Impacts of the Financial Crisis on Regional Policy and Development
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Jan Mønnesland

The financial crisis of today is mainly a result of the crisis of 2008 – 2009, and shaped by the actions taken at that stage to handle the crisis. The internal imbalance of the euro market has added to the problems.

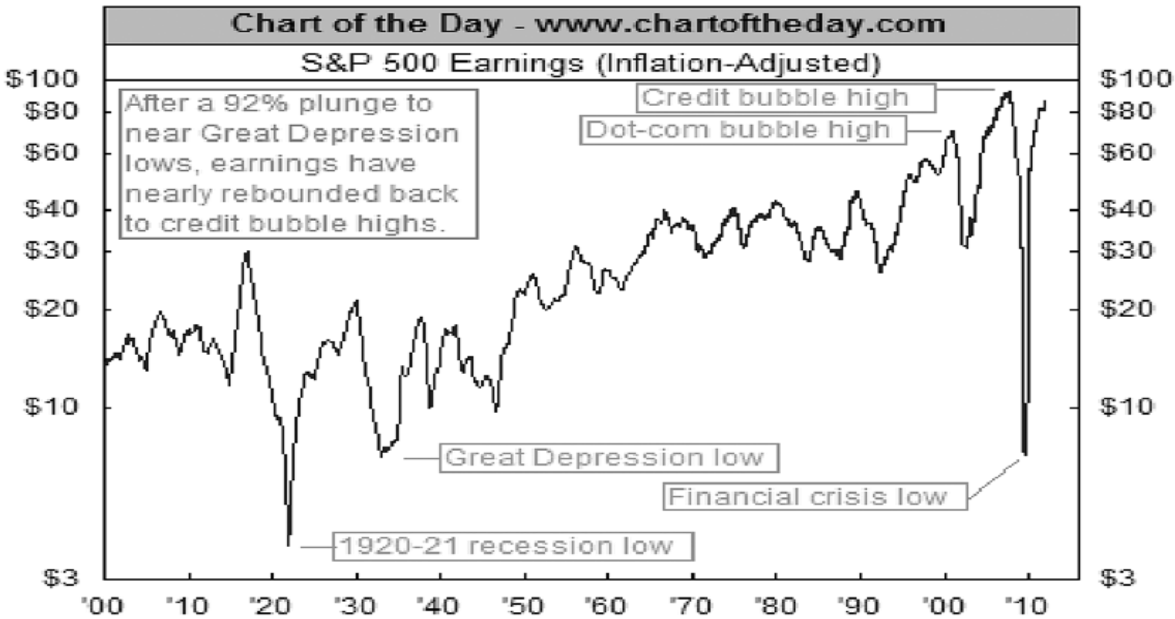
The actions taken by the EU to handle the crisis are to enforce substantial cuts in public expenditure and selling out of public assets (infrastructure, service institutions etc). When public employment and social security funds (pensions etc) are cut down, the effect will be reduced domestic demand, which will generate a downscaling also for domestic oriented industries. In sum, the effect will be reduced employment also in the private sector, reduced income, and then reduced taxes and growing budget deficits.

<u>The starting point: financial crisis 2008-2009</u>

The starting point was the general financial crisis of 2008-2009. The financial sector has in the last decades expanded far off the rest of the economy. They were expanding money investments more than productive investments, operating speculative products in a kind of pyramid games etc. Due to a liberalistic ideology, the governments had gradually taken away the regulations for the sector, allowing them to expand free from any security limits.

When the bubbles exploded, the result was nearly a stop in the interbank loan marked, threatening the supply of money for the rest of the society, and then hampering also the production spheres.

The response from the governments was to pop up great amounts of public money to feed the banking system. By such actions, they succeeded, the banking system started to operate again, and the production could go on as before after a few months.



Inflation corrected earning in the 500 most wealthy firms (including finance sector).

This success was, however, temporary. In order to finance these bank donations, the governments had to loan money by selling state bonds. Then, they were enforced to tighten their public budgets to get back to a balanced path. Such budget tightening will in turn have a contractive effect on the economy. In many countries, this has been an important factor generating the debt crisis of today.

The result is a severe downscaling of the solidity of the public sector. The public net asset was nearly emptied by the public bank transfers of 2009. Then, the financial sector started to be unsure about the security of the state bonds. The state bond interest rates started to arise. This mechanism explains much of the new crises of today, where several countries will have to pay higher interest for their state bonds, and then it will be harder to operate the budget balance at home and harder to pay back the debt at scheduled path. The negative spiral of higher interest generating need for greater state loans to finance the repayments had made a deteriorating effect for more and more countries.

This is the background for the specific EU crisis. The reason why Europe is harder hit by the crisis is twofold. First, we have the instability of the Euro zone, making the Euro countries stronger effected by a growing scepticism in the financial markets about state bonds. Second, we have the political actions set forward by the EU in response to the crisis, which made the crises much deeper than needed.

The instability of the euro zone

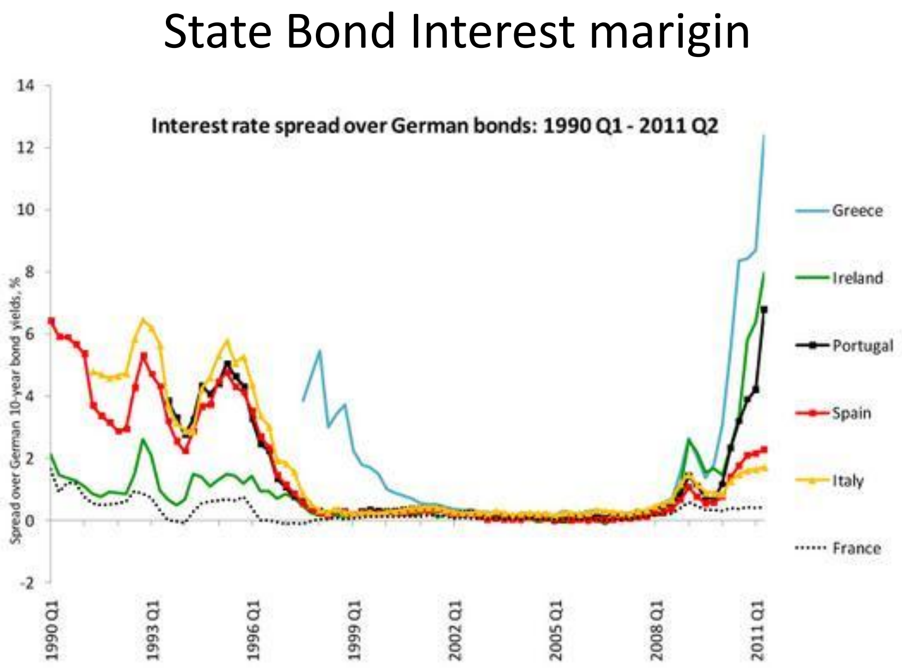
Euro is the official currency for (so far) 17 of the 27 EU countries. From the beginning the euro countries differed substantially regarding to industrial structure, economic level, political traditions etc. Financial policy was defined as a matter of the individual country, not for the federal EU level.

When you have different financial policies, where some countries could generate deficits without any risk of devaluated currency, those bills would in fact be paid by the whole Euro area. To avoid such problems, The Stability Pact was settled at the same time at the Euro was launched, January 1999. According to that pact, no Euro countries were allowed to have budget deficit exceeding 3 % of their GDP, or to get public debt exceeding 60 % of GDP. If these rules were violated, the EU should decide on a punishment procedure against these countries.

The first country to violate this rule, making a budget with higher deficit than 3 %, was Germany. No actions were taken. Thereafter, it was nearly impossible for EU to punish other countries.

When the countries within the Euro area differ in their industrial structure, the effect of getting a common currency will vary between the countries. The exchange rate against countries outside the Euro area will be the same for all the Euro countries. The rich countries will get an exchange rate at a lower level than before, and the poorer countries will get an exchange rate at a higher level than before. This will give a positive stimulus for the export industries in the richer countries. Germany has made good money based on this mechanism. The poorer countries will get a higher price for their export due to the same mechanism. This had especially ridden the Mediterranean countries, with low manufacturing growth and closedown of factories as a result.

Another effect of the common currency has been a common interest rate of state bonds. The state bonds were nominated in Euro, and regarded as EU granted in the financial markets. Then, the poorer countries got lower interest rates of their state bonds than before, as the buyers regarded them as more safe due to the common EU currency.



This mix, a deteriorating export market together with cheaper loan interest, made it reasonable for the poorer Euro countries to finance their costs by taking up state loans. This situation was more or less stable as long as the financial market trusted the EU Central Bank as a last resort guaranty for those loans.

This trust was rubbed late 2010 and early 2011. The debt crises in several EU countries made the EU to declare that the Central Bank should not assist the debt countries with liquid money. Instead, they set up a special EU fond which could buy state bonds and convert them to EU bonds, with lower interest rates in the financial markets. The condition was that the countries accepted to cut down the public budgets and selling out of the public property. This was a signal to the financial market that the common EU guaranty for the earlier state bonds of individual EU countries was no longer granted. The result was a steep rise in the state bond interests for several of the Euro countries, which added substantially to the debt problems.

During 2011, the problems were gradually worsened. Greater debt problems led to higher interest rates and then still greater debt problems. The tightening of public budgets enforces by the EU financial packets generated higher unemployment, and in turn lower tax income and higher budget deficits. The new EU packets were always too small to avoid a worsening of the budget situation and a rapid growth of the public debt.

<u>Changed Central Bank policy December 2011</u>

In December 2011 the EU Central Bank changed their policy. Up to then, they had been reluctant to issue bonds in order to hamper the growing interests in the financial market. Then, they added to the mistrust of the state bonds, the private banks regarded this policy as a signal that the Central Bank would not act in a way making the bonds safe from collapse.

In December 2011 the EU Central Bank popped up with a cheap loan (1 % interest) to the private banks, on the total amount of 480 billion Euro. In late February, a new loan were added, this time on 520 billion Euro. So far, a total amount of 1000 billion Euro is donated to the private banks as cheap loans, in order to dampen the interest rates.

Such a strong action was a new thing, and a signal that from now on, the finance sector could trust the EU Central Bank as a guarantist of the Euro state bonds. The effect came immediately. Most of the debt countries (Italy, Spain a.o.) got their interest rate to fall from around 6-7 % down to 2-3 %. For these countries, the problems seemed to be solved.

There were no rules for how to use these new loan amounts. The private banks were totally free to use them as they like. The result was that some countries still were regarded as dubious, and still got the extreme high interest rates. Portugal is one clear example.

Why did the EU Central Bank wait so long before they acted, and thereby added to the debt problems of the Euro countries? The answer is the new Stability Treaty. This new treaty was accepted by all Euro countries, and most of the other EU countries, at the summit of December 2011. The Central Bank made it clear that they would not act in the market before this new treaty was politically confirmed. This was the pressure they made in order to get the text adopted.

The new Stability Treaty

The new treaty was politically confirmed at the summit meeting of December 2011, and formally signed at the summit meeting of January. All the country leaders, both Euro countries and non-Euro member states, signed the treaty, with the exception of United Kingdom and the Czech republic (both non-Euro countries). The treaty will now have to be ratified by each member country. If ratified by at least 12 of the 17 Euro countries, it will be implemented by January 2013 for those countries accepting the treaty. Ratifying will be a condition for receiving financial support.

The countries are obliged to bring the public budgets into balance. The public budget deficit should not be greater than 0,5 % of GDP. This is a much stronger limit than the 3 % limit from the earlier stabilisation treaty. The total public debt should not exceed 60 % of GDP (same as in the former treaty). If the public debt is lower than 60 % of the GDP, the country will be allowed to have a public deficit up to 1 % of GDP.

In the former treaty, sanctions against countries violating the rules had to be decided by the council by majority voting. As Germany was the first to violate the rules, no one has been punished when the limits were broken. In the new regime, if the budget deficit is above the limit, sanctions are set in force automatically. It must be a majority in the council for not implementing the sanctions, contrary to before where a majority would have to vote in favour of sanctions.

In order to avoid budget deficits, a new budget procedure is established. Early in the year, all countries should present for the Commission proposals for the next national budgets, within the limits of deficits and debt level set in the treaty. Countries in a position making this to be difficult (as they today may lie far above these limits) will be set on a programme to gradually scale down to the rules over a couple of years. Such a plan will specify a downscaling of public activities and a scedule for selling out of public property, in similar ways as is now set into action in Greece.

The final budget proposal must be in line with the outcome of the budget communication with EU before the proposal is sent to the national parliaments. Failure to stick to this will imply a violation of the treaty and will be subject to economic sanctions.

By accepting the treaty, the countries are obliged to implement the treaty rules in there national constitutions. Then, to deviate from the rules should be not only a violation of the EU treaty, but also a violation on the national constitutions.

The effect of the new budget rules

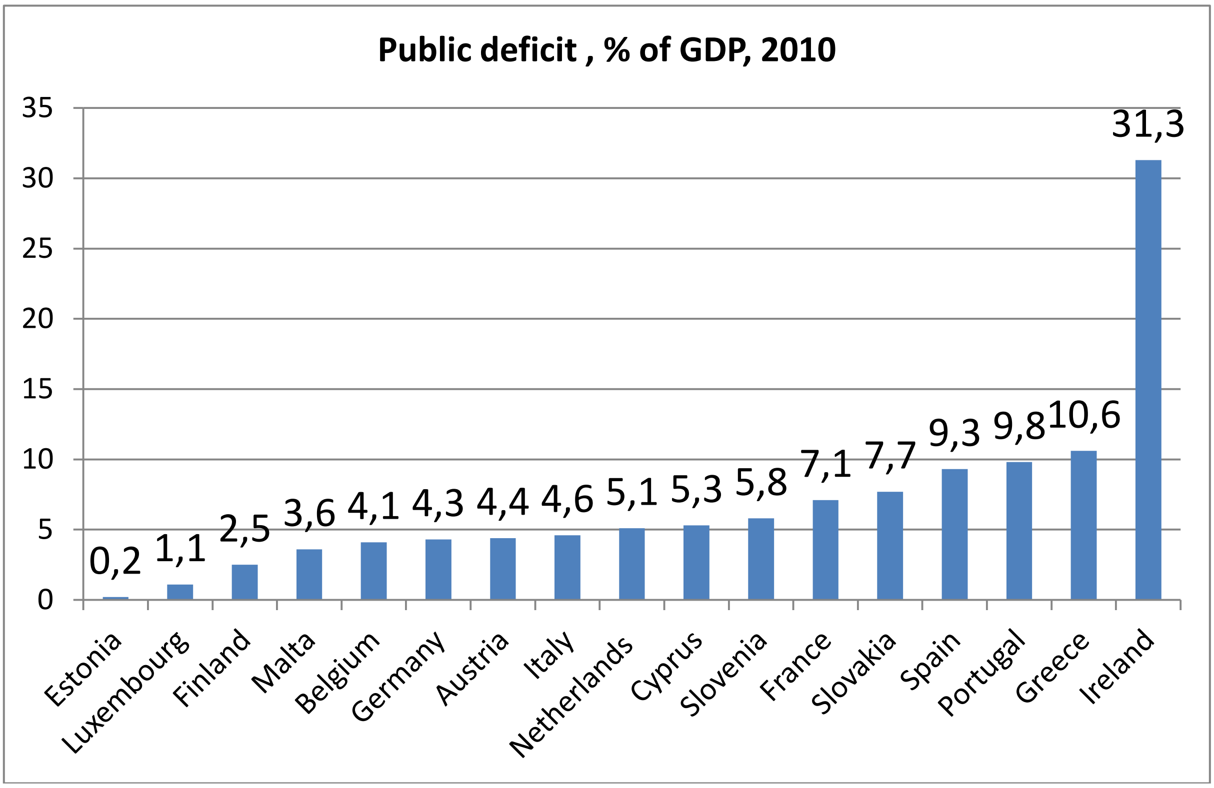
By these rules, financial policy is made a federal task, and is no more a task to be handled by the member states alone.

The scope for the financial policy is changed. It will not be allowed to use the financial policy to act in a counter-cyclical way, i.e. to expand the budgets in periods of recession and to tighten the budget in pressure periods. To tighten up in pressure periods will no doubt be allowed, but not to stimulate in the recession periods. Even when the country has generated net funds, the treaty do not allow budget deficits above 0,5 % of GDP.

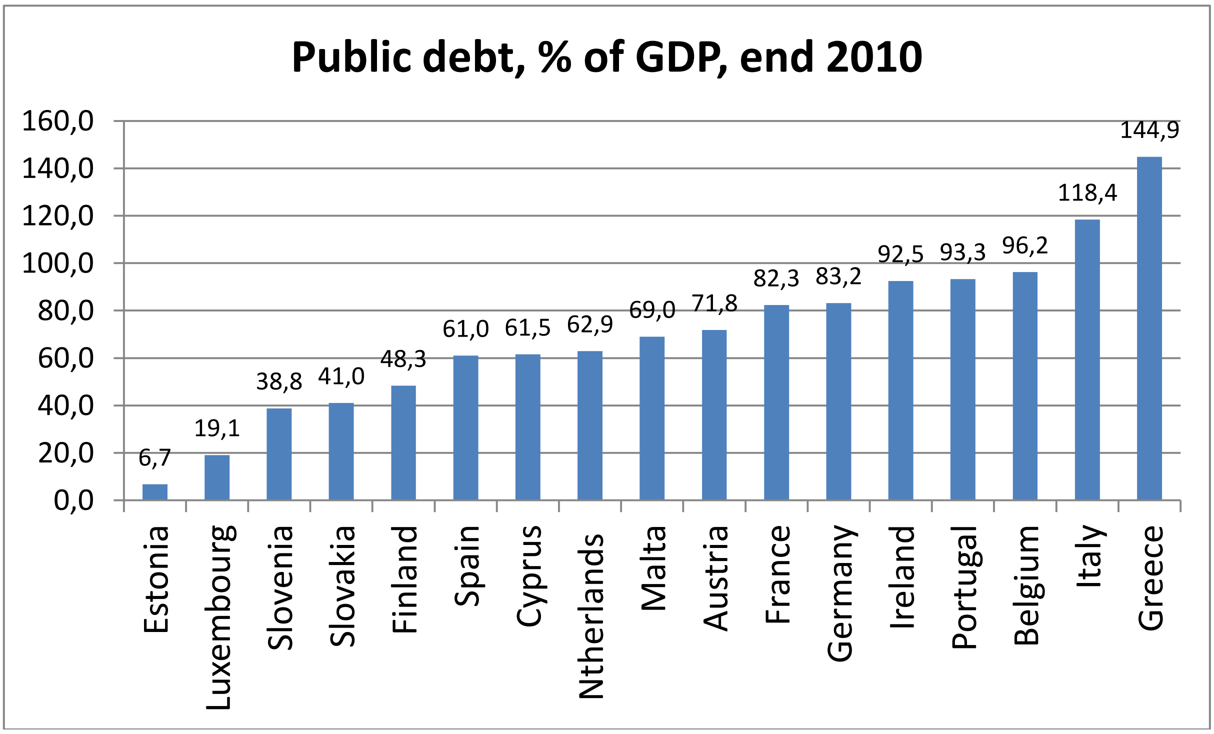
There are options in the treaty to overcome such barriers if accepted by the majority in the council. In a political sphere of market liberalistic ideology, it will be difficult to get such an acceptance. In practice the effect will be that counter cyclical financial policy will be forbidden. Keynes is not only dead, he is made illegal.

It will be difficult, near to impossible, to expand the scope of the public sector under such a regime. Expanding public sector will normally have to go hand in hand by tax expansion. Under the new treaty, the tax expansion will have to come first, to avoid a temporary deficit. Even if financed by a sound borrowing, the treaty will stop such actions. Then, the status will be that you may limit the scope of the public sector without problems with the treaty, but you will not be able to expand the scope. In the longer term, this will lead to a gradually reduction of the public share of the economy.

This will be the case also if the treaty had been established in a balanced economic situation. However, the starting point is far from balanced. The figures below show the situation of 2010, which is the last year where figures are available at Eurostat. The 2011 figures will be published in April 2012. All indications so far imply that most Euro countries will have higher deficits and a higher debt level in 2011 compared to 2010.



Estonia is the only Euro country with a public deficit below 0,5 % of GDP in 2010. Luxembourg is rather close to 1 % of GDP, and as that country has a lower debt share than 60 %, Luxembourg is close to fit the deficit limit of the new treaty. All the other Euro countries will have to face substantial budget cuts in order to fulfil their treaty obligations.



Five of the Euro countries (Estonia, Luxembourg, Slovenia and Slovakia) are below the treaty maximum debt limit of 60 % of the GDP. Spain is nearly at that limit. The other ten Euro countries will have to make strong cuts in their budgets over a long period, combined with substantial selling out of public assets and properties, in order to fulfil the treaty claims.

If the treaty had been operative in 2010, the table below show how much the debt and the deficits had to be reduced in order to fulfil the claims.

Cuts to be taken to fulfil the treaty claims:

	Public deficit to be max 0,5 (1,0) % of GDP:		Public debt to be max 60 % of GDP	
	Cuts in % of GDP	Cuts in % of public expenditure	Cuts in % of GDP	Cuts in % of public expenditure
17 Euro countries	5,7	11,3	26,3	51,6
25 EU countries signed the treaty	5,5	10,8	23,3	46,0
27 EU countries	6,0	11,9	22,5	44,5

All cuts needed to fulfil the claims will not have to be take the first year. As mentioned, countries who do not fit to the claims will be set on a programme where budget cuts and outselling of public property will be scheduled over a couple of years until the limits set in the treaty are reached.

Anyway, the amount to be scaled down is formidable. Only to get the current balance down to 0,5 (or 1) % of GDP will imply to cut down 11 % of the public expenditure, for the Euro area and for the EU in total. This is on the level of 6 % of the Euro or the EU GDP.

The downscaling of the debt will imply a much tougher task. The total cuts needed to get all countries down to 60 % of GDP has the amount of half the size of the total public expenditure, counting for one quarter of the GDP level.

The effect of the new treaty will, if implemented as intended, imply that nearly all the countries will be put on saving programmes of the same style as Greece is operating today. The public expenditures will have to be scaled down, and the public property (infrastructure, hospitals, schools etc) will have to be sold off, in order to fulfil the treaty claims.

Such a tough downscaling of public activity will no doubt have a negative effect on the economy. Then result will probably be of the same type (if not the same scale) as we have seen in action in Greece: downscaling of the public sector will lead to a downscaling of the economy, growing unemployment, lower tax income, and in turn even worse figures for the public balances and the public debt.

Why is this type of policy set into action? Here, the statements from the commission and the European Central Bank are quite clear. The idea is what they call “urgently needed structural reforms”. They have the same ideas as have dominated in the US political milieu for a long time: public sector is regarded as a burden for the economy. The public sector should therefore be scaled down, in order to broaden the scope for the private sector, to get a new economic growth based on the vitality of an unrestricted private initiative. The director of the European Central Bank, Mario Draghi, has commented the situation in a.o. Spain, with a growing unemployment up to 25 %, that he is proud of the active structural reform taking place here. As mentioned, it was more or less a result of the conditions set by this bank, that this new treaty was signed. When this treaty was politically accepted, then the Bank started to print money in order to feed the financial sector so that the interest levels calmed down.

<u>The perspectives for regional policy and development</u>

Regional policy is, as the name says, a policy set up to influence regional development. The alternative will be to accept a regional development generated by unadjusted market forces. In most countries, such a solution is regarded as non-optimal. The market forces will normally tend to polarisation, in the economic as well as in the social and regional dimension.

The profile and the strength of regional policy actions will then be influenced by the political ideology. When liberalistic ideology is dominating, regional policy will not be regarded as needed. When social democratic ideology is dominating, regional policy will normally be regarded as a necessary policy field in order to promote a balanced economic development.

To be noticed: I am here talking about the dominating ideology and not the label used by the ruling political parties. When the Nordic social democratic parties met in Stockholm in February, they all announced full support of the actions taking by the Danish party, having the chairmanship in EU, in their effort to obtain common support for the new EU treaty. To argue for a policy rolling back the public sector and advocating strong budget cuts as the main course for the European countries is traditionally far away from a social democratic ideology.

Looking at the market effect alone, the enforced downscaling of the public sector will have a centralizing effect on regional development. A high share of the public services and public transfers are directed towards the population, such as schools, health care, pensions etc. Then, these expenditures are distributed regionally according to the settlement pattern. In a situation where regional development is influenced by centralizing market forces, the settlement pattern will normally be lagging behind the changing pattern of the economic development.

Downscaling of the public sector will not be equivalent with downscaling of personal services. To some degree private firms will expand their supplies of the same type of services. These private services will be located according to the purchasing power of the richer consumers, with a pattern more concentrated towards the central metropoles.

Also the private industrial sector will be negatively influenced by downscaling of the public sector, through the well known multiplicator effect. The regional dimension here will vary from country to country, according to the regional pattern of the domestic oriented industries.

In the primary sectors, those segments oriented towards export and higher scale activities will be affected according to what type of market segments they are serving. The more small scale units serving the local market will be less hardly effected, as the food consumption are less effected by income reduction than other types of consumption goods and services. Then, in this sector the periphery areas may be less hardly ridden than the metropole areas.

The total regional effect will then be generated by different effect for the different industries. The total effect may vary from country to country. Nevertheless, the general picture is that a downscaling of the public sector will tend to a centralizing regional effect, partly through the direct effect of reduced public activity, and partly through the effect in the private sector influenced by reduced total demand and then reduced employment also in the private firms.

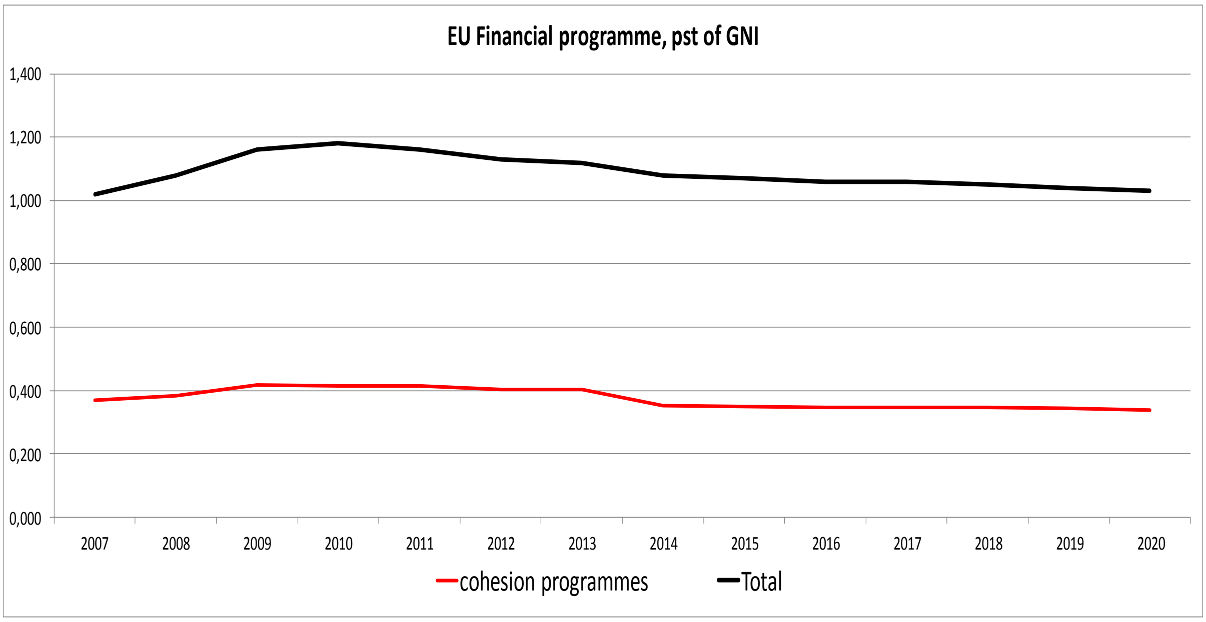
The regional policy actions will also be effected by the changing financial policy enforced by the new treaty.

On the national level, when public expenditure is to be cut down and public assets to be sold out, all public expenditures have to be undertaken a rather tough priority. Regional policy efforts have to be judged against pensions, health service etc. in a situation where even the most needed services will find their budgets scaled down. It is hard to believe that regional policy efforts will survive unchanged in such a situation.

For the EU countries, the EU regional policy programmes constitute the framework of the activities.

The EU financial plan 2014-2020, as well as the revisions of the ongoing plan for the years 2012 and 2013, were decided or last time revised about one year ago. They are so far not adjusted to the new financial regime. Anyway, it is not at all expected that the new treaty should imply reductions in the contributions from the member states to the EU budget. However, the contribution from the member state is linked to the economic strength of the state. To the extent that the reduction of public expenditures will lead to reduced economic level, then also the EU membership fee will be affected.

The financial plan is set up as per cent of the Gross national income (GNI). The nominal Euro figures will be adjusted as the final GNI figures emerge and are therefore subject to uncertainty. For the years to come, the most probable outcome will be a much slower GNI growth (including GNI reductions) than predicted last summer. Then, the nominal figures, with a rather stable nominal path of the structural funds, could easily be too optimistic.



Even when the framework for the future is too optimistic, due to the uncertainty of the one year old GNI prediction and the recessive effect to follow the new treaty regime, the figures still illustrate the tendency to a more restrictive economic policy on the EU level. The total financial programme expanded from 1,02 per cent of GNI in 2007 to 1,18 per cent in 2010, and since then we have a stable dowvward trend passing 1,13 per cent in 2012 going down to 1,09 per cent in 2020. The cohesion part of this budget, including the cohesion fund as well as the regional structural funds, has a similar trend, from 0,37 per cent of GNI in 2007, reaching a top of 0,42 per cent in 2009, and then going down to 0,34 per cent in 2020. The new programme period makes a clear reduction already from the stating point in 2014.

The EU regional policy is based on co-financing, the EU money has to be supplied by a defined share of national public money. The share will differ somewhat from programme to programme, but will in most programmes be of a substantial level. Then, in a tough financial situation, several countries may find themselves unable to pay their national share of the programmes.

Both on the national and the EU level, regional policy actions will not be able to hamper the effects of the new financial policy adopted in the new EU treaty. Therefore, the most likely future will be a situation where the market forces will dominate the regional development. This will then take place in a situation characterized by a downgrading of the public sector not only in the field of regional policy, but affecting the total economic and welfare development in Europe.