

Swings and roundabouts

WE SEEM TO have entered a parallel world where the unusual has become the norm. Before Northern Rock's nationalisation and the demise of Lehman Brothers, exchange rates changed but the movement tended to be predictable and slow to happen.

Nowadays exchange rates can move two or three cents in the matter of two or three hours. But having said that, what I have found interesting over the last two years is that although movement in the euro/pound exchange rate has been volatile, the range in which it has moved has been fairly limited too.

When queues stood outside Northern Rock branches it was fairly clear that sterling was going to move one way and that was downwards. In the following years it lost 25 percent-plus against most currencies and even more against other currencies such as the Australian dollar, where the commodity-based economy enjoyed higher yields and better economic conditions.

Now that we are seeing rioting in the streets of Greece and the possibility of the eurozone being split up it seems strange that the euro hasn't been weaker. Against sterling it has stayed in a limited range of €1.10/£1 to €1.20/£1 over the last twelve months. I must admit I find it difficult to find any cogent explanation, especially when you look at the depth of the debt problems for both eurozone governments and their banks.

The recent meeting of the eurozone prime ministers agreed that the eurozone banks needed another €100bn in equity and that the European Central Bank needed another €600bn

in fire power to help the debt-laden eurozone governments fund their debts in the short term. And these figures are viewed as being on the low side by international investors who would have no problem in doubling these additional amounts of equity.

So why hasn't the euro plunged against all other currencies? I think there are two reasons. Firstly, the eurozone in totality has a balance of payments surplus. The reason for this is

Germany, who is the world's second largest exporter after China. This puts the eurozone in a much stronger position than say the UK or the USA, who both have significant balance of payment deficits. The other is that these two economies have not been in the best of health themselves and the recent upheaval in the eurozone has been detrimental to their economic recoveries.

And I don't see this position changing any time soon.

Detailed discussion of the woes of the UK economy have not been front page news for the last two months, but they are still there. UK government expenditure is still too high. I do wonder how much expenditure has actually been cut. And we can see from Italy and Greece the dangers of not doing this properly and quickly.

Ireland sits at the other end of the spectrum, having attacked its government costs quickly and by significant amounts at the start of the financial meltdown. Although not out of the woods, at least they know they have given themselves the best chance of benefiting from better days when they finally return.

The commodity backed currencies are in an interesting position as they are so dependent

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As we attempt to explain the currency turbulence of 2011, what can we expect from the coming year?

on China and its – to date – insatiable need for commodities. Their great fear is that if this comes to an end it will be a major source of pain as their economies have grown on the back of Chinese demand. How likely is this? It is very difficult to assess, as there will be extreme political pressure on the Chinese government to keep their economy growing, albeit not at the breakneck rates of recent years.

The US dollar has had mixed fortunes. Their economy is in a bad state with unemployment staying stubbornly high and close to the 10 million level. However, the dollar does have the benefit of being viewed as a safe haven asset and as such, as risk aversion increases, the dollar strengthens. But interest rates will be kept at their very low levels for quite a while yet. In fact, I don't expect them to increase rates until 2013 at the very earliest.

And interest rates are likely to be held, or even lowered elsewhere in an effort to encourage growth and avoid a double dip recession. Australia and the eurozone have both had interest rate cuts in the last quarter of 2011.

So where to next for sterling? I don't see much upside against the US dollar, even with its extensive economic problems. It is still the world's largest economy – but the USA does have to reduce government expenditure and increase tax. Against the euro, my best bet would be more of the same, but with a greater likelihood of sterling strengthening and perhaps consolidating at around the €1.25/£1. But, as ever, I could be very wrong if the eurozone finds a long-term solution to its debt problems, or alternatively breaks asunder. □

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