Why is it taking so long for Europe to take decisive action and rescue its monetary union? Wednesday Conference Call

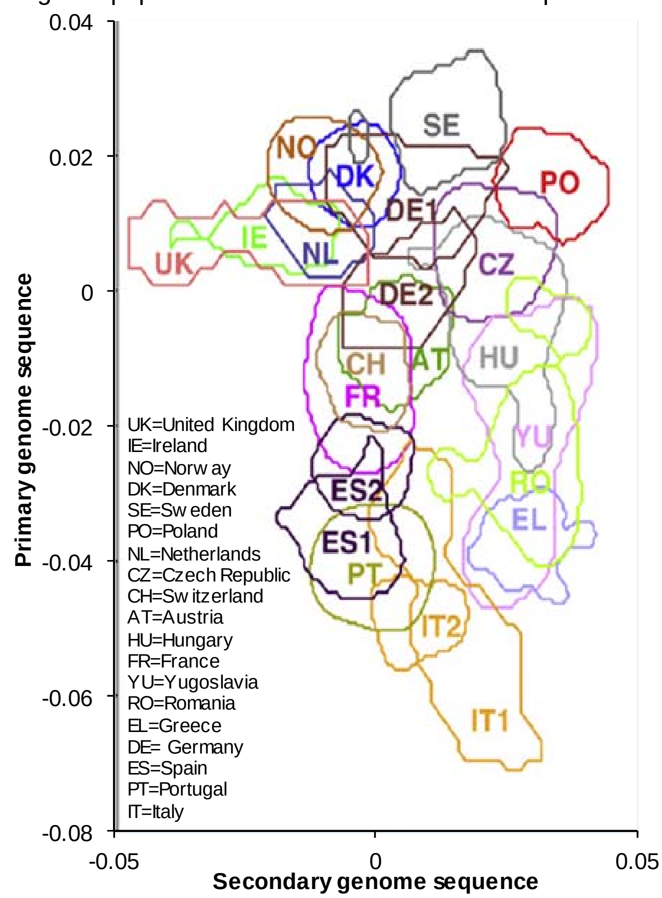
Why isn't Europe acting more decisively to save the European Monetary Union (EMU)? After all, there is precedent for great sacrifice to achieve political goals: German reunification costs of $2 trillion are more than peak Versailles reparations[1]. Consensus opinion is that Germany will cave in and save Europe (either through massive fiscal transfers, joint and severally guaranteed Eurobonds, or infinite expansion of the ECB balance sheet). So far, they have not. At this point, it is fair to wonder if something more fundamental is at work: does Europe have, as we have cited before from the German Constitutional Court's 1992 opinion on Maastricht[2], **a "European consciousness, with a concrete capability and readiness for statehood?"**

As things stand now, it will take more sacrifice to save "Europe". But does being "European" mean as much as it is *assumed* to mean? In a piece we wrote a year ago, we wondered about that, and cited research from Christian Welzel at the University of Bremen, and earlier studies from renowned Dutch anthropologist Geert Hofstede, that show substantial cultural differences between European countries. These differences are as large as between countries in Asia and Latin America which are *not* joined in monetary or fiscal union (try to imagine a union between Korea, Japan and China…). **If this seems abstract, it played a large role in our decision to avoid European equity and credit this year, given the need for coordinated action to address the spiraling debt crisis.** Other kinds of research may be informative here as well. The accompanying chart shows DNA mappings of European citizens. What researchers[3] found: while genetic variations were small (all humans are quite similar), the variations were tied very closely to geography. By grouping similar DNA results together, one obtains something that looks very much like a map of Europe.

I'm taking this research well afield from where it started, but to me, these patterns may explain the origins of cultural differences that Welzel and Hofstede refer to. This map reflects hundreds of years of migration, weddings, funerals, births, language, values passed to children, circumstances that call for charity, sacrifice, revenge and everything else that define "culture". The greater the degree of DNA overlap, the more these experiences may have been shared across regions through inter-marriage. The reverse may be true as well, particularly where there is much less overlap (Greece, Italy). The universe of sampled individuals may not be a perfect proxy for all of Europe, but various studies that looked at the DNA data came to similar conclusions. **The map shows clear patterns of ancestry tied to geography**, which is perhaps why the EMU was designed to retain the region's fiscal, economic and cultural identities.

The search for a "European consciousness" vs. the contours of history

Regional population clusters based on DNA sequence



Perhaps we should not be surprised that Northern Europe is struggling with whether it will mortgage its future to save the South. Yes, it's expensive, given the financial imbalances. But apart from cost, is the "will" there? In terms of shared experiences and values measured by anthropologists, and the contours of history implied by genetic research, they may not have enough in common. It took almost 150 years for the US to reach the same point in its history, when it began to cede more control to a Federal, centralized government (see bottom of p2).

It is now 6 months after passage of legislation creating a backstop for Southern Europe, and it's not yet operational. US money market funds cut exposure to Europe from 55% of total assets in 2009 to 35%. The crisis is spreading to Belgium (chart 1, p2), whose debt is almost at Italian levels. Italy paid 6.5% for T-bills last week (almost 2x the rate paid a month ago), and forensics on Italy are worrisome: after stripping out non-recurring items like asset sales, Italy made almost no progress bringing debt down in the years heading into EMU (chart 2, p2). Even unlimited ECB buying ("spread targeting") might not work in the long run. **There would probably be a substantial relief rally around the world if the ECB announced 1 trillion Euros of bond purchases; but what happens after that if everyone sells Southern European bonds to the ECB at their inflated price?**

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[1] Computed in real terms. See July 25 2011 EoTM, based on Carl-Ludwig Holtfrerich, and the Zentrum fur Europaische Politik (Freiburg)
[2] A citation from Paul Kirchhof of the German Constitutional Court, courtesy of Bernard Connolly of Hamiltonian Advisors
[3] "*Correlation between Genetic and Geographic Structure in Europe*", Current Biology Magazine, August 2008.

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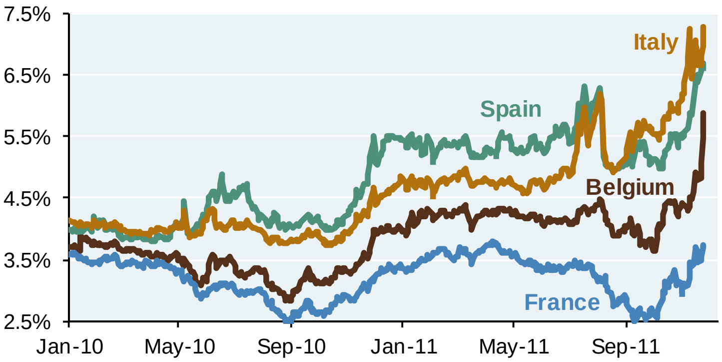
The IMF? As we showed in the Nov 14 EoTM, in prior debt crises, expanded IMF credit lines took place a few months *before* markets collapsed, possibly for the same reason: it becomes a means for investors to exit. One idea involves the ECB funding the IMF, which makes my head spin. Our understanding of Precautionary Credit Lines is that based on current quotas, the IMF could only address a small part of Italian funding needs, if Italy lost access to debt markets. EU politicians and regulators are reportedly frustrated in being beholden to markets and rating agencies; that's something they should have considered before its various governments and financial institutions borrowed 22 trillion Euros from fixed income investors (chart 3, below).

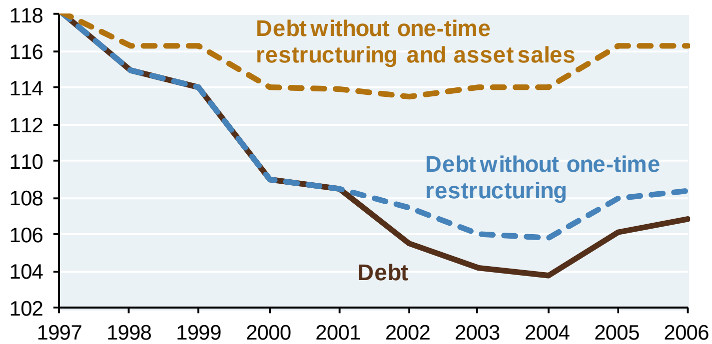
To sum up, I remain worried about Europe's ability to back its political rhetoric with sufficient action. Negotiations between France and Germany on Maastricht 2.0 (e.g., **allowing member countries to veto each other's budgets!**), designed to coax the ECB into buying more bonds, has a long road ahead of it. Second, as we have documented time and again over the last 2 years, competitiveness differences brought into high relief by the Euro make its monetary union difficult to manage (see chart 4). **Nothing would be better than for me to be wrong on both counts; for massive ECB purchases to permanently improve sentiment; and for there to be a White Knight solution we have not thought of yet. Concrete action could unleash what might be more sidelined cash than I have seen in 25 years. If not, the risk of another period of very disorderly markets may lay in front of us when the European sovereign and bank issuance calendar picks up in the first quarter of 2012.**

European sovereign 10 year yields
Percent



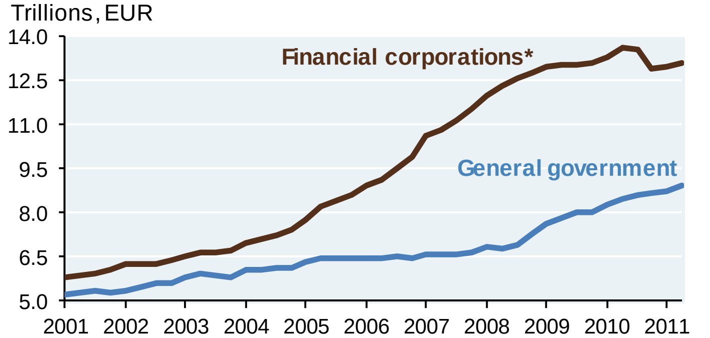
Source: Bloomberg.

Italian public debt with and without asset sales and one-time debt restructuring, Debt/GDP, percent



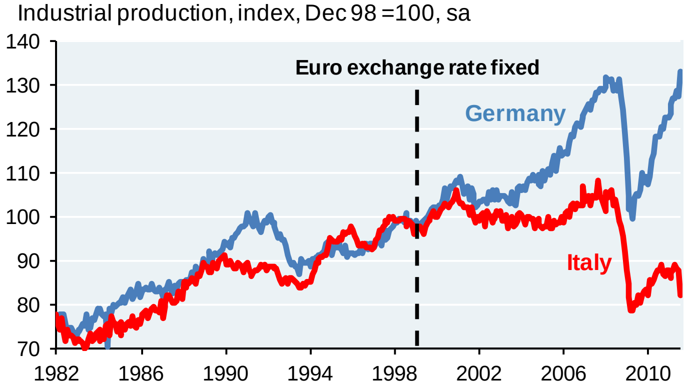
Source: *"Temporary measures in Italy: buying or losing time?"*, Momigliano and Rizza, Bank of Italy Public Finance Division, 2007.

Outstanding debt in Euro Area
Trillions, EUR



Source: Statistical Office of the European Communities/Haver.
*Includes 5 trillion of bonds issued by Monetary Financial Institutions (MFIs), 3 trillion of bonds by non-MFI financial corporations and 5 trillion in loans issued by MFIs/non-MFIs. Data as of Q2 2011.

The Euro Novella: *Death in Venice*
Industrial production, index, Dec 98 =100, sa



Source: OECD.

The US as monetary and fiscal union, for context

The lack of ancestral commonality does not prevent the US monetary and federal union from functioning. But there is an "ideal" at work in the US that translates into shared fiscal sacrifice not seen in Europe**.** How real is this ideal? **Americans pay 2x as much to their Federal government as to state and local ones, something unimaginable in 1913 when a 7% Federal Income Tax was created.** This dynamic allows fiscal transfers from wealthier states to poorer ones. The chart at the top of the next page shows transfers from California, Connecticut, Illinois, New Jersey and New York to Missouri, Tennessee and Kansas, measured as $ of Federal spending received per $ of Federal taxes paid. Below the chart, we show transfers of equivalent size that *could* take place in Europe. The lesson of the US is that people can adjust to an expanding federal/executive branch over time, although in the US, it took almost 150 years to get there. Could that ever happen in Europe? I asked some French clients if they could imagine sending just 30% of their taxes to Brussels; I cannot repeat the responses.

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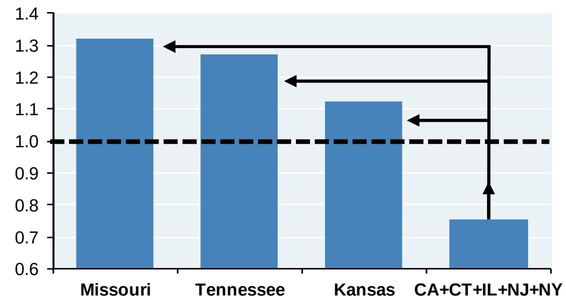
Two other points about the US. During its formation as a monetary union in the 1800's, US wage rates converged (rather than *diverged*, which is what happened in Europe after EMU). Secondly, through a series of wars, against enemies internal and external (both real and imagined), an American consciousness was created which supports the fiscal transfers, wage convergence and labor mobility shown. The US now faces challenges related to income and wealth distribution, and entitlements, which have yet to be resolved. The failure of the Super Committee puts these in high relief. But so far, the U.S. has proven to be a viable monetary and fiscal union, and has retained its status as a reserve currency, which is what matters to marginal buyers of Treasury bonds. As Otto Von Bismarck is reported to have said, **"There is a special providence for drunkards, fools, and the United States of America."**

Fiscal transfers between states in the U.S.
Dollars, federal spending received per dollar of tax paid, 2005



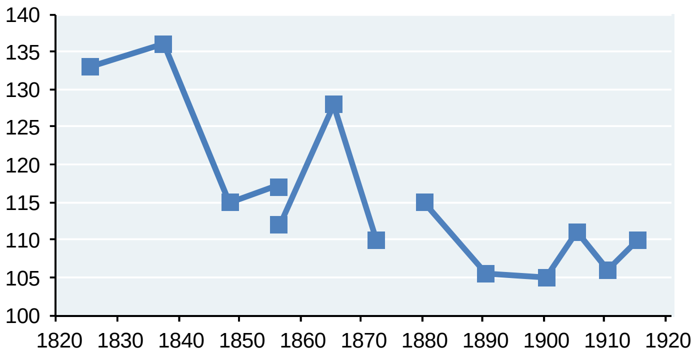
Missouri	Tennessee	Kansas	CA+CT+IL+NJ+NY	
1.7%	1.8%	0.9%	30.5%	% of US GDP

If seamless transfers existed in the EU, they might look like this:

Portugal	Greece	Ireland	DEU+LUX+ NLD+AUT+FIN	EU proxy
1.7%	1.8%	0.9%	27.8%	ECB capital weight

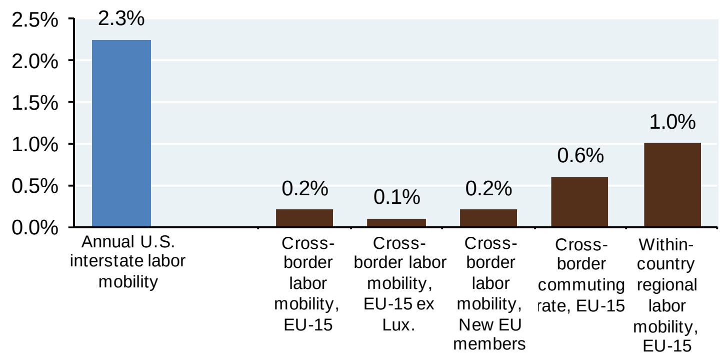
Source: US Census, Tax Foundation, ECB. ECB capital weights based on EU membership, not Eurozone membership.

Midwest real wages relative to Northeast
Northeast = 100 in each year



Source: Joshua Rosenbloom, University of Kansas - "The History of American Labor Market Institutions and Outcomes".

Labor mobility: U.S. vs Europe
Value



Source: "Geographic Mobility in the European Union", April 2008, European Commission, Directorate General for Employment, Social Affairs and Equal Opportunities.

Not all the news is bad; despite weak income growth, Americans continue to spend like crazy. Please join us on a conference call on Wednesday morning at 10am EST. See your J.P. Morgan coverage team for details.

Michael Cembalest
Chief Investment Officer

Sources and Acronyms
"*Changing Mass Priorities: The Link between Modernization and Democracy*", Inglehart and Welzel, Perspectives on Politics, June 2010
"*One Money for Europe? Lessons from the US Currency Union*", Barry Eichengreen, UC Berkeley, 1990
EMU = European Monetary Union; ECB = European Central Bank; DNA= Deoxyribonucleic Acid; IMF = International Monetary Fund