Trend Macro

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MACROCOSM

Crunch Time for Reform in Europe

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Lorcan Roche Kelly

The honeymoon is ending for Monti and Rajoy, as labor reforms get politically difficult.

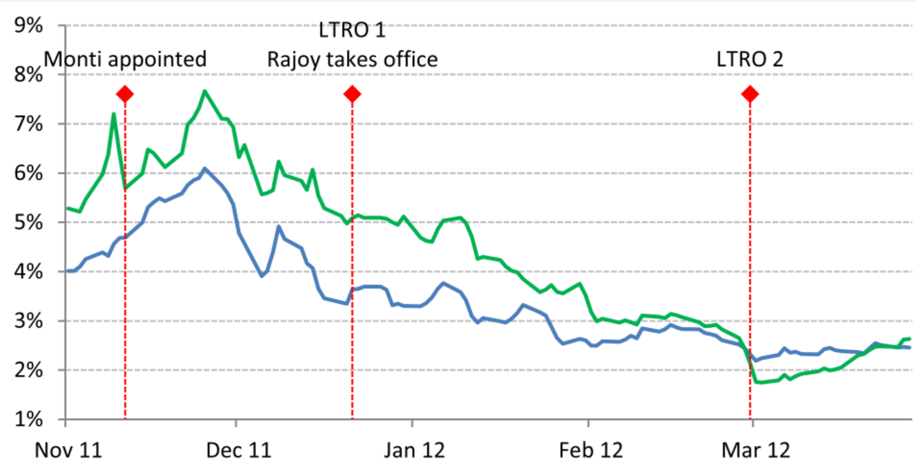
Both Spanish Prime Minister Mariano Rajoy and Italian Prime Minister Mario Monti have been reminded this week that structural reform has political cost.

- Rajoy's People's Party failed to secure a majority in the regional elections in Andalusia -- an election where they had long held the lead in polling.
- Monti is encountering increasing resistance to his labor market reforms in Italy, leading him to threaten that his government may resign if the reform process stalls.

The uncertainty caused by this has led to the halt we forecasted for the rally in Italian and Spanish sovereign debt (see "Unquestionable Success?" March 9, 2012, and the chart below). But it does not mean the end to reforms in either country. Indeed, as sovereign yields back up, the pressure for reform is intensified.

Leaders who try to unwind the entitlements of vested interests are always going to come under attack (a universally popular politician is one who does not have to make difficult decisions). But Monti and Rajoy have a

2-year sovereign yield — Spain — Italy



Source: Bloomberg, TrendMacro calculations

Update to strategic view

EUROPE MACRO, EUROPE STOCKS: This is where the hard work starts for reform in Italy and Spain. Both Mario Monti and Mariano Rajoy are hitting political resistance as they attempt to overturn labor market inflexibilities. Fighting vested interests is never easy, but both leaders must -- and we think will -- stay the course. Reform continues to be a powerful thematic driver for Italian and Spanish stocks.

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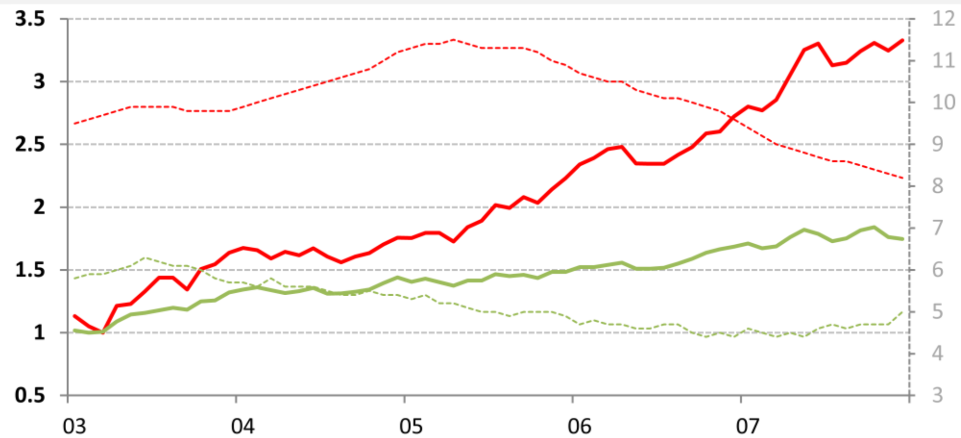
clear reform roadmap to follow -- that laid down by Gerhard Schröder's wildly successful "Agenda 2010" reforms begun in Germany in 2003 (see ["Europe's Supply-Side Revolution"]() February 17, 2012).

The problem for Italy and Spain with the structural reforms they are implementing now -- especially in labor markets -- can be seen by looking at the effects of the 2003 German reforms (see chart below). Between 2003 and mid-2005 the German unemployment rate rose to become the highest in the euro area. It has since fallen to one of the [lowest in the developed world]() -- and even when it was rising, German equities turned in the best performance among the major developed markets, including those like the US where unemployment was *falling.*

DAX Index **S&P 500** Month-end, normalized to 1 at 2003 low
German unemployment **US unemployment**



Source: Bloomberg, Eurostat, BLS, TrendMacro calculations

But while hindsight shows the German reforms turned out to be a brilliant move, the pressure to halt any labor market reform builds throughout the process as unemployment increases. Structural reforms need time, and a long term commitment from politicians to continue to drive them through.

- The Spanish growth model for the past decade has been built on debt. Credit has long since dried up. Refocusing the economy is going to take time.
- The first test of Rajoy's commitment to reform comes this Friday, when his government [unveils its 2012 budget](), the [day after a national strike]().
- Any cuts in the budget -- and, with [nominal cuts of $46 billion]() needed there will be many -- will be strongly resisted. While Rajoy's 10-seat majority is likely to remain safe, too much perceived "austerity" will be fuel to his critics.
- Rajoy has already shown himself to be aware of the political unpopularity of the likely measures -- he already delayed the budget until after the Andalusia election. But he is committed to reducing the [Spanish deficit to 3% of GDP]() by end of 2013.

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[**From a vicious to a virtuous circle in the Eurozone - the time is ripe**]()
Marco Buti and Pier Carlo Padoan
VoxEU
March 27, 2012

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- We expect Rajoy to stay the course on the reforms. But there will be lots of political noise. Bad news sells papers and stories of "grinding austerity" in Spain are going to become the norm while the process continues.
- The risks to reform are high, but so too are the rewards (see "Spanish Flu?" March 16, 2012).

The Italian story is somewhat different. Sovereign debt is very high, but the deficit is under control. Italy's biggest problem is growth: it has not grown at all over the past decade.

- Monti, whose term as prime minister ends in 2013, has a shorter political time-line than Rajoy, so he is pushing reforms through at a faster pace. During this process, he relies on a carefully built cross-party consensus in the Italian parliament for support of his decrees. This is not as stable as Rajoy's majority, but is holding well so far.
- A flashpoint now for Monti is his intention to repeal Article 18 of the Italian labor laws, which makes it virtually impossible for employers to fire workers. Needless to say, unions are unhappy about the prospect. While some have endorsed Monti's initiative, one has vowed to stage strikes to coincide with the parliamentary debate on the measure. And the Democratic party, which controls one third of the Italian parliament, wants the reforms diluted.
- Monti is standing firm -- hence his threat to resign. But the euphoria accompanying the end of the Berlusconi period has passed, with confidence in Monti's leadership falling according to some recent polling -- although it is still well above 50%.

For both leaders, we are entering the period when reforms get hard. Popularity will wane as political opponents score points decrying "austerity" -- the vested interests' word for "reform" -- a lesson that can also be learned from Gerhard Schröder's experience in Germany. He lost the German leadership in the 2005 election, just as his reforms were starting to bear fruit.

For investors, the lesson to be learned from the German Agenda 2010 template is that markets can gain considerable ground during the reform process, as equities begin to impound expectations for higher potential growth through more flexible labor and product markets (again, see the chart on the previous page). So if the reforms are credible to investors -- to our minds, they very much are -- the best time to invest is at the start of the process, and not to wait until the process is complete.

Bottom line

This is where the hard work starts for reform in Italy and Spain. Both Mario Monti and Mariano Rajoy are hitting political resistance as they attempt to overturn labor market inflexibilities. Fighting vested interests is never easy, but both leaders must -- and we think will -- stay the course. Reform continues to be a powerful thematic driver for Italian and Spanish stocks.