
From: O'Neill, Jim [IMD]
Sent: 14 January 2012 16:41
Subject: Europe Needs More Growth, not More Austerity



Asset
Management

Viewpoints
FROM THE CHAIRMAN

Europe Needs Growth, not More Austerity.

Late Friday, the S&P finally followed through with their early December 2011 threat and downgraded a number of European countries' credit rating, including Austria and France, who lost their AAA status. This threat had been hanging over the markets ever since the last EU Summit and, at least for this credit rating agency, the framework proposed for the "fiscal compact" has not been sufficient to avoid the downgrades. I am going to devote my Viewpoint – shorn of my picture you might be pleased to notice – to the topic of Europe and its challenges.

Markets Since the Turn of the Year.

As with most weeks, I spent my time last week talking to a vast and diverse group of people from all over the world. This week, I had a call with a well-known NY-based hedge fund and they wanted to know why markets weren't trading better in view of the stronger news from the US and Europe so far this year. I hadn't quite realized the subtlety of their line of enquiry at first, assuming that they were expecting markets to soon start falling sharply again, despite the fact that the year had got off to a stronger start than many had expected (and my beloved 5-day trading rule in the S&P 500 passed with flying colours!). The only answer I could think of is that people were braced for further bad news from Europe and that, any day, S&P were likely to go ahead with their downgrades. Our fixed income investment team had been expecting the downgrades at any moment since mid-December, soon after the last EU Summit, and I lose count of the days when rumours swirled it would be that evening.

In this broader regard, it will be fascinating to see what happens Monday when markets have the first full day to respond to the S&P announcement. Despite widespread expectations that this bad news was coming, in addition to the generally stronger performance of global equity markets, different sectors have led this recovery, with US banking stocks and many commodity-related markets showing leadership. As I remarked to some of my colleagues on our weekly CIO call, it has been extremely interesting to observe the rise of US financials, despite the weakness of many European financials persisting. This is a change from the weekly, and often daily, behavior of last year. It is also the case – despite a lot of negative media commentary – that a number of the larger "Growth Markets" have gotten off to a much better start in 2012. Brazil, India and Russia are all up more than 4 pct and China is also in positive territory.

Europe is Not the World.

In the context of the slightly healthier start to the year, before I delve into Europe's many challenges, I would like to reiterate that Europe is not the world. Everyone should know this, but as I move from meeting to meeting, it often doesn't seem so. On Friday, I attended a lunch along with 4 other guests hosted by a foreign government here at their UK embassy, and at least 80 pct of the discussion was about Europe. It is generally the same pattern everywhere I go, except for when it is a specific Growth Market event that I have been asked to lead.

I attach our January Viewpoint which applies the GS Economics Paper number 208 to our Growth Market mindset and our view of the future of the world economy. As we point out, despite China growing at a slower rate in the 7.5 pct vicinity this decade, because of their and other Growth Markets rising importance, the world can grow by close to 4.5 pct this decade, higher than the past and previous two decades. This is despite rather modest assumptions about the growth potential in Europe and the US, and relatively conservative ones across the Growth Markets.

In this vein, as I suggested back in December, over the next 12 months, the four BRIC countries alone will probably add close to \$2 trillion in US\$ nominal terms, not far off the equivalent of a new Italy. And, as we show in the January

Viewpoint, in a couple of years, the combined GDP of the four BRICs will be bigger than the US. Before the end of the decade, the combined US\$ value of consumption in the eight Growth Market economies will be bigger than the US consumer.

As pointed out to me by Neeti Bhalla last week, a significant proportion of quoted European company earnings are dominated by their global sales, and despite their severe domestic sovereign and financial challenges, many European companies will be influenced by the rest of the world. This is, in turn, why the German economy has generally performed so well since 2008, but it is also relevant for some parts of other Euro Area economies.

The S&P Decision.

So the big question this weekend is whether we have learnt anything new? Given that the downgrades were highly signposted, it has to be one of the most widely anticipated moves of all time. Putting this together with the fact that when both Japan and the US lost their AAA credit ratings a long time ago and there were no discernable negative market consequences, I am not sure this news is that interesting. It will certainly be a source of political fun and games especially in France, but whether it is relevant for the markets remains to be seen.

Against that, this is Europe we are talking about and everything is always more complex. With 2 of the 6 previously AAA-rated countries losing their rating, the effectiveness of the EFSF is likely to be questioned even more, as it can no longer be treated as AAA unless either Germany contributes more (presumably tough) or there is some other clever scheme dreamt up. As important as a complication as this is, given that the downgrades were expected, markets have likely, to a large extent, been pricing in this issue also.

What is more interesting to me as I read the S&P statement and the brief comment from John Chambers is the rationale used. S&P appear to doubt the likelihood that the fiscal compact will be successful in contributing to a framework for stronger growth, implying that fiscal tightening leads to weaker growth which then leads to bigger deficits. In that regard, their decision endorses the views of many observers that the German-inspired fiscal compact is not really the right path.

Europe Needs Growth.

I strongly sympathize with this judgment. In addition to the remarkable challenges facing Ireland and Greece, who have both undertaken their own versions of the austerity medicine, one of the more revealing pieces of news so far this year is that Spain's budget deficit appears to be closer to 8 pct than 6 pct, an announcement that was followed by plans to further tighten fiscal policy. When you consider the fact that before 2008 Spain appeared to have the best fiscal position of the big 5 Euro Area member economies, you can see the importance of the lack of growth.

In this context, some might describe the fiscal compact as more like "compost" as, without some offsetting measures elsewhere, all indebted countries tightening fiscal policy further simply to satisfy some new numerical target doesn't seem like sensible economics, especially for those with large youth unemployment and members of a union that, never massively popular, is increasingly regarded as a problem.

To complicate matters, some Euro Area policymakers realize the potential insanity of the above and have inserted an "escape clause" into the fiscal compact discussions that allows countries to avoid tightening further "in periods of severe economic downturn". This strikes me as sensible in principle, but whether Berlin and Frankfurt will agree remains to be seen. The early signs from ECB members is that they worry it will be an excuse for countries to avoid structural challenges.

From a big picture perspective, there is a lot of evidence that major fiscal tightening, especially if it includes reductions in government spending, is rather key to raising countries economic growth potential. If you throw in supply side reforms, and – what might normally be the case – easier monetary conditions such as a decline in the exchange rate and lower interest rates, this is the classic recipe for a nice long-term outcome. However, given the constraints of a monetary union, and one seemingly dominated by Germanic caution, it is not so obvious that we can get there.

Competitiveness Issue a Slight Red Herring?

It is increasingly fashionable for many to suggest that whatever medicine thrown won't work because the problem for most of the troubled countries is that they are uncompetitive, and have been unable to adjust to the slow and significant improvement in German competitiveness the past decade or so. While a number of simple measures support these general conclusions, taken too far, they belong in the same box of "dangerous economic theories" as the fiscal compost idea. For Greece, Portugal, Spain and Italy to all deliberately improve their competitiveness relative to Germany would involve additional domestic cyclical pain, as many argue. But my point is not this. It is what the consequence would be if they did. The consequence would be a less competitive Germany, which would mean a possible future fresh attempt to superficially improve competitiveness' there. It does seem to me that Greece and Portugal need to significantly improve their competitiveness, but this argument is unclear to me for Italy, and to some extent, Spain. The research I

am most familiar with, such as the GSDEER model (Goldman Sachs Dynamic Equilibrium Exchange Rate), which incorporates relative productivity, doesn't suggest anything dramatic for these countries, at least within the monetary union.

Where the Euro Area can achieve more competitiveness is against the rest of the world, and this links to the broader required response to the S&P verdict this weekend, an easier monetary policy from the ECB, and stepped up efforts to reduce long term interest rates in the troubled Club Med countries. A further significant easing in Euro-wide financial conditions is the appropriate response to the fiscal compact, as it will be this that will help soften the cyclical blow from tightening. Whether the Euro Area can achieve this at a time when Japan, the UK and the US are all eager to maintain their own easy financial conditions, if not strive for even easier ones, is amongst further challenges, but at least the ECB needs to try.

Italy Seems Key.

While the immediate spotlight will shift to France once more, not least of which because of the forthcoming election battle and the anti-fiscal compact stance of the opposition, I find ongoing things with Italy rather intriguing. Speaking in the days before the S&P news, PM Monti suggested that if the fiscal compact is signed up by all Euro members by the end of January, the ECB should "relax" a little. This follows some rather positive comments about the new Italy the day before from German Chancellor Merkel. When ECB President Draghi was asked about Monti's comments, he successfully sidestepped them, although he did add that markets appeared to show some attention to recent policy developments in Italy, which was itself interesting.

As my colleague James Wrisdale suggested to me Friday, it is not clear what anyone can expect more of Italy in the short term. Already probably the more credible cyclical fiscal stance of the G7, the additional tightening announced by Monti's technocratic government, along with announced supply side reforms, the ECB should be embracing them. By coincidence, I happened to be a guest on a conference call with around 40 of Italy's leading CEO's this week as these events were unfolding. I was asked some quite searching questions at the end of the call. In particular, how come the markets are treating Italy with such a discount to Spain, and even more so Japan? And, why did Italy's major banks have the equivalent market cap as just one leading French bank? Beyond Italy's legacy of debt and the fact that Italian governments don't have long histories, I had no good answer. In fact, hearing these comments added to my belief that it might be time to turn away from this focus on Europe to elsewhere.

Japan versus Italy.

I mentioned twice in the past recent weeks that, when you stand back from the fray and take a cold look, why does Italy deserve 6-7 pct 10-year bond yields when Japan with a debt/GDP ratio of 220 pct has 1 pct yields? As I said, I was asked this on the above call. I increasingly suspect that, within the next couple of years, their 10-year yields will be closer to each other in the middle, i.e., 3.5 pct. The question is especially interesting at a EUR/Yen exchange rate below 100.0. On the quiet, the Japanese situation is deteriorating quite markedly and, as some investment banks have suggested recently, Japan is closer to another major structural shift, i.e., going from current account surplus to current account deficit. The post nuclear energy requirements of Japan, on top of its slowly declining household savings rate, suggests the sort of concerns being expressed about Italy are much more valid in Japan, given that Italian markets have adjusted and Japan's have not. For all you macro players out there, the Japan picture we have all had the occasional flirt with over the past decades, it is getting closer.

And then there is Greece.

I can't leave the European issue without a mention of Greece. If all the above complicated twists and turns are not enough, then there is the Greek debt situation and, according to weekend reports, negotiations over the so-called PSI have broken down and the prospect of a default is back on the agenda. For many, this is the issue to really focus on and where the next bearish phase will come from. Maybe so, but to me, once this is finally out of the way, if the monetary authorities play the role that they should, then in fact, on the contrary, we might be able to move forward.

And the Noisy Neighbours.

I was tempting fate on two levels in last weekend's Viewpoint. In addition to raising the likelihood that the S&P500 would close up after the 1st five days of trading with still a day to go, I also talked about Manchester United shutting up the noisy neighbours a little. Well we beat them – despite making very hard work of it – but so did "they" from down the road later in the week, which pending results in the next couple of games, might make them rather less noisy at least for a while. Life is not all bad...

Jim O'Neill

Chairman, Goldman Sachs Asset Management.

Jim O'Neill is the Chairman of Goldman Sachs Asset Management, which is a separate operating division and not part of the Global Investment Research (GIR) Department. The views expressed herein by Mr. O'Neill do not constitute research, investment advice or trade recommendations and may not represent the views and/or opinions of GSAM's portfolio management teams and/or the GIR Department. © 2011 Goldman Sachs. All rights reserved. Please visit our [website](#) for additional disclosures.

This message may contain information that is confidential or privileged. If you are not the intended recipient, please advise the sender immediately and delete this message. See <http://www.gs.com/disclaimer/email> for further information on confidentiality and the risks inherent in electronic communication.

(47177.OTHER.OTU)

Jim O'Neill is the Chairman of GSAM, which is a separate operating division and not part of the Global Investment Research (GIR) Department. The views expressed herein by Mr. O'Neill do not constitute research, investment advice or trade recommendations and may not represent the views and/or opinions of GSAM's portfolio management teams and/or the GIR Department. Copyright © 2011 Goldman Sachs. All rights reserved. Please visit our [website](#) for additional disclosures.

This message may contain information that is confidential or privileged. If you are not the intended recipient, please advise the sender immediately and delete this message. See <http://www.gs.com/disclaimer/email> for further information on confidentiality and the risks inherent in electronic communication