View from the Bridge

an alternative look at the investment world

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A sterile landscape

A place incapable of supporting life as we know it – a good description of where ECB monetary policy is leading us. Currency debasement is almost certainly where we are headed because of Dr. Aghi's assertion that the euro is irreversible, not despite it. He bravely assumes that in making such a statement he is creating an aura of consensus and strength. In its current form the euro is a busted flush and is being held together solely by political intransigence and ECB connivance. From the very beginning the rules of engagement were ignored because without political and fiscal centralisation they weren't going to work anyway.

But did this stop most of the eurozone countries – and the Southern "Methadone" Zone in particular – from getting on board the gravy train and going on one hell of a trip courtesy of German style interest rates. It would have been rude not to! And no worries about the lack of a long term structure to keep this thing on the rails; we can deal with that later. Well later is now and guess what? They all want to stay on the train but can no longer afford the fare; ignoring the fact that they never could in the first place.

One of the many problems the eurozone faces, along with the US, UK, Japan et al, is how to service their massive debt burden. They can't, but insist on reapplying the band aid to create the illusion of progress. As Einstein put it, "insanity is doing the same thing over and over again and expecting different results." We now have OMT to ponder upon – Outright Monetary Transactions. My reaction thus far has been "OMG!" Typical of an ill conceived contrivance, the press release on the "technical" features of OMT comprises 17 short sentences; one of which says, "the liquidity created through Outright Monetary Transactions will be fully sterilised," but doesn't say how – that would just be too technical!

Money "printing" involves a central bank buying "assets", usually sovereign debt, and crediting the seller with money that it has created electronically. The theory being that this money is used to encourage spending by way of loans to consumers and corporates, but which has the potential outcome of higher inflation. It should also drive short term rates down if, like with the OMT operation, the ECB is buying at the short end of the curve – the complete reverse of the Fed's Operation Twist by the way. The announcement of OMT has had the desired effect on rates, especially Spanish and Italian, where the cost of new issuance was creating the debt servicing issue mentioned earlier. However with more than a nod to the Bundesbank, the ECB has declared that it will sterilise the purchases so that there will be no inflationary effect. They can do this either by selling other assets, for example long dated issues or attract deposits at the ECB both of which remove the newly created money from circulation. The first option is unlikely as they really don't want to drive longer term rates upwards, so they are left with the second or they could instead sell some of their gold reserves, but that would be akin to selling the family "silver". They wouldn't do that would they? Well they might! Thinking that politicians and central bankers would be so crass is another example of one of life's "heroic" assumptions. The Chinese would have it off them in a trice and how would that help the cause?

Currently, such is the lack of trust in the interbank market that attracting money into ECB deposits is not a short term problem, but by such sterilisation the benefit of loan growth on spending is lost. So this is just another short term breathing space to allow the PIIGS to refinance their maturing debt at less penal rates, but does absolutely nothing to solve the longer term problems of creating growth in economies stifled by ECB "conditionality"; a very sterile landscape indeed. But cheer up! QE3 will be along any day now to help the banks remain solvent for a while longer. Can exits stage right after another good kicking…