Economic Viewpoint

A failing currency warrior draws on German taxpayers to bail out Rome and Italian bank stakeholders

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KEY MESSAGES

- ECB Chief Draghi's latest currency offensive has failed.
- Simultaneously the chief launched a vast new transfer program which takes from German taxpayers and savers and gives to weak banks and sovereign governments in Southern Europe.
- Yet Chancellor Merkel refuses to say or do anything in support of the Bundesbank which is protesting this program.
- The political consequences of the Draghi transfer coup and Berlin's silence are incalculable but surely immense in any long-run perspective

Berlin and Washington's silence is deafening

Almost certainly Mario Draghi anticipated that his latest monetary package would depreciate the euro.

This did not happen, largely because first the rate cuts were trivial (5 to 10bp) and more than discounted already in market prices; second the chief hinted strongly that no further cuts were on the agenda under likely future circumstances; third, the extra amount of bond purchases over the next year amounting to around 2% of GDP was hardly a game changer in any sense.

Finally, the ECB chief's new demonstration of largesse (at the German taxpayer's ultimate expense) – a potentially massive bail out of the equity holders and bond holders in weak European banks, concentrated in Sig. Draghi's home country - effectively banishes the spectre of European banking crisis any time soon, which in principle is euro-positive.

In effect given the extent to which Italian banks have lent to the government in Rome, the ECB is drawing credit lines on the German taxpayer to underpin the price of Italian government debt. The ECB is to organize four unlimited LTROs which will provide long-term finance to European banks at -0.4% interest cost.

German savings banks will earn significantly negative rates on their huge surpluses at the ECB which are lent on as part of the Draghi transfer program to weak sovereigns and banks in Southern Europe, most of all Italy. This is a far cry from the lender of last resort function as envisaged by Walter Bagehot and as practiced by orthodox central bankers up to the wild lending at non-penal rates by the Bernanke Fed from 2007 onwards.

Yes, there was a lot of excitement in Mario Draghi's remarks about the decision that the ECB would now buy non-financial corporate debt as part of its QE operations, but what non-official investor in their right mind would now buy such paper at premium prices when there are huge supplies of now better value non-euro corporate debt whose price is not artificially inflated by such operations. The ECB is simply scaring non-official buyers away – not a great feat.

One might have expected some unfavourable reactions from Germany and the US to Mario Draghi's latest monetary experimentation. The Treaty of Maastricht does not permit such t transfers to be imposed by the ECB – effective levies on taxpayers in one nation for the benefit of another.

In another world, the German Chancellor would be sounding the alarm and putting Chief Draghi on warning that unless the loan program is reversed the Federal Republic might not remain a member of his monetary union. And indeed a renowned ex-Bundesbanker and other German financial experts have expressed some dismay. But there has been total silence from Berlin.

But this is the world of Chancellor Merkel and her costly legacies for Germany – including the virtual crumbling of democratic checks and balances in that country.

According to Sig. Draghi's response to a press conference there were votes against his latest package from the German Board Member at the ECB and the Dutch central bank president. According to the rotation voting system for national central bank presidents, the Bundesbank did not have an explicit say this time round, but its President nonetheless made his objection known.

It would not be surprising if German public opinion were to become hostile to the elites which had brought about a situation where an Italian ECB chief could effectively transfer vast amounts of German wealth into the black hole of the Southern European banks and public finances. It is as unpredictable as to how populism will crystalize in Germany as in the US. Strong outcomes for the Far Right in this weekend's regional elections in Germany are already widely expected, but much more important are the possible convulsions ahead within the mainstream German parties.

One might have thought that Washington would react negatively to what is tantamount a new currency war offensive, even though it seems to have failed rapidly on this occasion. But we all know by now that the Obama Administration sides with Paris, not Berlin, and sees euro-system “stability” as crucial to avoiding any repeat of the 2008 financial crisis. Perhaps Mr. Trump could include Europe alongside Japan and China in his list of currency manipulators to be punished by trade sanctions should he become President, but the white working class population in the US whose living standards continually deteriorate are not blaming unfair European completion in the main.

In sum Germany will suffer Mario Draghi until they don’t.

The huge and growing ECB balance sheet is ultimately a liability of Germany, something which safe-haven investors in German government bonds should consider seriously. In the meantime his experimentation will dampen or more likely suffocate any stirrings for economic reforms. Why when governments can borrow at negative rates and the ailing banks have unlimited access to negative rate finance should anyone incur wrath from voters or anyone else such as would occur under programs of meaningful reform.

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