



Foreign Exchange and the Crisis



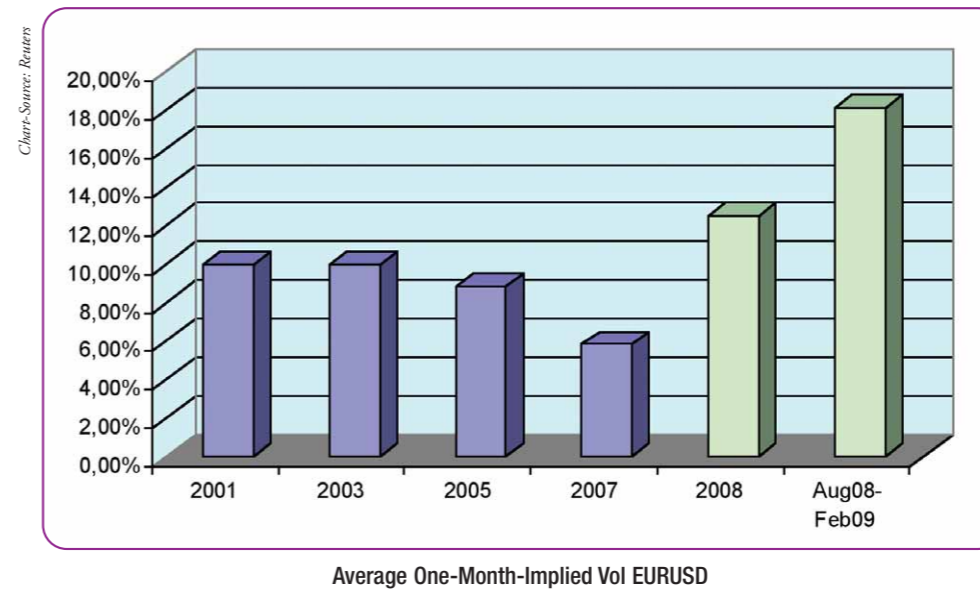
Forex is also a dynamic market that has evolved and survived countless financial crises since the gold standard was abandoned in 1971 and in particular, is handling the current financial earthquake remarkably well. This is not to say that it is immune to the economic crisis. In fact, as with all other markets Forex has experienced an extensive increase in volatility as a consequence of the dislocations in other financial markets.

With the transition in Europe of the single currency, both historical and implied volatility have declined during the past decade and remained persistently low until last year. Taking the Euro Dollar pair as an example, the one month implied volatility in the year 2000 averaged around 13%. As graphically illustrated below, in the subsequent years volatility has gradually declined to reach a bottom at just under 6% in 2007 and simply to shoot-up to around 12.5% in 2008.

Then if we had to look even closer, the same average one month implied volatility registered in the past six months (AUG08-FEB09) was of 18%.

Manfred Wiebogen,
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The foreign exchange market is arguably the most exciting market of all. Daily average turnover has increased by 210% during the period 2001 to 2007 according to the latest BIS Annual Report. More importantly, Foreign Exchange has become a respected asset class on its own merits and given that it is typically non-correlated to other assets it provides good diversification.



Albeit for different reasons, the best performing currencies in the past 12 months were the US Dollar, the Swiss Franc and the Japanese Yen. The dollar gained from repatriations and perhaps from its status as a safe haven, given that it is the world's preferred reserve currency. The Swiss Franc appreciated thanks to its historical role as a safe-haven and the Yen surge was prompted due to a dramatic unwinding of the carry trade. On the other hand, as shown below the worst performers amongst the main currencies were the British Pound and commodity currencies.

Given that the problems originated in the US and given that the US finances are in a much worse state than that of peer G7 countries I was amazed by the performance of the US dollar which, with the exception of the Swiss Franc gained across the board.

Massive debts running into trillions of dollars ought to be repaid and this time round, the global economy will not allow the US to solve its woes through endless

cheap credit. The only feasible way that the US debt could be manageable is through inflation and US policy makers are sure to induce inflation so as to inflate asset prices and reduce the burden of debt. Both initiatives could point to a lower dollar over the medium to the longer term.

On a way forward, many are now starting to speculate whether the current crisis will push countries closer to the European Monetary Union and its single currency. Eastern European Countries can only observe with envy how much stability the Euro has brought to Slovenia, Slovakia and even Ireland during the crisis.

Whether new countries are now able and still welcome to join the Euro is still to be discussed. Certainly, what this crisis has taught us is that when liquidity dries up, you need to have a strong Central Bank able to print not only its own currency but also to provide other hard currency, as has happened in the recent months.

