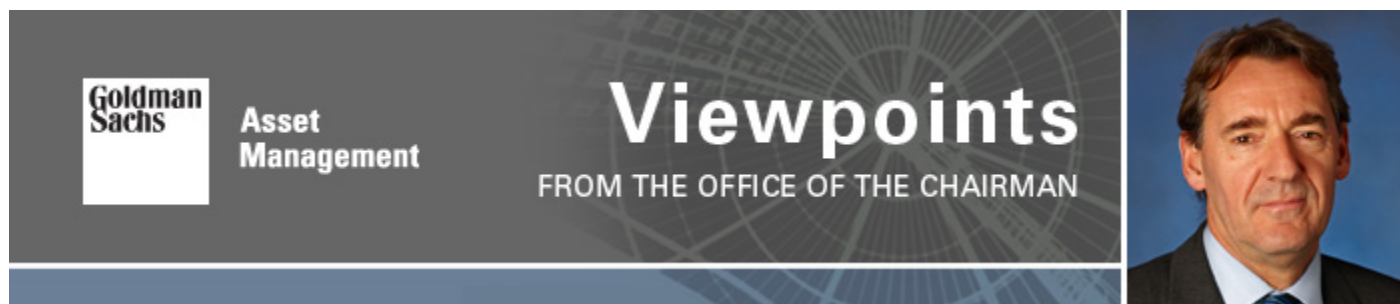


**From:** O'Neill, Jim [IMD]  
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**Subject:** BERNANKE AND OTHER MATTERS.



### BERNANKE AND OTHER MATTERS.

August 2011 is coming to an end and this final week has been a bit calmer than the preceding three. It was a week full of anticipation about what Chairman Ben Bernanke would say on Friday in Jackson Hole. In the end, this event appears to have been not quite as dramatic as some had hoped or feared.

Sticking with my general theme of Viewpoints during this tumultuous month, I shall discuss the economic and policy news that has emerged this week from what I think are the three chief areas of focus – the US, the Euro Area and China.

### THE US AND BEN BERNANKE.

The economic data this week didn't really tell us much as it was one of the quieter release weeks. Next week will be the biggie. Of real note will be the release of the August ISM manufacturing number and we will look to see whether or not it reflects the full weakness exhibited by the shocking decline in the Philly Fed index.

The Bernanke speech was this week's highlight and, in many ways, the Fed Chairman had no major surprises for us. As I expected, he gave us his updated views and appeared to suggest that the Fed still believes the economy will strengthen further, despite acknowledging the considerable issues which have rattled August markets. Most importantly, however, he made it clear that the Fed stood ready to do more in the event that the economy disappoints. In this regard, news that he had extended the late-September FOMC meeting to two days from one day caught many people's attention. It remains to be seen whether this is a sign that he wants the extra time to persuade his dissenters that the Fed should take further steps beyond its August moves to ease more, or whether he needs the time to consider all the options in the event of fresh market dislocations. The other aspect of Bernanke's speech that caught my attention was that he appeared to imply that he supports the idea of additional Administration policies to help ease the burden of those facing challenges due to the housing market's weakness. As I have stated throughout the month, it seems to me that more specific and targeted government policies to help boost employment and encourage companies to spend all that cash on their balance sheets are more likely to have a positive impact on the economy than any marginal tinkering with Fed policy. While further easing of financial conditions wouldn't be harmful, it is not clear that these steps will have lasting effects unless additional jobs are created, companies are willing to invest more, or consumers feel less pinched by weak house prices.

Nonetheless, one can't help feeling that the Fed Chairman gave a clear message. Compared to some of the policy leadership issues elsewhere, especially in Europe, Bernanke's comments are refreshing and a relief to hear.

Many believe that the US and global equity market recoveries since the dark days of 2008 are all due to the Fed's aggressiveness, and that the violent swings interrupting the upmoves have occurred when the Fed has started to curtail its largesse or has threatened that it is closer to doing so. In this context, many believe the peaking of the S&P in May occurred in anticipation of the end of QE2 and without "more" from the Fed the market's post-2008 recovery is over. In my judgement, while the Fed's actions have played a major role, especially for domestic US markets, other actors are also relevant for the global scene. This being said, the tone of Bernanke's comments can't really be seized on by the bears as he made it clear that, if needed, the Fed will do more.

### GERMANIC-TYPE RESTRAINT BROADENING IN THE EURO AREA?

After another wild week in Europe there is no real clarity, as there is in the US, about where things might go post August.

Governments need to approve the expanded European Financial Stability Facility (EFSF) proposals. Beyond this, the world awaits some clearer signs from the Euro Area's main actors as to how the European Monetary Union (EMU) can function better and indeed survive. In Germany, there remains considerable hostility to the notion of anything "more" in terms of German financial aid for the more challenged Euro Area members. We are left with the impression that we know what Germany doesn't want (no rush to Euro bonds for example) but we have no real indication of what German leaders really do want from the rest of the member countries.

As some of my colleagues in the GSAM Fixed Income team have pointed out this week in our ongoing intense discussions, not only are there still disagreements between the stronger and weaker EMU members, there are signs of growing disagreements between the stronger nations as well. The latest example of this is the dispute over Finnish desires for collateral related to Greek lending.

Then we have the continued concerns about the policy intentions of the European Central Bank (ECB) and, in particular, whether it is prepared to continue intervening in the secondary markets to support the bond prices of challenged countries. The suspicion remains that even if the ECB continues to intervene, it is reluctant to do so and eager to pass the baton to the EFSF when the Facility's extra powers have been formalized. Beyond this rather important issue is the broader topic of the ECB's basic stance on interest rate policy. Given the surprisingly soft Q2 GDP data reported by France and Germany, followed by a softening in the latest business and consumer confidence indicators, one would imagine that the ECB might have softened its general hawkish posture.

On top of all of this is the rather important issue of where the EU stands in terms of leadership. September promises to be an important month in this regard. Economic and Monetary Affairs Commissioner Rehn is due to present the EU's plans for strengthening the governance and effectiveness of the Stability and Growth Pact and it will be interesting to see both what is proposed and whether key countries are prepared to give the EU institutions any true support.

It is only too easy to expect continued disappointments across the board. All this said, the one thing that has really caught my attention this week is that Germany, perhaps in an odd way, is starting to get its message across, at least to other capitals. We currently have the prospect of each of France, Italy and Spain introducing constitutional amendments to ensure much tougher underlying fiscal discipline. It remains far from clear if these proposals will be passed fully into law. Judging from the reports I have seen in the past two days, the proposals now on the table in France and Italy are similar to the German balanced budget amendment, while the proposal in Spain is a touch less austere. Given that these four economies account for the vast majority of the EMU area, maybe, just maybe, there are signs that this crisis is not entirely going to waste.

The benefits of instituting strong, underlying fiscal discipline, however, are not as straightforward as one might think. Where will the Euro Area get its economic growth from in this new and tougher world if such fiscal austerity is indeed embraced by their parliaments? If the US Federal Reserve were the central bank of such an area, one would imagine that a more accommodative stance on monetary policy would be one of the consequences. But with the ECB, can we be so sure?

So many questions still and so much room for error.

CHINA.

Which brings me to China. Not a big week for economic data here either but lots of interesting things going on policy-wise. To reiterate for the umpteenth time, as the second largest economy in the world and one that is growing 7-10 pct, what happens here is rather more important to the world and to the economies of the Euro Area and the US than so many seem to still realize.

Three things caught my eye this week. The first was the announcement by the authorities of further measures to allow for growth in the use of RMB in Hong Kong – adding to suspicions that Beijing is by degrees allowing more opening up of the currency. Certainly in the conversations I have had this week, and in contrast to the tone following the 2008 crisis, Chinese policymakers seem increasingly to believe that they do control their own destiny.

The second concerns the visit to China of French President Sarkozy and his new Finance Minister Baroin. During the visit it was announced that a working party had been set up to consider how the RMB can be brought into the SDR basket. I suspect we shall hear more about this topic. Whether this group will conclude that the RMB should be brought in sooner than the current formal timetable for the next adjustment of the SDR basket in 2015 remains to be seen. The likelihood of this occurrence will certainly be closely linked to ongoing policies to allow the RMB to be used more freely, as well as movements in the value of the RMB against the Dollar and other currencies.

The third was that on Friday, the Chinese monetary authorities announced a broadening of the application of required reserves to include margin deposits. This appears to be designed to stop some sources of liquidity from escaping the desired policies of the People's Bank of China (PBOC). It is hard to avoid the conclusion that this is essentially an additional form of policy tightening. Given the current economic backdrop in the US and Europe, as well as the confident belief of many that Chinese CPI inflation is in the process of peaking, this seems like a slightly odd time to undertake these steps. As often with China, there is an additional twist to the story. Many think this step has been taken just ahead of moves by the PBOC to start reducing the rate at which required reserves will be charged.

Watching how local Chinese markets react to these developments early next week will be extremely interesting.

Anyhow, there are only three working days in August left. Such a shame...good luck!

Jim O'Neill  
Chairman, Goldman Sachs Asset Management

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

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