

People often ask how I spend my time. Some is spent reviewing economic data (US: weaker than most recoveries but stable at ~2%; China: growth falling to 7%-8% with another stimulus drop coming; Europe ex-Germany: don't ask). Some is spent reviewing corporate profits (US: margins are high, but profits growth is slowing a bit), and valuations (on the low side). And some is spent reviewing investments we like, such as distressed US real estate (Jan 31st), oil and gas (Mar 22nd), high yield (Jan 11th), Asian private equity (Apr 17th), US tech stocks (Feb 8th) and European bank loan sales, mezzanine debt and macro hedge funds (Jan 1st); dates indicate when we wrote about them. The rest of the time, given the situation in Europe and its 38.6% equity underperformance vs the US since the EU crisis began in November 2009, I find myself in suspended animation, waiting.

<p>WAITING FOR GODOT, 2012</p>  <p><i>Vladimir Estragon</i></p>	<p>[At a bar in Madrid, or Milan]</p> <p>Nothing is to be done</p> <p>Can't the ECB just start buying Spanish bonds again?</p> 	<p>Yes but what if Germans resign from the ECB like last time?</p> <p>Is the ECB running out of Germans?</p> 	<p>I don't think so; I believe there is 1 left</p> <p>Then let's find some more. What else can be done?</p> 
<p>A pan-European Deposit Guarantee, since most EU insurance coverage ratios are much less than the US FDIC</p> <p>I already moved my Euros to DeutscheBank</p> 	<p>Or maybe joint and severally guaranteed Eurobonds</p> <p>I think you meant EuroBunds</p> 	<p>But Maastricht Article 125 may prevent both of them</p> <p>Did you know that an anagram for Maastricht is "Chasm Trait"?</p> 	<p>And then there's the German Federal Constitutional Court ruling in 2011</p> <p>What did it say?</p> 
<p>That large unquantifiable financial risks enforced by international treaty via a permanent mechanism are unconstitutional</p> 	<p>Ok, then Eurobonds should be fine</p> 	<p>You are demented; and also fat. Are you asleep?</p> <p>I don't know. How can I tell?</p> 	<p>You would be dreaming</p> <p>I had a dream about the IMF. They gave 360 bn to Europe</p> 
<p>That's all the money the IMF has, and it's for the entire world</p> <p>In my dream the IMF ignores that since a European runs it</p> 	<p>There's 10 trillion of economy-wide Peripheral debt in existence. Nothing is to be done</p> <p>Maybe the EU Stabilization Fund can lend to or recap banks directly</p> 	<p>Finland, Austria, Netherlands and Germany reject that idea</p> <p>That spells FANG! Anyway, EU stress tests say banks are fine</p> 	<p>Yes. That Dexia and BFA-Bankia passed the tests and then got nationalized are exceptions</p> <p>Yes, exceptions, just like Greece</p> 

<p>Can't the ECB just buy more Spanish bonds? Wait, I already said that</p> <p>Sarkozy said the crisis was over in March</p> 	<p>Maybe a new one just started</p> <p>OK, instead of buying bonds, can't the ECB keep lending to EU banks to buy EU bonds?</p> 	<p>Yes, but credit spreads are widening anyway, bank bondholders are getting more subordinated, and there's still another 500 bn of foreign interbank funding that may flee</p> 	 <p>I had a dream where Christo the artist wrapped a giant plastic austerity belt around France before Hollande could capture him</p> 
<p>What is wrong with you? Maybe China will bail Europe out</p> <p>China has problems of its own. We must have Eurobonds.</p> 	<p>Wouldn't they bind Germany to debt 3x the size of its own? German debt is already over 80% of GDP after 2 trn Euros spent on German reunification</p> 	<p>Who cares? Monti likes them, although why an Italian politician would push so hard for them escapes me. Eurobonds! The "M" countries would be so jealous*!</p> 	<p>But the EU has almost no Federal taxation, vs the US where 66% of taxes are paid to DC. Only 2% of all European taxes collected are earmarked for EU level activities</p> 
<p>That sounds like a structural problem...but Trichet said there was no design flaw in the Euro</p> 	<p>That's why the new Redemption Fund is such a good idea</p> <p>Explain please</p> 	<p>In exchange for quasi-Eurobonds, countries like Italy would run a primary surplus of 4% of GDP for 25 years in a row and agree to constitutional debt brakes whose levels would have been breached 70% of the time since Italian Unification in 1861 if they existed</p> 	<p>All ideas are good ones as long as you don't think about them</p> <p>If something doesn't work, it's OK, it will eventually</p> 
<p>I suppose the ECB could buy more bonds. There is of course no risk to that</p> <p>Yes, since Greece was a special case</p> 	<p>Totally special. And remember, Tremonti said there wouldn't have been a crisis if Eurobonds existed</p> <p>Yes, Eurobonds! But wait, Germany is against Eurobonds</p> 	<p>[in unison] Can't the ECB just keep lending to EU banks to buy EU bonds?</p> 	<p>We cannot go on like this</p> <p>That's what you think</p> <p>F I N</p> 

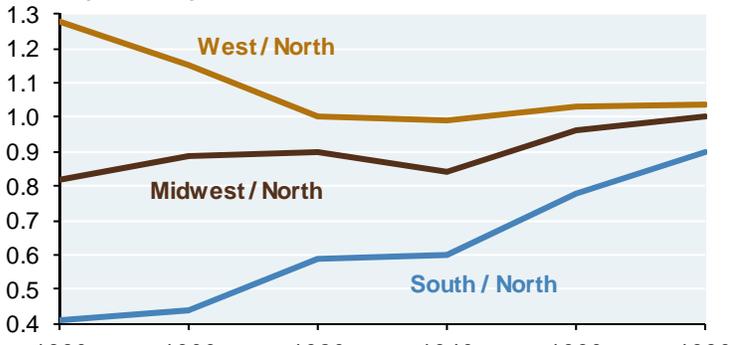
* All countries in the world beginning with the letter "M". See chart on page 3.

How long can this go on? It feels like a new policy option is needed (particularly in Spain, which looks terrible), but you would have to be a wide-eyed optimist to believe it will be a decisive one. Over the weekend, I reread an influential paper from the 1949 US Quarterly Journal of Economics which looked at how the US survived the Great Depression. A critical factor: US regional transfers undertaken by the US Treasury which were "*unilateral in nature, akin to a capital movement, a gift or an indemnity in international trade*". These unilateral transfers enabled weaker US districts to maintain a level of growth and consumption which would otherwise have been impossible (see Sources). Other signs of the US monetary union becoming

more durable are found in the gradual disappearance of regional wage differences (1st chart). If the hallmarks of a durable union include unilateral transfers to smooth out regional income differences, and signs of wage convergence, **Europe could sure use a lot more of both.** Just having a willing lender of last resort may not be enough.

Monetary unions should look like this...

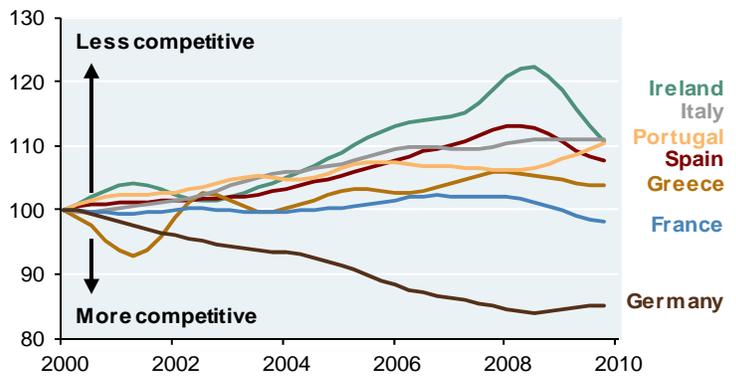
US regional wages relative to Northern states, ratio



Source: "The U.S. Structural Transformation and Regional Convergence", Journal of Political Economy, 2001, vol. 109, Caselli and Coleman.

...and not like this

European unit labor costs, Jan 2000 = 100



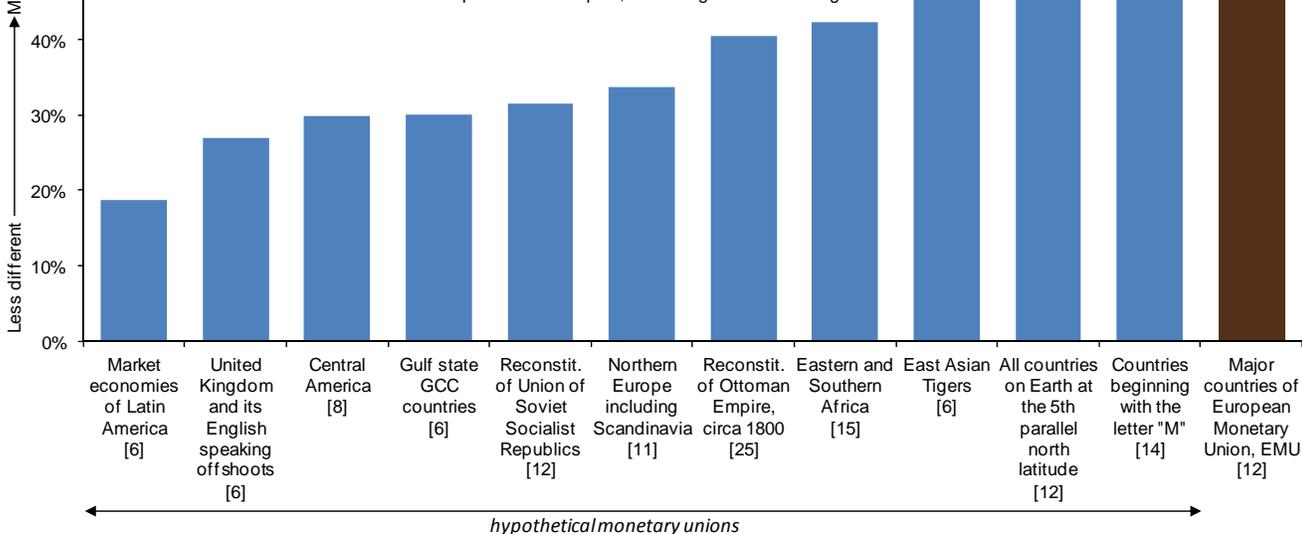
Source: EU Commission.

From a political perspective, the European Monetary Union might deserve more time before final verdicts are rendered, as it's only 10 years old. But from an economic perspective, they may not get the chance: the resolution of a staggering **€10 trillion** in Peripheral sovereign, household and corporate debt may not wait. The pressure is resulting in the propagation of views like this: the Italian newspaper *Il Giornale* wrote that Germany, not Greece, is Europe's real problem, "because it is bursting with health and, as a result, is also causing its neighbors to burst. Germany has to adjust to the rest of Europe, not the other way around." Ah yes, German growth is the problem. I am rendered speechless by this logic, and can only guess that it is a manifestation of combining insufficiently similar countries in a monetary but-not-fiscal union (see chart below). Even if post-election Greece remains in the Euro, none of the fundamental questions will have been answered. The idea that Italy would run a budget surplus before interest of 4% of GDP for 25 years (as per the European Redemption Fund proposal) is frankly ridiculous.

No one has any idea what will happen next, as the Europeans are making it up as they go. From an investments perspective, it makes sense to continue to watch Europe mostly from the sidelines and focus on other things, such as those listed on page 1. **The shadow of European distress has made many of these assets cheaper.** Next week: prospects for a U.S. manufacturing renaissance and a look at the 2012 Presidential election.

The European Economic and Monetary Union (EMU): A Road Less Traveled

Measuring the dispersion of hypothetical and actual monetary unions
Dispersion measures the standard deviation of country-specific factors in each union. Factors reflect over 100 economic, social and political characteristics. Number of countries in each union shown in brackets.
See May 2, 2012 Eye on the Market for further details.
Source: World Economic Forum Global Competitiveness Report, J.P. Morgan Asset Management.



Sources

“*Interregional Payments Compared with International Payments*”, Penelope Hartland, Quarterly Journal of Economics, Vol. 63, No. 3 (Aug., 1949), pp. 392-407. Hartland found that during the Depression, unilateral US Treasury transfers from stronger industrial and financial regions into weaker agricultural regions almost completely offset the departure of private sector flows from the latter. We included charts on these transfers using Hartland’s data in our April 20, 2010 *Eye on the Market*, as we had a premonition that Europe would not replicate them, and that they would play a role in understanding the structural problems of the European Monetary Union.

Il Giornale quote as reported in Der Spiegel Online, May 26, 2012

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