

The future for the Euro and Sterling

Charles Purdy reports for Business Destinations on public debt and currency exchange on the continent

WE HAVE BEEN STUCK IN A FAIRLY NARROW RANGE CLOSE TO €1.16/£1 FOR A FEW WEEKS AND THE QUESTION OFTEN ASKED IS: "WHERE TO NOW?"

At the start of 2009, finance experts set a target price for sterling against the euro of €1.25/£1. The logic for this was that sterling had been oversold [i.e. was too low a value] and to regain purchasing power parity sterling needed to regain lost ground.

What was the cause of the euro gaining ground against sterling three months before Christmas? It was very simple: the disasters that befell most of the major UK banks. HBOS and RBS would have gone bust without Government intervention as they seemed to have bet on [or invested in] the US sub prime housing market. The fact that HBOS nearly took Lloyds with it indicates how the UK government underestimated the depth of the problems [as did Lloyds]. Even HSBC, who didn't need a bailout, had to write off huge amounts of money invested in the US. So, Sterling lost ground as it became totally unloved. At one point it was very close to parity with the euro.

Post Christmas, sterling began to gain ground against the euro as it became clear that Euro land was not immune to the rest of the world's problems. This manifested itself in two ways. Firstly, countries like Spain and Ireland who had run with the crowd saw property prices fall through the floor and their respective construction industries grind to a halt. Secondly, countries like Germany, the world's largest exporter, found world trade stopped and there was no home for their production. The fall in exports was staggering - twenty five percent on a year by year basis. To put this in perspective, it probably took Germany nearly 20 years to build up to the pre-crash level of exports and less than three months to see it disappear. Frightening.

The world now seems to have stabilised and the world economy, in most people's views, is close to bottom. I think that's probably a fair assessment. And most sensible people agree that it is going to be a slow and steady process in the recovery phase. Anything better than slow and steady should be welcomed as and when it happens.

In both the UK and Euro land the banks threw huge amounts of money at the problem and introduced new and untried methods to help keep interest rates down.

So why hasn't sterling continued to gain ground against the euro if it is viewed to be undervalued? The major problem is the astronomic level of debt the UK

government has to raise and the complete lack of a plan to pay it back. The first element means that each month, the UK government has to issue large amounts of government bonds which means that it has to entice investors from throughout the world. These investors have to buy sterling to invest in the bonds

which exerts downward pressure on sterling. The second point is that everyone knows we have to reduce government expenditure so our inflow exceeds outflow.

What about Euro land? They have different problems. The Euro land banks seemed to avoid the worse of the US sub prime loan debacle. However, they did lend huge amounts to Eastern Europe and given the collapse in the world's



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economy there seem to be problems in how these loans will be serviced and/or repaid. If the lending banks have to write off these debts, the European Central Bank [ECB] may well be looking at a banking crisis equal to the one we saw in the US and UK. The ECB does have a couple of advantages. Firstly, access to huge amounts of funding given the makeup of Euro land and secondly, the ability to make funds available in a much simpler way than the UK Government - which means they can act more effectively and efficiently.

So what does this mean? In simple terms, until there is clarity on how the UK Government is going to start paying its debt with a believable plan and/or the extent of the Euro land banking problems with Eastern European loans and how they are going to be serviced, I think the €/£ exchange rate will lack any direction. It needs a catalyst to say "go this way" and such a catalyst seems to be sorely lacking. In the short term, we will see some better days for sterling and some better days for the euro and as such, I would recommend taking advantage of any short term gain - as it could be a very long wait! ●