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Who is the Euro Zone's Alexander Hamilton?

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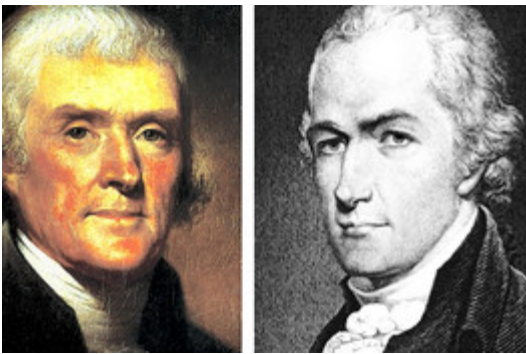


This is the year in which we will find out if there is an Alexander Hamilton somewhere among the euroland political and bureaucratic elite. Recall: it was Hamilton, the first U.S. secretary of the Treasury, who finally persuaded his political opponents to allow the new federal government to assume the debts of the 13 states that formed the new United States of America. Those opponents, led by Virginia's Thomas Jefferson, secretary of state and later president, argued that states that had repaid a good portion of their debts should not be forced to subsidize their more profligate neighbors. In 1790 Hamilton and Jefferson cut a deal: the Virginian supported the debt-assumption plan, and Hamilton supported the establishment of the nation's capital close to Virginia.

The euro zone now faces a similar choice. The markets are making it very clear that they are no longer willing to lend money to the profligate, no-growth periphery nations at sustainable rates, but do find the region as a whole, represented last week by a €5 billion (\$6.45 billion) offering of five-year bonds by the European Stabilization Mechanism, an acceptable risk. Perhaps today's European Hamiltons and Jeffersons can cut a deal: the debts of troubled individual nation-states are assumed, somehow, by the euro zone or perhaps the European Union as a whole, and Germany, as reluctant to support profligacy as was Virginia, gets to name at least the financial capital of Europe—Berlin being too freighted with historical problems, Frankfurt might do.

It is either that or lurch from crisis to crisis with Portugal first at bat. Lisbon officials privately concede that Portugal cannot remain viable if

it has to pay more than 7% on new borrowings. The market has already driven the price of Portuguese bonds so low that interest rates are above the magic 7% level, which bodes ill for Portugal's bond sale on Wednesday, part of its effort to refinance some €9.5 billion of debt maturing in the first half of this year. No surprise that 44 of 51 economists polled by Reuters say Portugal will need a bailout.



Associated Press (2)

Thomas Jefferson, left, and Alexander Hamilton came to an arrangement.

Had European Central Bank President Jean-Claude Trichet not decided at the end of last week to have the ECB step in and buy Portuguese bonds, the sell-off, which took Portuguese banks stocks down with it, would have been sharper. The Swiss National Bank made matters worse for Prime Minister José Sócrates' government by announcing that it will henceforth treat Portugal as it has been treating Ireland, and refuse to accept Portuguese government securities as collateral. And, as if to demonstrate that when it comes to an exquisite lack of understanding of markets and of timing, Michel Barnier, the European Commission's internal market commissioner, chose last week to issue a draft report calling for holders of senior bank debt to share the pain of any future losses. This is the very same Michel Barnier who now has a major voice in the regulation of London's financial sector.

All of which led Thomas Mayer, chief economist at Deutsche Bank, to announce that the future viability of the euro "can no longer be taken for granted." Mere statements that the euro-zone nations will do anything necessary, without laying out specific plans and describing the institutional arrangements that will be made might have enabled the euro-zone powers-that-be to muddle through 2010; such vagueness invites a major disaster in 2011 unless the 17 individual

euro-zone governments can demonstrate that they are willing to change their domestic bankruptcy and other company laws to permit a move in the direction in which Alexander Hamilton took his new nation.

Oddly, the problems of Portugal and Spain—the latter also saw its bond yields jump to close to euro-era records—seem to have benefited Germany, in two ways. First, its triple-A rated bonds were snapped up by investors fleeing the risk of the periphery countries' offerings. Second, the euro fell sharply, making German exports of capital goods, production of which is up almost 18% on the year according to Markit, even more competitive. Unlike the euro-zone periphery countries, which sell what China sells, Germany sells what China buys.

China, of course, is a buyer of influence. So it has agreed to buy Greek, Portuguese and other such bonds in support of those countries' governments. This is not a bad investment from China's point of view. A weaker euro relative to the dollar is also a weaker euro relative to the yuan, which is more-or-less pegged to the dollar. That hurts China's exports to euroland. Then there is the small matter of China's desire to have the EU declare China a "market economy". That designation would make it more difficult for the EU and its members to bring trade actions against China at the World Trade Organization. So far, no deal. But Vanessa Rossi, senior research fellow at Chatham House, estimates that China already holds €700 billion of euro-zone bonds, 10% of the area's government debt. If the Chinese regime agrees to add to its holdings at this difficult time for the borrowers, it just might be in a position to demand rather than patiently wait for a show of gratitude. Unless, of course, a European Hamilton appears on the scene first, and substitutes the credit of the entire 17-nation area, including most especially that of Germany, for that of the struggling countries.

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