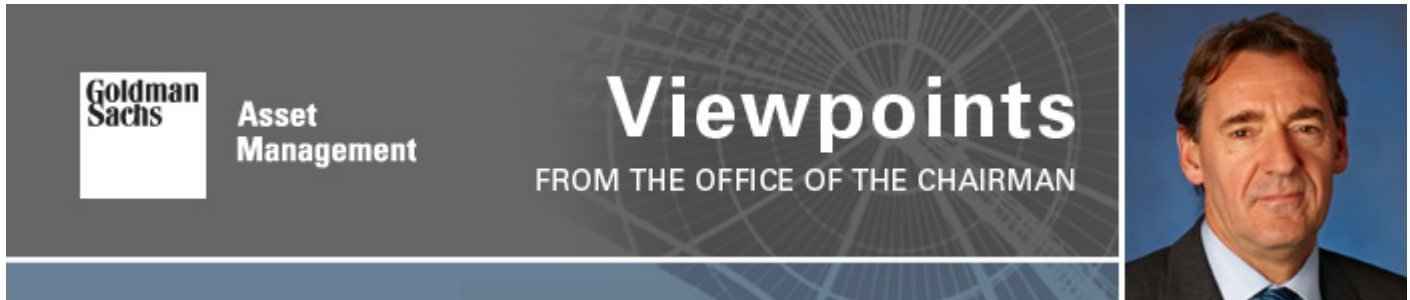


From: O'Neill, Jim [IMD]
Sent: 26 June 2011 17:16
Subject: SOLVING CHALLENGES REQUIRES LEADERSHIP



SOLVING CHALLENGES REQUIRES LEADERSHIP.

I am going to focus on the European Monetary Union (EMU) and the crisis surrounding it, again, this weekend. You wouldn't have noticed from the way markets closed the week on Friday, but there was some rather good news on some globally important issues last week. First, while controversial, the decision by the International Energy Agency (IEA) to announce it was releasing some of its strategic oil supplies was highly appropriate in my view. The fact that oil prices have been so sticky despite evidence of slower world growth hasn't made sense to me. When combined with the fact that the increase in energy costs is one of the factors that might have weakened world growth in the first place, this makes the IEA's decision even smarter. The second welcome development is that Chinese policymakers seem to be more confident that they are dealing with their inflation challenge. Amongst others, Premier Wen stated that inflation was getting under control ahead of his European visit. Interestingly, Chinese markets appear to have noticed this as well, since unlike much of the rest of the world, they enjoyed a better week last week, rising by closing to 4 pct.

One topic where significant problems remain is the EMU, where Greece and its debt is currently the biggest challenge. I have written an article in today's UK Sunday Telegraph in which I argue that this is really not a true debt crisis, but instead is a crisis about the structure and leadership of the EMU. Like most problems, to solve it will require bold leadership.

This week, I spent 24 hours in Brussels participating in the annual meeting of BRUEGEL, a European think tank where I have the privilege of sitting on their Board. As usual, they held a conference for members. Not surprisingly, the challenges facing the EMU were a major topic. There were also other topics, including a very interesting discussion about North Africa and the role Europe could play, but that is for another day. I was asked to participate in a panel discussion about the future of the EMU once it emerges from its current challenges. My fellow panelists were Professor Barry Eichengreen and two European policymakers.

Both Barry and I took some time to suggest that it might be very presumptuous to believe that the EMU will easily get beyond its current problems. I actually argued that, as tough as the problems currently are, the challenges might get even tougher. I suggested this for three basic reasons.

Firstly, despite all the immense challenges and problems, the Euro currently still trades above 1.40 against the Dollar. This is about some 15 pct or more above what most people would suggest was "fair value". This is likely a reflection of the very accommodative policies in the US and the stance of monetary policy. While I find it tough to be bullish about the Euro, I also find it tough to see its value going significantly below fair value for quite some time. The US needs as weak a Dollar as it can get away with in order to help itself recover from its excessive dependency on the over-levered consumer. For troubled EMU members with competitive challenges, this is quite an additional burden. The fair value for some of the challenged Club Med countries is likely much below 1.20, fair value for the average.

Secondly, and a bigger problem as we go through time, is the dramatic change of world trade patterns and, in particular, the rise of the BRIC economies and their influence on global trade. Specifically, as I have highlighted on many occasions, Germany is seeing a major shift in its export markets, with China rapidly ascending in importance. Within a couple of years, China may be Germany's biggest export market. The other BRIC economies are all becoming more important for Germany too. For a monetary union that had questions about its optimality for all the members that joined in 1999, this is real headache as time passes. Some other Euro members might also benefit, although not as proportionately as Germany. Others might continue to lose out, especially if they have no real "edge".

A third problem that I find myself thinking about is possibly even bigger and is perhaps generational. In many ways, the

EMU was developed not primarily as an optimal economic zone, but as a political project designed and implemented by those that had a deep personal memory of World War Two. It was seen by many as a valuable tool to avoid the horrors of 1939-1945 and before. As we move through time and a future generation of European leaders emerge, that history will not be so persuasive on their thoughts, and will probably not be nearly as good a reason to maintain EMU if the economic benefits aren't right.

If the third factor I mention above is true, then perhaps it is good that this crisis is occurring now. This way, the burden for responsibility in solving it lies with those that created it and implemented it. However, it requires leadership.

NOT REALLY A SOVEREIGN DEBT CRISIS.

As I argue in the Telegraph piece and have written before, while Greece clearly has far too much debt, the current debt position of the Euro Area compares favourably with most other developed countries. Greek debt itself, even if it is as high as the 160 pct some argue, is actually much less than Japan's 220 pct. Greece is a rather small economy, some \$ 350 bn, which is not much more than ½ pct of global GDP. As I am also fond of saying, China's 2010 imports rose by more than the size of Greece. And, if the Chinese leadership thought confidently that policymakers would stand behind their words, they might be tempted to buy much of Greece's debt, as it would be probably be only around 20 pct of their total FX reserves and, of course, it has such huge yields.

The current level of pan-Euro Area debt-to-GDP is close to 80 pct, which is better than the US, comparable to that of the UK and less than half that of Japan. None of those bond markets as of yet have problems, so it is not obvious to me that Europe has a true debt crisis. The crisis is more about the strength of the EMU and how committed all the major players are.

As some of the more thoughtful commentators are pointing out this weekend, as easy as it is for German policymakers and others to criticize Greek debt, it was actually both Germany and France who were the guiltiest for diminishing the credibility of the Growth and Stability Pact early last decade. When they both faced cyclical challenges of supporting their economies that threatened the deficit and debt criteria of the EMU, their leaders simply waived the rules. Not surprisingly, others thought if were good for others to do this, why not them?

This crisis will not end with the Greek parliamentary vote this week. While we will likely get a significant bounce if the government agrees with the proposed fiscal tightening, Greece is not the only country with issues. In addition to Ireland and Portugal, there is Spain and its real estate problem and all that goes with it. And lurking in the background is Italy, which at 120 pct of GDP, its debt is large enough to cause major global problems if it were to be embroiled in this situation.

Europe's leaders have to decide whether they want the EMU to still exist and to try and make it more optimal than it has been. As I touched on last week, and as I suggested at BRUEGEL and wrote about in the Telegraph today, one of the ways of demonstrating this is to introduce the common Euro bond that BRUEGEL and many others have proposed. The more I think about it, the more I don't really understand why it wasn't considered at the start. If a 60 pct of GDP ceiling was supposed to be the agreed limit for participants' national debt, why not "reward" all members with having that financed through exactly the same bond with the same credit rating? Any excess can then be charged at market rates. The problematic countries would still face a significant market punishment for not dealing with their fiscal laxity but, unlike now, they would not be punished for that which is permissible. I know that the "tough" members don't like this idea, but beyond history and symbolism, I am not sure why. There are many other bold leadership issues that Europe's leaders should move ahead with as well. For over 10 years now, pre-dating the BRIC idea, I have not understood why all Euro Area members insist on their own national participation in all the various "G" meetings. Anything like FX intervention requires ECB involvement, not the national central banks. I could think of more, but the idea of a common bond strikes me as increasingly important now. Having visited with large Asian holders of capital recently, I certainly think there would be huge demand for it.

Anyhow, we shall see what happens with the EMU saga this week. As I mentioned at the start, as important as this topic is, market participants shouldn't lose sight of other positive developments last week. As I have argued for many months, I don't believe (a) oil prices rise forever purely because they have done so for most of the past 10 years, and (b) Chinese inflation will start slowing in the second half of the year. Luckily for the world economy and its financial markets, these two factors are probably more important than the trials and tribulations of the EMU.

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