



Charles Purdy

Tough on debt; tough on the causes of debt

CAN IT GET ANY WORSE FOR EURO AND STERLING?

Given recent and not so recent events this is a question I am often asked and my very simple answer is yes. Especially as the world becomes a riskier place for governments defaulting on their debt.

It is not many years ago that Argentina decided to default on their government debt following years of austerity forced upon them by the International Monetary Fund (IMF). The reason the IMF was involved it because they act – put in simple terms – as a lender of last resort for countries where they are unable to pay their debt.

But when they do, they insist that the government undertakes a course of action where income is matched to expenditure. This usually means that expenditure is cut as it is more difficult to increase income. And in the case of Argentina, this meant that growth in their economy ground to a halt, unemployment rose and everyone became miserable.

But after too many years of misery, enough was enough and the government decided to ignore the IMF, move the economy forward and default on their debt. The well informed markets had already written down the Argentinean government debt.

The UK has also had to call on the services of the IMF as effectively a lender of last resort. If I remember correctly this was under Jim Callaghan and the Labour government. Strangely we seemed to sort out our debt problems much quicker than

expected and managed to avoid years of austerity and zero growth.

This time it is different – but not in a good way. Greece has been forced to impose draconian austerity measures, not by the IMF, but by its fellow eurozone partners so that it brings income back into line with expenditure. And as a result we have seen huge unrest in Greece and very sadly, the loss of life from the ensuing riots.

Why on earth did Greece adopt the euro? Who on earth believed the Germans and Greek economies could march to the same beat? These questions are not just common to Greece as they also apply to Spain, Portugal, Italy and Ireland, and there's no easy answer to them. Any solutions to the current situation and the eurozone government debt problems are going to be difficult to implement.

The first solution has been for the European Central Bank to put in place a rescue package of €750bn for Greece, Spain et al. This was done to avoid a run on eurozone government debt. But the road ahead is not going to be easy because, a bit like Argentina's experience, the medicine in some ways is worse than the illness as seen in Greece.

The one advantage that the UK has in the current situation relative to Greece or Spain and the others listed earlier is that sterling can be and has depreciated – which means that the UK's exports become more competitive. This should mean that the economy benefits. So our economy has greater flexibility in rebalancing itself and matching income to expenditure. Clearly,

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the hard yards still have to be covered which the new coalition government is doing by cutting expenditure. Their first instalment has been announced with £6.2bn of cuts.

The main beneficiary has been the US\$ which is seen as a safe haven asset in these volatile times. Slightly strange, given the level of US government debt – but they do have a couple of advantages. Firstly, the US economy seems to be ahead of the curve in its recovery. Secondly, the whole world holds huge quantities of US\$ and as such is keen not to see it lose value. Even the Russian and Chinese governments, who had hoped to diversify their holding of currency reserves away from the US\$, have been “forced” to increase their holdings.

So what are the next steps for the eurozone and the UK?

The markets are very concerned that if they cut expenditure we will see a double dip recession. So a very difficult balancing act. The markets want to see the government debts being controlled, but the respective economies still growing.

My overall thought process is positive long term for the UK and sterling. We will experience some pain, but UK government expenditure was out of control and British business was becoming too highly taxed. It was vital to realign the economy and be proactive in moving forward with a sensible balance between the private and public sectors. It won't be easy, but we do have the advantage of marching to our own beat.

In the eurozone, until they understand that one size does not fit all, I think they are going to have very major problems as the only tool in the box for the various under pressure countries is wholesale cuts in costs – and as Argentina has shown this is ultimately unpalatable. This will not be good for the euro short to medium term. □

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