

THE LONGWAVE ECONOMIC AND FINANCIAL CYCLE
ECONOMIC WINTER



The Rise of Populism Within the European Monetary Union

Virtually exhausted by austerity measures, staggering sovereign debt levels and persistently high unemployment rates, the economies of the euro zone countries located on the Mediterranean periphery continue to struggle for survival. It represents a long and arduous journey replete with seemingly endless challenges. Indeed, the austerity programs pursued by governments, either trying to regain or retain access to the bond markets, have resulted in a decline in domestic demand, with consumers and businesses curtailing their spending. Increasingly, the electorates of Greece, Spain, Portugal, Italy and to a lesser extent France, are making their voices heard whether by protesting in massive street demonstrations, or via the casting of their ballots on election day, the cause of populism is on the upswing.

In a recent speech in Dublin, International Monetary Fund Managing Director Christine Lagarde expounded: “The impact of austerity in Southern Europe could be offset by a boost to demand in Northern Europe, particularly in Germany. When we talk about demand, we must understand that it is unbalanced across Europe; being much stronger in the north than in the south. Restoring a sense of balance means lower inflation and wage growth in the south, but it also might mean allowing somewhat higher inflation and wage growth in countries like Germany. This too is an aspect of pan-European solidarity. In the interests of all euro zone countries, I won’t balk at continuing to speak that a more balanced euro economic model is desirable. We need to ensure that any spark to demand fuels sustained economic growth. This means reforms to boost the supply capacity of the economy. The IMF has done some interesting work here. We have found that large-scale product market, labour and pension reforms across Europe could boost the level of output by 4.5% over five years.



IMF Managing Director Christine Lagarde.

Source: Agence France-Presse/Getty Images

I also urge euro zone governments to forge ahead with plans to establish a single supervisor for their banks and take further steps to ensure that troubled banks become the responsibility of all, not just one. A single supervisor on its own is not enough. The EMU needs a single resolution authority that can restructure or shut down problem banks in a timely manner at the least cost, including by sharing the burden with the private sector. The EMU needs a common safety net, such as a common deposit fund to sustain confidence. In addition, it requires common backstops to deal with systemic problems across borders.”

Longwave Economic/Societal Parallels to the Past

At Longwave Analytics, we are avid, indeed incurable historians. Our love of history transcends both the millennia and a very broad range of topics and subjects. Interestingly, we currently find ourselves living through a unique time frame where many 80-year and 100-year economic and societal parallels are not only evident, but also meaningful. We only have to observe the monetary policies currently in place at several of the world’s leading central banks to witness the implementation of quantitative easing programs i.e. the monetization of sovereign debt, as well as a undeclared global currency war wherein countries battle to weaken their currencies in order to bolster their exports, in an attempt to achieve a surplus in international trade and current account positions. At present, Japan has implemented the most aggressive policy in this regard, attempting to extricate itself from the mantle of two decades of deflation and contraction in its gross domestic product (GDP). Similar trade policies were attempted by countries in 1933 during the Great Depression, but to no avail. Worse today, many countries are overburdened by staggering levels of sovereign debt, including Japan, the United States of America, Great Britain, Greece, Italy, Spain and Portugal, just to name several.

Indeed, in a recent interview with the magazine Der Spiegel, Jean Claude Juncker, prime minister of Luxembourg exclaimed: *“Anyone who believes that the eternal question of war and peace in Europe is no longer there, risks being deeply mistaken. The demons have not gone away – they’re only sleeping, as the wars in Bosnia and Kosovo showed. I am chilled by the realization of how similar circumstances in Europe in 2013 are to those of 100 years ago. Recent elections in Greece and Italy aroused national resentments to the surface, which we’d believed had disappeared. In 1913, many believed there would never again be a war in Europe. The great powers of the continent were so closely intertwined economically, that the widespread view was they could no longer afford to have military confrontations. There was a complete sense of complacency based upon the assumption that peace had been secured forever. The only way for Europe to continue to wield global influence in the future is through being united. The governments of Germany, France and Britain all knew that the only way that their voices could be heard internationally was through the megaphone of the European Union.”* Almut Moeller, a European Union analyst at the German Council on Foreign Relations, explained: *“Mr. Juncker is someone who wants to address the euro crisis in a political way. There has been a huge transformation in (European) society, which we’ve witnessed in the most vulnerable countries. In that sense, Mr. Juncker wants to sound a warning that this is a big job for politicians.”*



Luxembourg Prime Minister Jean Claude Juncker

Source: Associated Foreign Press

The Political Theatre of the Absurd Engulfs the Apennine Peninsula

As reported in *The Economist*, in the recent Italian election, 25% of the electorate – a post war record – did not bother to cast a ballot. Of those who did, about 30% endorsed Silvio Berlusconi whose ruinous policies as a clownish prime minister are a main cause of Italy's economic woes. A further 25% voted for the Five Star Movement, which is led by a genuine comedian, Beppe Grillo. This election result is a disaster for Italy and for Europe. In Rome, the centre-left coalition led by Pier Luigi Bersani, the pre-election favourite – who garnered only a shade more of the vote than Mr. Berlusconi – is now struggling to form a government: it is unlikely to be either stable or durable. As many as two-thirds of Italians rejected, not only German-imposed austerity, but also the entire reform agenda which was designed to improve their economy's dismal record of near zero gross domestic product (GDP) growth. Italian GDP per capita has actually contracted during the euro's first 13 years of existence. It has everything to do with steadily rising labour costs and declining productivity, which have undermined Italian competitiveness and exports. If Italy's government cannot regain lost competitiveness and reignite GDP growth through greater liberalization of its labour and product markets, plus reforms to the country's legal and welfare systems, the economy will suffer and youth unemployment will climb to an even higher level than today's 36%. This is dangerous. It is difficult to see Italy remaining in the EMU in such dire straits and equally difficult to imagine the euro surviving if it withdraws. Italy represents the euro zone's third-biggest economy and although its budget deficit is rather small, it has the biggest stock of public debt at almost 130% of GDP. This makes it too big to bail out. However, without GDP growth, Italy will not be able to service its national debt.

Italy's political convulsions underline the need for German Chancellor Merkel to adapt her austerity prescription. To date, there has been a lot of austerity and some reform, but it should be the other way around. Deep recession and rising unemployment across the Mediterranean countries are triggering a popular backlash. Structural reforms continue to be essential if southern countries in the EMU are to win back competitiveness and rekindle GDP growth. However, given the voters' response and the scale of the recession, the pressure for continued fiscal austerity should now ease. Several EMU countries – France being the most recent example – are expected to miss their budget deficit targets this year. The European Commission (EC) should accept this if governments implement reforms, while northern euro zone members, especially Germany, should be more ready to stimulate demand via tax cuts and spending increases. The irony is that both of Italy's clowns have got one thing right. Mr. Grillo was correct about Italy's overpaid and corrupt politicians. Mr. Berlusconi was correct that austerity alone will not solve Europe's sovereign debt crisis. In any event, that doesn't excuse Italians from ignoring their predicament.

Berlusconi Stages another Political Comeback

As documented in the *Wall Street Journal*, despite being saddled with scandal, felled by the sovereign debt crisis and deserted by his traditional allies, the 76-year old Mr. Berlusconi was on his political deathbed only a few months ago when he pledged to quit politics "*for the love of Italy.*" While he didn't keep that promise, Mr. Berlusconi silenced nay-sayers and stunned financial markets when his conservative coalition garnered enough votes to deny its main rival of the parliamentary support it requires to form a stable government. In the key lower house of parliament, Mr. Berlusconi came very close to grasping a victory – a scenario that was deemed unthinkable just two months ago. However, the election outcome won't propel him back in the Prime Minister's office. In a post-election comment, Mr. Berlusconi cited: "*We all need to reflect on what we can do for Italy ... I don't think Italy can do without being governed but the prospect of holding another set of elections within months was not useful.*"

Mr. Berlusconi possesses an uncanny ability to transform perceived weaknesses into political strengths. Many economists and investors assumed Mr. Berlusconi had been fully discredited in the eyes of the Italian public when, in late 2011, he was forced to hand power over to an emergency government led by outgoing Prime Minister Mario Monti. However, Mr. Berlusconi responded to the ouster with an act of political judo, blaming Italy's economic woes on the tax increases and pension cuts introduced by Mr. Monti's government.

At times, the former prime minister has even appeared fortified by scandals and criticism which might have crippled lesser politicians. He has repeatedly made political hay of a criminal trial, in which he's charged with paying an underage woman for sex and abusing his power in an attempt to cover up the relationship. Mr. Berlusconi has made dramatic court appearances denying the charges and denouncing the trial as a form of persecution by politically-motivated magistrates.



Former Italian Prime Minister Berlusconi mops his brow on a TV show in Rome.

Source: Reuters

Italy's Satirist Turned Activist /Politician

Beppe Grillo, the former comedian whose upstart Five-Star movement increasingly appears to be the only real winner of Italy's general election, recently described center-left leader Pier Luigi Bersani as a "*dead man walking*" and vowed that his own party wouldn't be joining any coalition to form a government. Mr. Grillo's remarks fueled concerns that Italy won't be able to form a government unless Mr. Bersani can forge a grand coalition agreement with former prime minister Silvio Berlusconi. Mr. Grillo has stated he intends to have consultations with Italian President Giorgio Napolitano on his own, signaling that a formal agreement is unlikely in the coming days. Post the elections, the Italian head of state meets with leaders of the various parties to gauge their intentions and decide whether to give someone a mandate to try to form a government, which then must win confidence votes in both legislative chambers. However, those consultations take place only after the new parliamentarians take up their seats on March 15th. If no government can be formed, new elections would be required.



Five Star Party leader Beppe Grillo

Source: Wikipedia

Europe Can't Afford an Ungovernable Italy

According to *Der Spiegel*, European leaders are nervous Rome might flout economic reforms and reignite the euro crisis as a result of the political stalemate which emerged from the Italian election results. German commentators suggest that now might be a good time to consider policy changes on both sides. European leaders are on edge about what are likely to be negative effects on the European Monetary Union. Financial markets and rating agencies, the everyday harbingers of economic turmoil, have reacted negatively to concerns that despite a deep recession, much-needed reforms will not continue in the euro zone's third largest economy. With the center-left and center-right political parties now pitted against each other, there is little to indicate that economic progress will be made in Italy. However, that hasn't stopped appeals from European leaders for politicians to consider the consequences for the euro crisis, which many fear could now return. German Finance Minister Wolfgang Schauble remarked: "*The onus is now on political leaders in Italy to do what the country needs, namely form a stable government which continues on the stable path of reform.*" His Dutch counterpart Jeroen Dijsselbloem, who is also head of the Euro Group, stated: "*Regardless of who controls Rome, I expect them to honour Italy's commitments to Europe. A stable government is important to the euro zone. To extricate Europe from an economic quagmire, stable politics are required, also in Italy. German commentators once again lamented the election result and many say it doesn't bode well for efforts to end the euro crisis.*"

The conservative daily *Frankfurter Allgemeine Zeitung* writes: "Governments that want to break down the state, economy and society to implement reforms incur the wrath of voters and must watch as their legitimacy crumbles. Instead, either radical forces or populists with irresponsible promises and no regard for consequences gain power. Austerity is unpopular. Even if drawing that conclusion is banal, it also has negative economic ramifications. Demands for an end to the austerity measures were to be expected, as was the renewed debate about euro bonds and debt union. This much is clear: European economies will continue drifting apart and their ability to compete will not equalize at a good level. Great uncertainty weighs on the EMU once again."

The left-leaning daily *Berliner Zeitung* writes: "Italy is an uncertain and polarized country rife with fear, resignation and anger. The election results must be a political alarm (bell) for Brussels, Paris and especially Berlin. Europe can no longer afford for the euro zone's third largest economy to be ungovernable for an extended period of time. Moreover, it certainly can't afford for Italy and other Mediterranean economies to be strangled by tough austerity measures, leaving an entire generation of young people from Malaga to Athens without a future. Shrill alarmism also won't help, since it only serves to accelerate the downward spiral on the markets. Instead, measures must be taken to give the lost generation prospects for the future. Only the will the European Union have a chance to survive, both economically and politically."

The Center-left daily *Sddeutsche Zeitung* writes: "The Italian election result is a disaster for Italy and for Europe. Why did Italians do this to themselves and to the Continent? One answer is that many citizens no longer believe in the state or in universal prosperity. For decades, their hopes for reform have been disappointed. Whether they voted for the Christian Democrats, the Communists, Berlusconi or the reform-minded left, little changed in the bloated ineffective and corrupt state, except that taxes rose. Earlier, their frustrations with their own country led Italians to turn toward Europe. No other country showed as much enthusiasm for the EU. However, Brussels is no longer seen as a lifeline. Rather it is seen as a lead weight that is pulling Italy into the abyss."

Monti's reforms have made the lives of many Italians worse. Young people are having increasing difficulties finding stable employment and the elderly can hardly live on their pensions. The economy is stuck in recession. The cool reform-realism from Berlin, which typifies the EU's approach to the crisis, is seen as a hostile diktat. Monti and Bersani – in addition to Berlin and Brussels – were unable to convince many Italians that economic recovery would follow on the heels of shock therapy. Italy isn't the only place where hopelessness leads to demagoguery."

The business daily *Handelsblatt* writes: "A race is taking place in Europe between those backing austerity and reform policies on the one side and the populists on the other. Right now, the populists are leading by a nose. Political leaders in particular must be shuddering with fear after the Italian elections. Yes, it may be true that Italy was already considered to be ungovernable even before the crisis. So, it's not unusual that the country is already talking about the prospects of new elections. The difference this time is that the country's political stability has become far more important since the introduction of the common currency."

If a new government in Rome, regardless of whether it is liberal or conservative, refuses necessary reforms in the long term, it will also have effects on the entire euro zone. Mariano Rajoy in Spain and Francois Hollande in France, both under enormous public pressure, could try to further soften their austerity and reform goals. Even Greece, which withstood a popular uprising by the skin of its teeth, could waver on reforms. Last but not least: the EU fiscal pact

pushed through by Berlin (requiring countries to implement a so-called debt brake in their constitution to limit annual deficit spending) would be worth less than the paper it is printed on.”

Conclusion: Europe Risks Losing a Generation

In an interview with *Thomson Reuters*, Martin Schulz, a German socialist who has led the European Parliament – the EU’s only directly elected institution – since January 2012 warned: “*One of the biggest threats to the European Union is that people entirely lose their confidence in the capacity of the EU to solve their problems. If the younger generation of Europeans is losing trust, then in my eyes the European Union is in real danger. Greece, Spain and Italy have perhaps the best educated generations they have ever had in their countries. Their parents invested a lot of money in the education of their children; everything they did was right. So, now they’re ready to work and society says: ‘No place for you.’ We are creating a lost generation. To my mind, direct links between the European Union and regional and local authorities is more needed than ever. The alternative is a system that places the social fabric of Europe under ever greater strain, resulting in the dire youth unemployment statistics now prevalent in Greece. That is a threat for social cohesion because if the social cohesion for those countries fails, the country explodes. This is the threat for the European Union as a whole.*” Youth unemployment figures released last week revealed 57% of Greeks aged 15 to 24 are out of work and a similar scourge is tearing apart the fabric of Spain, where some university graduates in their 30s have never had a job.



Portuguese students hold placards reading ‘This government of precariousness lacks legitimacy’ (L). ‘We want more education’ (C-top).

‘Youth unemployment 40%’ (R) and ‘Government out’ (Bottom).

Source: AFP / Getty Images

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“Those who cannot remember the past are condemned to repeat it.” Santayana