Who will win the global currency wars?

By Dominic Frisby

Whether the money has gone on expensive welfare states, bailing out banks, bureaucratic waste or the military, the majority of western governments are now sitting on debt they cannot realistically hope to repay. They have, in addition, unfunded liabilities that, were they properly accounted for, would be in breach of the regulations and standards governments themselves have set for major international corporations.

It's a huge problem. Some governments have made noises about cutting spending, others have even taken small steps in this direction, but big spending cuts don't win elections. Hence the preferred and widely implemented means to devalue debt: the insidious process of currency debasement.

Everyone wants a weaker currency, in the hope that they can sell more exports and reduce their labour costs without actually slashing wages. Every central bank is at it in some way or other – printing money and buying their own governments' bonds, holding interest rates at ultra-low levels, pegging their currencies to those of other countries, and concealing the real rate of inflation.

In the last few months we've seen a change of leadership in Japan and a sudden capitulation of the yen – a capitulation, it must be said, that had been many years coming. We've seen all sorts of tension between the US and China over currency values. We've seen European Central Bank (ECB) president Mario Draghi bend his rules to bail out the weaker nations under his jurisdiction. Federal Reserve president Ben Bernanke is notorious for his expansionary policies. And our new Bank of England governor-to-be, Mark Carney, believes there's a lot more that monetary policy can do to help the economy – which is office-speak for currency debasement.

Welcome to the global currency wars. Or, as my kids would call it, beggar thy neighbour.

The dollar versus the pound

Of the developed nations, this is a war that the UK is well-equipped to win. We've already listed Britain's many problems on page 8. Over time this should manifest itself in a markedly lower pound. The thing is, everybody else is playing the same game, which may limit how far we can devalue.

$1.63
The pound's 2013 high against the dollar

What's more, we have already stolen a march on our competitors. From its high of $2.11 in late 2007 to its low of $1.36 in early 2009, the pound lost about a third of its value. It has since rebounded, and has been locked in a trading range, for almost four years, between about $1.70 and $1.40. That range is tightening. The last 30 months have been compressed between around $1.65 and $1.50.

This type of narrowing range usually presages a big move. The issue is whether that move is higher or lower.

My instinct says lower, as might yours. But there is very long-term support in the $1.35-$1.40 range. The only time we have been below that was at the height of the unrest of the miners' strike in 1984-5. The $1.35-$1.40 mark even held during aftermath of Black Wednesday, George Soros's raid on the pound and its withdrawal from the European Exchange Rate Mechanism in 1992. It will take something very big to get us through that and back to parity (that is, where one pound is worth one US dollar), which some of the more extreme forecasters have been calling for.

It's quite possible that Carney could be the catalyst to push the pound down through that support. He has hinted that monetary policy can and should go further still to encourage growth (or inspire inflation, which is the more likely event). For now, though, we remain in the range. $1.50 is support and $1.65 is resistance. If you run a business that requires foreign exchange, my advice would be to sell sterling anywhere near $1.65, if it rallies back to those kind of levels.

The euro versus the pound

The euro situation is peculiar. Northern Europe, in particular Germany's economy, might gives it strength. But Southern Europe makes it weak. Draghi has made it known that he doesn't want a strong euro, but his hands are still rather more tied than those of his other central bankers who are in charge of one country alone.

Because of the political problems Draghi faces in printing money, euro strength may lie ahead. But if Spain, Italy, Greece, Portugal, France or Ireland require bailing-out or further bailing-out – and the precedent has been set – that is going to lead to euro weakness.

The pound has also traded in a narrow range against the euro over the last three years. €0.78 is support and €0.90 is resistance. The tightness of the range again suggests that a big move may be coming. Overall I favour the euro ahead of the pound, and would be a buyer in the €0.80-€0.82 range.

Another good reason to stick with gold

It all makes for a rather blurred picture. You're being forced to think: "Which is the least bad?" and: "Where is a crisis going to hit first?" It's hardly investing for growth. And that's why there is still such a strong case for owning gold. Gold can of course be undermined in many ways, but it is not subject to the same pressures of debasement that national currencies currently find themselves under. You can't print gold, as the saying goes.

Returning to the theme of tight ranges, gold itself has been stuck in a range for the last 18 months. $1,500 an ounce is support and $1,900 is resistance. The US dollar index, meanwhile, which measures the dollar against a basket of foreign currencies, has also been range-bound between 79 and 83. Such tight movements cannot last – it all portends some big moves ahead in the global currency wars. ●