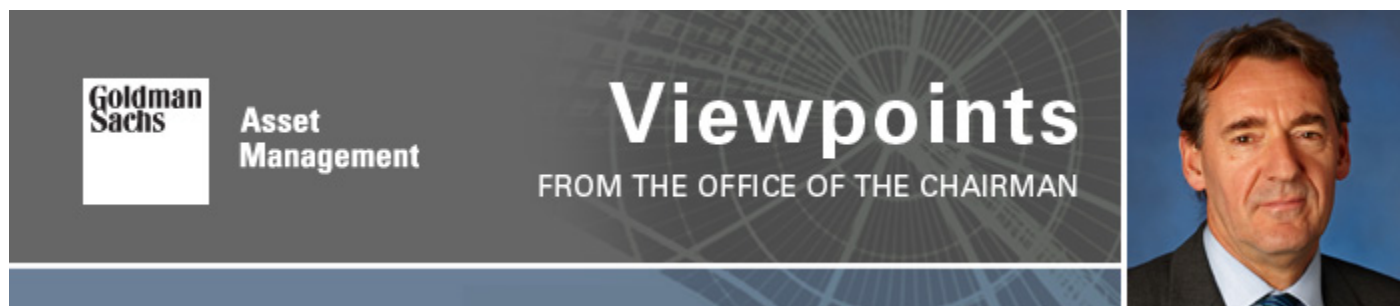


From: O'Neill, Jim [IMD]
Sent: Friday, July 15, 2011 2:19 PM
Subject: WHAT IF ANYONE COULD BE IN EMU?



WHO WOULD YOU WANT IN EMU?

Western sovereign debt issues rolled on again last week, with fierce competition between the US and the Euro Area for attention. As President Obama and Congress struggle to reach a budget compromise ahead of the debt ceiling deadline, two rating agencies made it clear that failure to make progress would result in a loss of the US's precious triple A rating. Meanwhile, Europe's leaders told us at the start of the week that they would soon have a new proposal to deal with their sovereign challenges and we await its detail. We did get the results of the latest European bank stress tests late Friday, about which I would imagine many will say, "Why did they bother?"

The Dollar and the Euro are the most widely traded and investable currencies in terms of liquidity, but would you put your close family and friends into either for the next few years and beyond?

WHAT IF ANYONE COULD BE IN THE EMU?

[SLIDES \[PDF\]](#)

On returning from Tokyo three weeks ago, I mentioned that I joked during the trip that a new European Monetary Union (EMU) could be created that would include only Finland and the "Growth Economies." I am reminded of this again this week. Imagine an odd world where the only requirement for EMU membership was the actual Maastricht criteria on budget deficits and government debt (as opposed, perhaps, to just geographical location!). To join the EMU, in theory, countries were supposed to have budget deficits of 3pct of GDP or less, and embark on policies that would lower the level of debt to 60pct of GDP or below. While many countries managed to creep into the system, as you can see in the attached slide titled "Budget Deficits and Government Debt," Finland is the only EMU member that currently satisfies these criteria. Austria and Germany are not far off. Due to the high level of debt in most Club Med countries, the average debt and deficit percentages for the Euro Area overall indicate that the EMU is not functioning by its own rules. If you think the situation is bad in the Euro Area, you will note that it is much worse in the other G7 countries (with the possible exception of Canada). The fiscal and debt positions of Japan and the US are notably weaker, and the UK's situation is no better, than the Euro Area average.

The next slide in this file shows the deficit and debt positions of the Growth Economies (as we call them at GSAM). I would like to remind you that these are the economies that many of you still call "Emerging." Six of these countries easily satisfy the Maastricht criteria for deficit and debt responsibility. The debt levels of the other two countries, India and Russia, are considerably better than those of the entire developed world except, perhaps, for Finland.

So you could combine all eight of the Growth Economies with the best four countries in the so-called "advanced world"—Finland, Austria, Canada and Germany—and end up with a really assorted bunch to assemble into a sound monetary union. They are not shown in the table, but to anticipate some putting me right, you could throw in Australia, Sweden and of course, Switzerland too. Each of these three would fulfill the criteria too. Setting aside their separated geographies, there is little else to justify such a union other than the Maastricht criteria. They aren't necessarily natural trading partners. But mind you, this may change. Trade patterns are evolving dramatically as the BRIC countries become more and more important to the global economy. EMU members are not trading as much with each other today as was the case before the conception of the union in 1999. By the end of this year, Germany will probably export more to China than any other country apart from France and the US. Short of a major slowdown in China, Germany will rise to

number one soon thereafter.

CHANGING PATTERNS OF GLOBAL FINANCIAL FLOWS.

Against this background, it is hardly surprising that everywhere I go I find many investors intensely debating the need for more appropriate benchmarks and fresh approaches to asset allocation. When you consider that the Growth Eight are likely to contribute around twice as much to global GDP growth this decade as the US and the Euro Area combined, the only real question is why all investors are not engaged in this debate. The other attachment is a chart that shows what the Goldman Sachs Global Economics, Commodities and Strategy Research group is assuming in terms of US\$ nominal GDP changes this decade. It is pretty straightforward.

[2019 Growth \[PDF\]](#)

So I find myself this weekend, asking the following questions again:

1. Why do people persist in calling these fiscally sound drivers of world growth “emerging markets?”
2. Why do we all derive the risk-free rate from the G7 world’s bond markets?
3. Why are so many people still benchmarked to such out-of-date things as the MSCI?

Amongst the possible answers to all three questions is that the current fiscal and debt positions of all the countries discussed are simply aberrations that emerged over the past decade or so, and the future might be nothing like the past. This is, of course, distinctly possible. It also might be that many of the Growth Eight will somehow stop growing so strongly. And it could also be true that Japan, all of Club Med, the UK and the US are going to solve their structural fiscal challenges and grow sharply. It is also true that Manchester City could one day become England’s most successful football team!

Have a good weekend.

Jim O’Neill
Chairman, Goldman Sachs Asset Management

Viewpoints are also available on our [website](#).

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.

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