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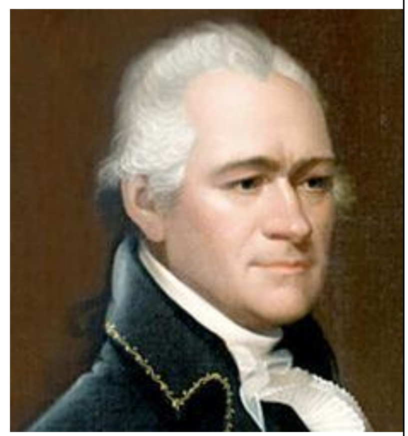
Thought for the Week: Monday, June 4th, 2012

The Solution to Europe's Problems?

Long term readers of our weekly *Thoughts* will be familiar with lines such as: "History doesn't repeat, but it does rhyme" and "plus ça change, plus c'est la même chose." Both of these phrases remind us that history can be used as a reference for what's to come.



With this in mind, this week's *Thought* looks back to the late 18th Century and the economic policies of one of our founding fathers: Andrew Hamilton. At the time, the United States was mired in economic problems created, in part, by the Revolution. George Washington appointed Andrew Hamilton as the first United States Secretary of the Treasury. Thereafter, Hamilton was the primary architect of the highly successful policies outlined below.

Would these policies solve our problems today? Obviously, the economic climate in the 18th century was very different to that of the 21st century.

In our opinion; however, they might provide clues as to the general direction of policies that may help to improve the situation in Europe. Many of their issues stem from the lack of fiscal unity between the various separate European states.

Hamilton proposed seven basic principles to solve the country's financial problems; the following outlines the ones we feel relate to Europe's current dilemma. We hope you find the parallels fascinating as they may prove to be indicators as to a lasting solution:

Foreign & Domestic Debt

In 1790, the United States owed other countries a lot of money, especially France and the Netherlands, and had to pay interest on this debt. Hamilton proposed that the federal government pay the interest out of tax revenues and borrow, over a fifteen-year period, enough capital to repay the principal of these loans. Our attention is drawn to the use of increased tax revenues to pay interest. If the interest on a loan increases, the revenues required to service the debt must also rise. This suggests increased taxes might be needed in Europe and soon!

Hamilton proposed that the money to pay off the international debt would be raised by issuing new permanent longer-term bonds with standard terms and attractive interest rates. The debt market in those days was fragmented with all manner of loans which came and went. The newly created Treasury redeemed all these varied loans and issued permanent debt with standard credit terms backed by a national, centralized fund held at a national centralized bank.

Although Europe has a similar centralized banking system, there is no central issuance of bonds with terms underwritten by all member states. One of the biggest debates at the moment is whether Germany, in particular, will allow "Euro Bonds" to be created. This would mean Germany, Europe's most creditworthy country, would be directly underwriting the debt of others.

The issuance of Euro Bonds would certainly go a long way to solving the problems of the less creditworthy countries in Europe, just as they did for the poorer U.S. states in 1790.

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State Debts

Hamilton proposed that the federal government take over the debts that the state governments had accumulated during the Revolution, even if the debtor states had exhibited little ability or desire to pay off their debts.

As it's clear a number of European countries cannot repay their debt, one way Europe's debt issues might play out is for a central bank to decide if they wish to back the debt of each country; one by one. This would be very expensive and require the issuance of a new type of debt instrument. But just like our central bank took over the debts of our banking system, some form of pushing the debt upwards seems to be a certainty.

Taxation

In January 1790 in the "Report on the Public Credit," Hamilton recommended an increase in tariffs and the introduction of internal taxation on distilled spirits, although he stopped short of poll taxes and property taxes. He left direct taxation as the exclusive province of state and local governments.

In August 1790, Congress passed four separate acts that adopted, with only minor changes, Hamilton's proposals for paying off foreign debts, redeeming domestic debts, assuming state debts, and increasing tariffs. At the same time, Congress asked Hamilton to submit a formal proposal for establishing the tax on distilled spirits. Isn't it hard to see a resolution to our own situation without a significant increase in taxation; direct or indirect?

The Bank of the United States

Hamilton proposed the federal chartering and funding of a national bank, which would be called the Bank of the United States and modeled to some extent on the Bank of England. The Bank of the United States, in Hamilton's view, would be very different from the other commercial banks. One difference would be its sheer size. Hamilton proposed capitalization for the bank that would make it five times the size of all the other commercial banks combined. This meant that the bank could expand significantly the size of the nation's money supply and thus enhance economic activity.

In contrast to the other banks, the Bank of the United States would conduct business on a national scale and thus be able to expedite the movement of federal funds around the nation. In an era of slow communication, this ability promised to enhance the efficiency and power of both the federal government and the nation's capital markets. Another difference, the participation of the federal government as a partner in the bank's ownership, would enable the government to share in the returns from the bank's operations and thus enhance federal revenues. A final difference, the requirement that investors in the bank use long-term obligations of the federal government to purchase bank stock, would support the price of government bonds. Hamilton meant for these differences, taken as a package, to reinforce other elements in his economic program.

It seems the current European Central Bank (ECB) is similar to Hamilton's bank in concept; however, it doesn't have the same level of control and ability for decisive action that our own Federal Reserve has recently exhibited. In 2008, our system pumped massive liquidity into a failing banking system in a number of coordinated, concerted efforts. The ECB seems content with making macroeconomic pronouncements while leaving the actual decision making to the leaders of Germany and France.

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Uniform Currency

In January 1791, Hamilton submitted the "Report on the Establishment of a Mint." His goal was the creation of a system of coinage that would be uniform across the United States and provide monetary stability. Uniformity and stability would promote commerce, enhance the credit worthiness of the United States, and protect the value of tax revenues.

Europe already has a uniform currency that many are predicting will be abolished. Looking at the historical parallels and benefits of a single coinage, it is hard to see the Euro disappearing. The Euro is one of the few things that have actually worked. It has already promoted economic expansion with stability; it is not the reason for the current instability. As with all clubs, membership should only be based on conformity with strict acceptable criteria and ongoing rules. The English are well known for their creation and adherence to rules and regulations – a big reason why they remain on the outside of a Euro Club that allows rule-breakers to join.

Promotion of Manufacturing

In January 1791 Hamilton suggested: "the encouragement and promotion of such manufactories as will tend to render the United States independent of other nations for essentials, particularly for military supplies." Hamilton urged the Representatives to adopt a broad range of policies that would encourage Americans to spend their money and their energy on the advancement of technological change in industry.

Europe has enjoyed a period of "across the board" expansion and advancement, based mainly on the "manufactories" of a few leading countries. Unfortunately, those countries who took more than they contributed are too much of a burden. Their lack of invention and productivity can no longer be supported in the current framework.

Although the outcome of political machinations is difficult to predict, it is hard to see Europe moving forward without a fairer distribution of wealth and power. Greece and other "Club Med." members will either have to give up their current excessive level of expenditure or cede more sovereign control to their financial superiors in Germany and France.

Hamilton's Legacy

Hamilton's economic policies established a fiscally strong federal government, just as Hamilton had planned. In 1793, under Hamilton's tax regime, the federal government collected enough revenue to pay off interest on the public debt, fund the army and navy, and still balance the federal budget. By 1795 the regular payment of interest enabled the Treasury to float new loans in the Netherlands and pay off its debts to Spain and France. Meanwhile, Hamilton redeemed the domestic debts, including the debts of state government, and the new securities circulated at close to par value. Vigorous capital markets, in turn, contributed to a dramatic economic expansion that began in the early 1790s and continued for a decade. Finally, Hamilton's economic policies established a model of a central government that worked creatively, positively, and effectively to unleash the nation's economic energies. For the next two centuries, Hamilton's model would influence the development of the federal government as an integral part of American capitalism.

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A Few Final Thoughts…

Yes, the numbers in 1790 are hardly a decimal place on today's numbers, but the same principles can be applied. Certainly, if and when we see measures similar to those above, we will feel more confident that the financial woes of Europe may be coming under control. Bringing the woes to an end will take much longer though!

History doesn't repeat, but let's hope it rhymes.

In another interesting parallel, Europe faces increasing popular and political opposition to some of its proposed solutions. Hamilton also faced his dissenters; a group of people who were soon to form the Republican Party.

One thing absent in Europe is a strong leader – when has anything significant in history ever been solved by a committee? As the country with the most money, Germany has to be the favorite place to look for a leader. However, the successful candidate is probably someone who can bring together the firepower of the United States and the IMF.

Another headwind is the European fear of inflation. Historically, Europe and Germany have struggled with inflation while the U.S. has been able to fight and beat it (see our previous writings on Paul Volcker). One of the main principles of the ECB is the control of inflation. This prevents them from reducing interest rates to the same degree and speed that we did here. It also makes them reluctant to expand monetary policy to the same degree as our own Federal Reserve has.

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