

MACROCOSM

## Renzinomics Renaissance

Thursday, February 20, 2014

 Donald Luskin with research input from **Lorcan Roche Kelly**

### Once more with feeling: an unelected prime minister brings supply-side reforms to Italy.

There was a time when political instability in Italy -- the most indebted of the so-called "PIIGS" of the euro area -- was a significant factor in global financial contagion (see ["The Sack of Rome"](#) July 13, 2011, and ["Rome Makes Athens Look Good"](#) November 10, 2011). Last year we argued that it no longer was (see ["Italy Gets Hung"](#) February 26, 2013). *Suddenly it is making the Italian stock market the best-performing among large developed nations in 2014 year-to-date (please see the chart below). After a power struggle that has ejected the ineffectual Enrico Letta as prime minister, the handsome and charismatic mayor of Florence, Matteo Renzi, has taken the reins with an ambitious supply-side economic reform agenda.*

- "Renzinomics" embraces supply-side principles of labor market, product market and tax reform, in the conceptual framework set in the 1980s by Margaret Thatcher in the UK and Ronald Reagan in the US.
- Such principles undergirded Germany's "Agenda 2010" program introduced by Chancellor Gerhard Schroeder in 2003, which

#### Update to strategic view

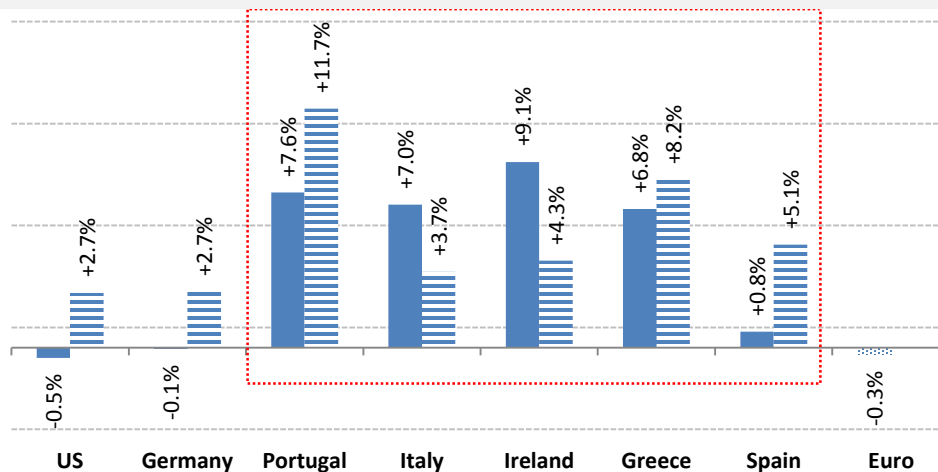
#### EUROPE MACRO, EUROPE STOCKS, EUROPE BONDS:

Charismatic Matteo Renzi has emerged as Italy's new unelected prime minister, with an aggressive supply-side reform agenda designed by Israeli consultant Yoram Gutgeld. Lacking a mandate or electoral legitimacy, it will be difficult for Renzi to actually implement much of his agenda. But that he and his agenda should come to power is in the air in the euro area, even in France. We continue to see the euro area as a unique growth opportunity: free now from existential risks of currency disunion, implementing supply side reforms to various extents, and being still early cycle in coming out from under the Great Recession.

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2014 year-to-date USD

■ Equities price return ■ 7-10 yr gov't bonds total return ■ Currency



Source: Bloomberg, TrendMacro calculations

transformed Germany's once sclerotic economy into the most dynamic in the developed world.

- And it has been a template for structural reforms imposed on peripheral euro area nations in exchange for various bail-outs over the last three years (see "[Europe's Supply-Side Revolution](#)" February 17, 2012). Applied in different ways and with different degrees of success across peripheral Europe -- most effectively in Spain, led by Prime Minister Mariano Rajoy -- these reforms have lifted the PIIGS out of seemingly intractable recession and, we have argued, position them for superior early-cycle growth this year and next (see "[When PIIGS Fly](#)" February 10, 2014).

Renzi is set to present his new coalition to parliament on Monday. So far he has offered only [a vague outline](#) of his reform agenda for the first 100 days of his administration -- the electoral system this month, the labor market in March, public administration in April, and the tax system in May.

- Electoral reforms will likely include a system of prohibitive thresholds that will make it more difficult for small radical parties to get into parliament -- a key reason why Italian coalitions can't stay together for long.
- Economic reforms will likely be guided by the philosophy of a key Renzi advisor who is emerging as his reform czar: [Yoram Gutgeld](#), an Israeli and a former McKinsey consultant (his surname means "[good money](#)" in German).
- Gutgeld has written [a book](#), in Italian, called *Più Uguali Più Ricchi* -- or, *More Equal More Rich*. Despite the populist title, Gutgeld argues that to "bring fairness to the center of political debate does not mean creating a country of equals, but one in which companies are able to operate at its best and people are rewarded according to their ability."
- Specifically, Gutgeld advocates:
  - Reducing taxes on labor
  - Streamlining the complex system of permits and licenses for all kinds of development
  - A large round of privatizations (with the intention of raising €20 billion) to cover the transitional revenue losses from reduced taxes
  - Simplifying the byzantine Italian taxation system, including centralization of the taxation function
  - Liberalizing the labor market by making it easier for companies to fire and hire workers
  - Reforming the pension system, placing caps or increasing taxes on overly generous pensions

Such reforms would be transformative. But they inevitably run up against vested interests, especially unions and public employees.

- Former Prime Minister Mario Monte tried -- and failed -- to implement a similar program, even when Italy was embroiled in a debt crisis and had every incentive to accept reforms.

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- Perhaps the charismatic Renzi can pull it off. But charisma only takes one so far, as Japanese Prime Minister Shinzō Abe is learning as he struggles to implement the "third arrow" of "Abenomics" (see, most recently, "[Japan Breaks Out -- Does It Matter?](#)" November 19, 2013").
- And reform is very much alive and well in Spain, and accelerating -- so it *can* be done.

Renzi will face one of the same barriers that thwarted Monte -- he is an unelected prime minister and lacks the legitimacy of having earned a mandate in a general election. Instead, he came to power through internal machinations within his Partito Democratico. Indeed, Renzi has never even been elected to the Italian parliament -- until this week his only elected position was mayor of Florence.

- But of all the politicians that might have been able to seize power now, by whatever means, it was Renzi -- with his reform agenda -- who did so. So surely there is *some* appetite of *some* reform.
- And as we have argued in the case of Japan, a deeply sclerotic economy can produce a most gratifying spurt of growth with even the smallest application of reform.
- But be that as it may, for us the overriding strategic reality for the euro area is that it is now emerging from three years of constant existential risk, and thus is effectively still in the early cycle of recovery from the Great Recession.
- And reform in the euro area is very much in air, however frustrating it may be to see it applied unevenly across various nations, and hardly at all so far in Italy where it is needed so desperately.
- Even in France, a nation with a far-left president that was spared the crucible of the euro area debt crisis, there are glimmers of supply-side reform. President François Hollande has [met with Peter Hartz](#), the architect of Germany's labor market reforms, and is [taking openly about](#) "likely the biggest social compromise in decades."

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### Bottom line

Charismatic Matteo Renzi has emerged as Italy's new unelected prime minister, with an aggressive supply-side reform agenda designed by Israeli consultant Yoram Gutgeld. Lacking a mandate or electoral legitimacy, it will be difficult for Renzi to actually implement much of his agenda. But that he and his agenda should come to power at all signals that reform is in the air in the euro area, even in France. We continue to see the euro area as a unique growth opportunity: free now from existential risks of currency disunion, implementing supply side reforms to various extents, and being still early cycle in coming out from under the Great Recession. ▶