April 20, 2012

Dear clients and colleagues,

In the last few weeks, Europe has been in the spotlight again. Economic numbers out of the region continue to show disparity between the north and the south. Germany's economy continues to be very strong. With low unemployment and rising consumer confidence, domestic demand and real estate markets are very strong, creating concerns for the German Central Bank. The south, however, with Portugal, Spain and Italy, is facing a dilemma of reducing deficits in a declining economy. Many doubt it will be possible and bond rates have recently been on the rise with Spanish 10-year bonds breaching the psychological 6% level.

We are confident that the actions undertaken by the governments in Spain and Italy are appropriate. Although painful in the short-term, both countries will be stronger in the future.

What makes us optimistic? Nobody doubts the attractiveness of these two countries from a tourism perspective. As new tourists from China and other emerging markets start to travel, Spain and Italy will be prime beneficiaries.

Another source of optimism is the very high savings rates they enjoy. Individuals and corporations have great balance sheets; the government is the problem. This is not so bad compared to the US, where corporations are on a sound financial footing with individuals and governments in bad shape.

The most important reason behind our optimism is the important labor reforms being undertaken in the two areas. Around 2002, Germany embarked on an important reform of its labor market policies with the aim of reducing unemployment and decreasing non-wage labor costs. The most important reforms were to make the labor markets more flexible and increase the use of part-time labor and outsourcing. They also reduced unemployment benefits and created programs to help retrain and find jobs for the unemployed. Since March 2005, the German unemployment rate has declined from 12.1% to 6.7%. Meanwhile the participation rate has trended up from 76% in 2002 to around 81% now. The downside of the reform, adjusted for inflation, is that employee wages fell by 2% in 2002-2011.

Turning to Italy and Spain, we see that now both countries have embarked on similar paths of labor reform.

In Italy, Mario Monti, the new prime minister since November 2011, is also the minister of economy and finance. Monti served on the European Commission from 1995-2004 with responsibility over competition. He was also rector and president of Bocconi University in Milan, one of the leading universities in the world.

Earlier in 2012, the Italian government adopted a package of reforms. First, the reform opens many professions from taxi drivers to doctors to more competition by reforming their licensing system and abolishing the minimum tariffs for their services. The reform also eliminates Article 18, which forces companies with more than 15 employees to re-hire rather than compensate employees fired without cause.

The goal is to increase the incentive for employers to create permanent jobs; in effect eliminating the ‘dualism’ of Italy’s current labor market where many older employees essentially have jobs for life while younger people are subject to unstable part-time contracts.

In Spain, the labor reforms modified aspects of the collective bargaining system, making it easier for firms to break with sectorally-agreed wage increases. It also reformed the training system by making training a right of workers and mandating 20 hours of training per year. It also reduced the severance pay for unfair dismissal from 45 days per year worked to 20 days. It will also use temporary work agencies to support the unemployed.

What will be the effect of those reforms? In the short term, it will unfortunately destroy jobs. In Germany, we saw that the unemployment rate went from 9.5% in 2002 when the first set of reforms was adopted to 12.1% in 2005 before subsequently dropping after.

In the longer term, we believe that these reforms will stimulate job creation. We would expect to start seeing the effects in 2013 or 2014.

Have a good week.

The Global Alpha team