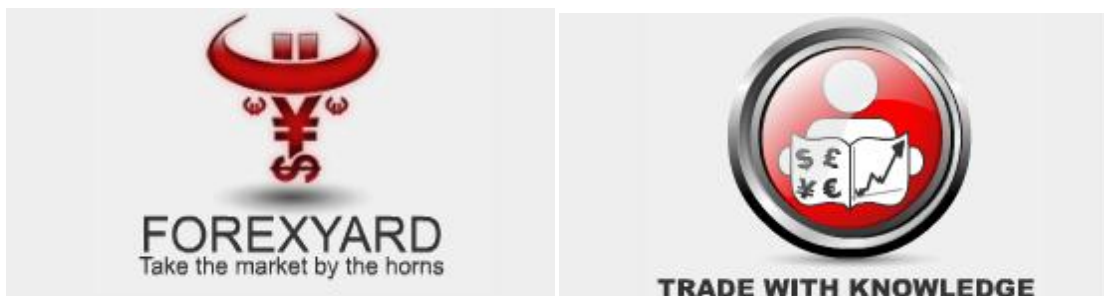
Conversely, if an economy were to publish a negative report, such as a decline in consumer confidence or employment, then safe-haven assets, like the USD and JPY would rise as traders fled from riskier assets and moved en masse to currencies which have a relatively safer status among financial markets and lower rates of interest.

This could get confusing occasionally, especially if the US or Japan was the country to publish the negative reports. For instance, if the American government announced that its GDP was shrinking and consumer optimism had decreased, the USD would actually rise due to the flight away from risk, which made little sense to many investors looking only at the micro view of the economy.

This third approach takes into consideration the impact of globalization and puts currency trading in the perspective of the macro view of the global economy. Here, investments move as an ocean of magnetic objects bouncing back and forth between two poles. On one side are the safe-haven assets protecting investments from risk, on the other are the risks traders are willing to take when things look slightly more optimistic.

Conclusion

In the perspective of the Greek Debt Crisis of 2010, Europe was one of the only regions in the "riskier assets" column. As news got worse, regardless of locale, European currencies fell (with the exception of the Swiss Franc – CHF – which was growing rapidly against its European counterparts for various reasons). Once news turned positive, however, we've seen the euro and British pound paring losses and regaining their former status. The big question to ask now is whether these gains are due to the actual growth of these countries, or from the ebb and flow of risk appetite in line with this third approach.



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