How Dangerous Is Crypto Leverage?

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The prospect of there being spot Bitcoin ETFs has driven Bitcoin values higher. It also appears to have sparked an altcoin rally. One of the worrisome aspects of all this is the increased use of leverage in crypto trading. Traders in the Forex markets have used leverage for years. Today in the world of crypto trading this tool offers both advantages and risks. What are the ways in which leverage helps a crypto trader? How dangerous is crypto leverage when misused?

Rising Leverage in Crypto

Bloomberg reports that there is **rising leverage in crypto** largely indicated by higher DeFi rates. The increasingly higher interest rates for borrowing stablecoins indicates that traders are betting on a continued crypto rally. After being suppressed due to crypto winter, decentralized finance operations are making a comeback. One aspect of this business is charging interest to borrow stablecoins like Tether or USDC. These rates have recently risen to the 10% range. In what is called the perpetual futures market funding rates have turned positive. This fact indicates that crypto speculators are expecting crypto prices to rally. What the crypto market shows us is that XRP went up 12%.

How Does Leverage Play Into This Crypto Picture?

Leverage trading in crypto allows a trader to command positions in excess of the amount of money they have committed to trading. As we noted, this approach has been used in trading currencies (Forex market) for years. Foreign currencies like the dollar and euro trade at extremely high volumes and liquidity. Daily price swings are generally very small. In order to make money in trading major currencies like the dollar versus the yen, euro, or British pound, traders borrow from their broker and trade with leverage. This increases their potential profit and also increases their potential loss. Because major currencies do not fluctuate greatly, the risk is generally not excessive. This is not the case in trading cryptocurrencies which are much more volatile.

Profit Potential Versus Risk in Crypto Trading

In the crypto world a trader puts money in a trading account and can borrow against that account to trade with leverage. The amount of leverage can range from five to one to fifty to one. Thus, with fifty to one leverage a trader puts up the money to purchase 100 tokens of their choice but get fifty times that or 5,000. When the token goes up in value they can sell and get a much greater profit than if they had only purchased 100. The problem comes when the price of the token falls. If this were the Forex market where prices move by fractions of a percent, the risk of getting wiped out is very small. In the crypto market where prices can easily fall by 15% in a day, such a drop with one to fifty leverage means that the person's initial investment is wiped out and they owe the broker about six and a half times that initial investment!

Danger of the Wealth Effect in Crypto Trading

When anyone buys crypto tokens, stocks, or currencies and the price goes up they often start to feel very rich. This is the "wealth effect." An old saying in the stock market is that you do not have a profit until you take a profit. Namely, your profit occurs when you cash out and have more money than you started with. Until then you are still in an active investment or trade which can go down as easily as it went up. Novice traders can, often by luck, make a trade that works out very well. Rather than taking their profit they act like someone in a movie at the roulette tables in Monte Carlo and "let their bet ride." What goes up also comes down and in the real world folks who try to win many times back to back at roulette lose their money. This is the risk of the wealth effect in crypto trading, especially when the trader uses leverage again and again and leaves all of their potential gains in their trades.

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