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## For All the Talking G-20 Leaders Do, the Bond Vigilantes Are in Charge

- By IRWIN STELZER



The leaders of 20 nations representing more than 90% of the world's gross domestic product gathered amid the security, pomp and circumstance they consider appropriate to their exalted positions. Exalted, but hardly permanent — witness the absence of deposed Australian Prime Minister Kevin Rudd and Gordon Brown, the father of the anti-crisis measures that most of the nations present relied on for their survival. The leaders met, they 'et', they pronounced, they posed. Signifying nothing, or at least not very much because the most important players were not at the table. The bond vigilantes were nowhere to be seen.

Look at it this way. The European leaders present organized a package they confidently announced would halt the spread of the Greek contagion. It didn't. Greek, Irish, Italian, Portuguese and Spanish bonds still sell at substantial premiums over safer German bunds, with Greece leading the parade at a 5 percentage point premium, a huge increase from the quarter point premium it paid at around this time last year. Europe's banks remain reluctant to lend to one another, and investors are looking elsewhere to deploy their funds, forcing the troubled countries to borrow from the European Central Bank. Banks in Greece, Portugal,

Ireland and Spain, representing 18% of euro-zone GDP, account for 68% of the €332 billion (\$441 billion) increase in ECB lending since last June according to the [Royal Bank of Scotland](#). The markets and the bond vigilantes are unimpressed by the €750 billion rescue fund euro-zone leaders are amassing. Something is missing, and it isn't more bail-out money.

Equally inconsequential are the pronouncements of the G-20 leaders. This impotence is due in part, but only in part, to the shaky domestic position of three of the most important players. Barack Obama's approval rating has dipped below 50%, and he was unable in advance of the meeting to persuade his own Democratic congress to pass a second stimulus package of the sort he is proposing other nations adopt.

Angela Merkel lost an important local election and saw the approval rating of her coalition plunge to 35% after she reluctantly agreed, in effect, to make Germany's balance sheet available to profligate Greece. And Nicolas Sarkozy's popularity isn't what it once was as he nervously prepares for an electoral challenge from long-time rival Dominique de Villepin's new political party and, perhaps International Monetary Fund head, Dominique Strauss-Kahn.

Add to that the failure of these weakened leaders to agree how to fashion a sustainable recovery. Mr. Obama wants continued stimulus spending by surplus nations such as Germany to boost demand now that Americans are too deeply in debt to be the world's consumers of last resort. He is joined in that view by Mr. Strauss-Kahn and Indian Prime Minister Manmohan Singh. Mrs. Merkel prefers austerity, which she argues will create confidence and stepped up consumer spending. She has ECB President Jean-Claude

Trichet, European Commission President José Manuel Barroso and China's President Hu Jintao in her corner. Mr. Sarkozy would like to see a bit of inflation to help pay down the debt his nation has run up with 30 years of unbalanced budgets, and push the euro exchange rate down further to make France more competitive in markets outside the euro zone and help it grow out of its indebtedness. Absent that, he fears, France, already paying a 0.5% premium over German bunds, will lose its triple-A rating, which would have a negative effect on "La Gloire Française," even more important to Mr. Sarkozy's constituents than higher interest rates.

All three leaders are victims of their countries' histories. Mr. Obama fears a repetition of the double dip depression caused by premature tightening by the Federal Reserve Board in the 1930s. If he forgets, he has the premier student of that period, Fed chairman Ben Bernanke to remind him. Mrs. Merkel is also in thrall to her country's history in the 1930s: runaway inflation caused by large debts wiped out thrifty German savers and added to the attraction of Adolph Hitler. And Mr. Sarkozy is mindful of the civil strife produced by students, trade unions and ordinary folks when some entitlement is taken away from them. This is, after all, a polity that considers it a violation of human rights to extend the retirement age from age 60 to age 62.

This contributes to the sterile debate of austerity vs. stimulus, diverting attention from what really needs to be done—"prune to enable healthy shoots to grow", as Robert Zoellick, the seemingly horticulturally inclined head of the World Bank puts it. Austerity for the financially anemic, spending support from the robust. Less regulation of entrepreneurial activity. More freedom for employers to fire so that they feel more comfortable to hire. More reliance on

consumption taxes, less on business taxes. More support for a Schumpeterian wave of creative destruction, even if it washes away national champions.

That would appease the market vigilantes, who won't wait for the November meeting in Seoul to remind the G-20 just who is in charge of the world economy.

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