

## Economic consequences of location: European integration and crisis recovery reconsidered

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Henry crosses the room. Stamp, stamp stamp in his riding boots; he is ready for *la chasse*. He turns, rather slowly, to show his majesty to better effect: wide and square and bright. 'We will pursue this. What constrains me?' 'The distance,' he says (Hilary Mantel, *Wolf Hall*).

The European Union as a whole has not recovered from widespread financial cum fiscal crisis that emerged in 2008. However, as is well known, this does not mean that some countries or even regions have not left recession behind. Typical official political answer for why some have recovered involves a combination of well-applied austerity measures (indicates correct choices once the crisis hit) and relatively less corrupted elites (indicating healthier political economy prior the crisis). There are ample reasons to doubt this official line of reasoning, most of them pinpointing to financial and fiscal architecture of the Union as fundamentally faulty and at fault. Essentially these doubting arguments take two often interrelated forms: either the European crisis is caused and perpetuated by balance of payment imbalances between surplus and deficit countries without a clearing union, or by the lack of (transparent) lender of last resort.<sup>2</sup> Simply put, European architecture assumes all countries within the Europe Union can be successful with exports based development strategy; everybody just needs to be competitive enough to manage in good and bad times – without the help from exchange rate management or lender of last resort. In what follows, I argue that under such circumstances what becomes important for economic success and failure are accidental features of a country and not the ones based on political and especially policy choices. And more precisely, under above mentioned specific European circumstances geographic location – distance from core European economies – becomes a key determinant in how countries fare in Europe. However, geography is not a policy choice, it's an accident.

Location as an important feature in economic development is obviously not a new argument. From Johann Heinrich von Thünen's *Der Isolierte Staat* (1826) to modern research on economic agglomerations by Jane Jacobs (1984) and Ann Markusen (1996) to regional innovations systems studies (Asheim and Gentler 2006) and to explaining the rise of the West as location based historical development (Morris 2010) and, most recently, to research on global value chains (Gereffi 2013; Ernst 2009) – location is seen as one of the key economic factors in all the mentioned avenues of economics. This short paper does not pretend to add to any of these research strands. Rather, the paper assumes primacy of human agency (choices made by entrepreneurs and policy makers – available to researchers as institutional facts and interactions) and it aims to show under which circumstances and how location becomes to dominate over human agency, that is, over policy choices.

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<sup>2</sup> For the former type of argument, see Kregel 2011; for the latter, see Mitchell 2015.

Analytically, the paper is based on what could be dubbed a Schumpeter-Minsky-Kregel institutional framework.<sup>3</sup> Any economic unit (company, country) can be institutionally (in the sense of various interactions it has and rules that govern these interactions) viewed from both its innovation profile (its technological, managerial, etc capabilities; well established in Schumpeterian line of research, see Schumpeter 1912, 1939 and 1942) and from financial profile (also already present in rudimentary form in Schumpeter's analysis but later substantially further developed by Minsky (1986a; 1986b) and by Kregel, particularly in the sense of international institutional dimension (2004)). According to Minsky, economic unit can be either in hedged (all its liabilities are well covered by assets), speculative (it has to sell some of the assets or borrow to make position, that is to cover liabilities) or Ponzi (neither selling of assets or borrowing is enough to cover liabilities) financial position. This institutional framework can be expressed in a greatly simplifying figure as follows (Figure 1):

**Figure 1.** Analytical framework

	Financing position of economic unit	
	Hedged	
Innovation profile of economic unit	Speculative	Financial profile of economic unit
	Ponzi	

Within this framework, economic unit's financing position (health of its balance sheet, in other words), depends both on changes in innovation profile (e.g., licensing new technology, setting up new factory) and financial profile (e.g., changes in interest or exchange rates). Geography and location have played a marginal role in such analysis. In what follows, I try to show that at least within the European context, location has become a huge factor in determining health of balance sheets (of countries and companies).

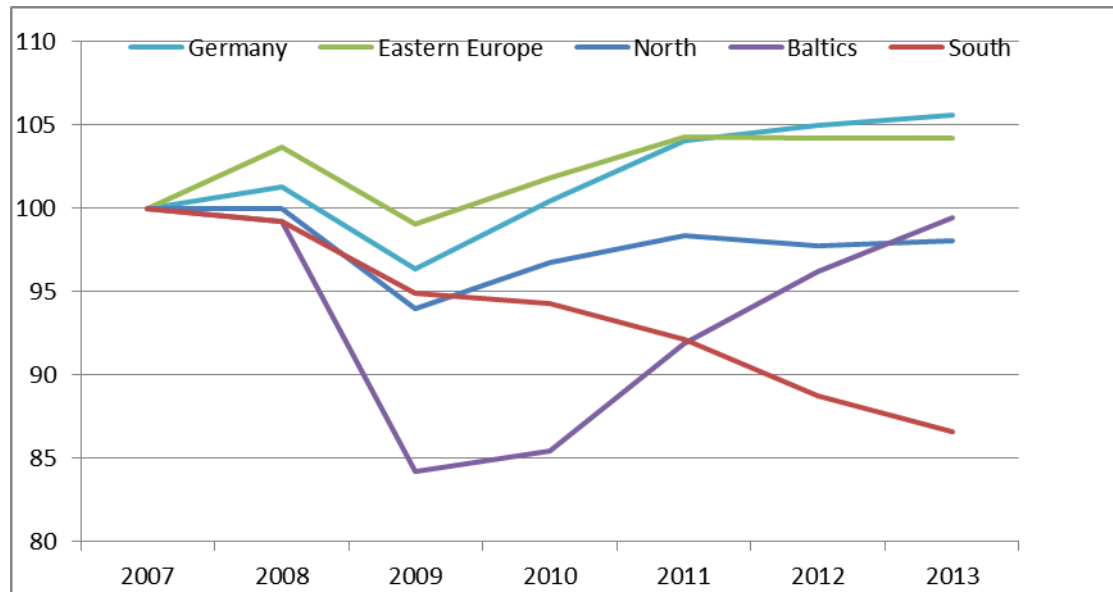
### **I Post-crisis Europe: deceptive simplicity**

One of the first things in terms of location one notices is that Europe has indeed become a region of different growth (or crisis recovery) speeds. More precisely, we can see three different sets of countries as depicted on Figure 2.<sup>4</sup>

<sup>3</sup> See also Burlamaqui and Kattel 2014 for more detailed discussion.

<sup>4</sup> Here and on following figures not all EU or eurozone countries are depicted; in order to keep figures less cluttered, the figures look at Germany and diverse regions within the EU: Northern European (Netherlands, Finland, Denmark, Sweden), Southern European (Greece, Italy, Spain, Portugal), Eastern European (Czech Republic, Hungary, Poland, Slovakia and Slovenia) and Baltic (Estonia, Latvia, Lithuania) countries. Here and on other figures regional figures are based on simple averages.

**Figure 2.** Gdp per capita since 2007, selected European regions (averages), in 1990 gk\$, 2007=100.



Source: The Conference Board Total Economy Database™, January 2014, <http://www.conference-board.org/data/economydatabase/> calculations by the author.

We can see a three tier Europe emerging:

*First*, Germany and Eastern European economies – tightly knit together via Germany’s transport equipment production networks<sup>5</sup> – experienced virtually no crisis (with the exception of Hungary);

*Second*, Northern Europe and Baltics – knit together via electronics and tourism value chains of Northern Europe – have converged around similar growth rates after deep shocks in the Baltics in 2009-2010;<sup>6</sup> and

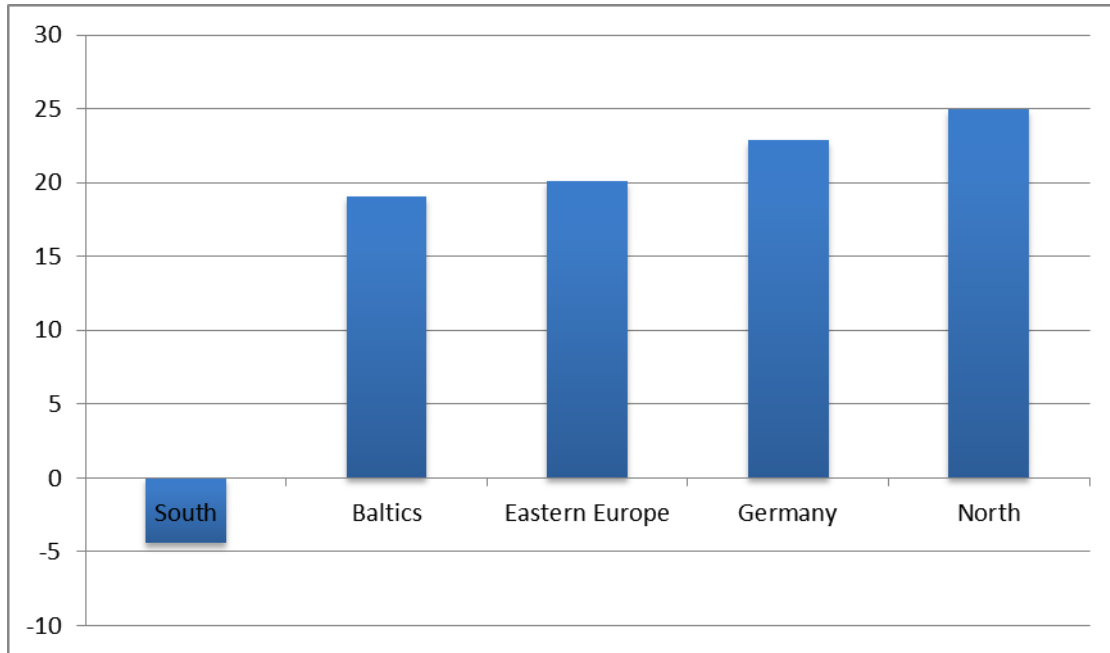
*Third*, Southern Europe, with low levels of exports and accordingly without significant intra-European value-chain interdependence (see further below), are in continuous slow decline.

There seems to be also a obvious culprit – austerity is killing the South; all other regions under consideration here have rather noticeably increased government expenditures from 2007 to 2013 (latest year available), as we can see from Figure 3.

<sup>5</sup> For a detailed discussion, see IMF 2013.

<sup>6</sup> Kattel and Raudla 2013 offer further details; see also Reinert and Kattel 2013.

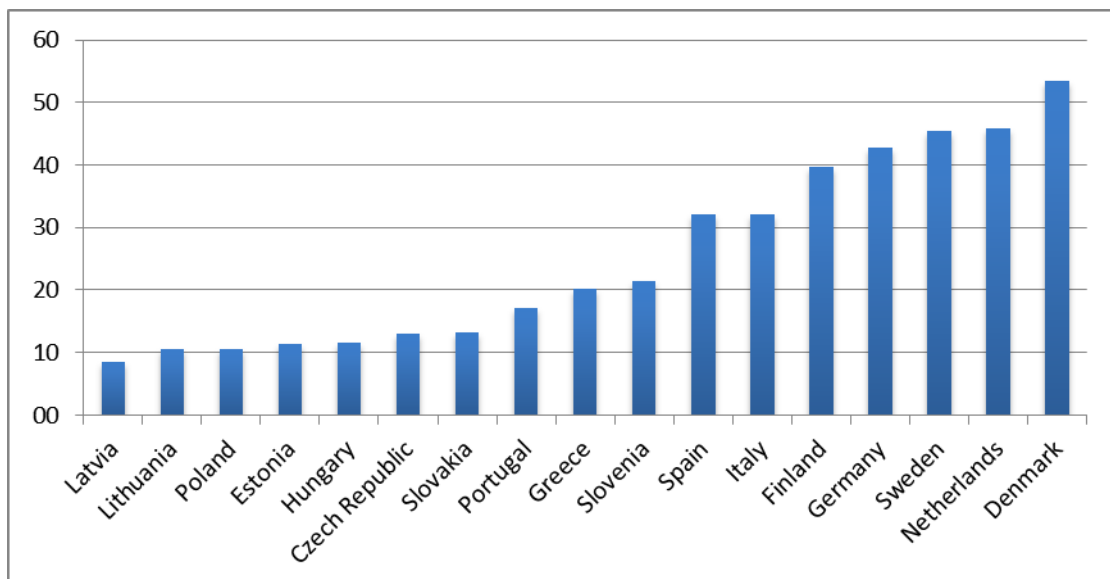
**Figure 3.** Growth of government expenditure in selected European regions, 2007-2013, current prices.



Source: Eurostat; calculations by the author.

If we think of labour productivity as a proxy for competitiveness of an economy, then this impression that the Southern countries suffer under artificial external constraints (i.e. why they do not increase government spending), is only strengthened. In terms of labour productivity, Europe looks a rather linear ladder going upwards, as we can see on Figure 4: countries grow gradually more productive from the Baltics and Eastern Europe over Southern Europe towards Germany and Scandinavia.

**Figure 4.** Real labour productivity per hour worked, selected European economies, 2013.



Source: Eurostat.

However, this straightforward picture – remove fiscal and monetary shackles and the South will catch up with the North – is deceptive. In order to get a better and more complex understanding, we need to also understand innovation and financial profiles of European economies, in the sense depicted above in the analytical framework.

## **II Innovation and financial profiles of European economies**

Both innovation and financial profiles of economies are obviously highly complicated and complex issues. In what follows, I use therefore rather simplified proxies to get a quick and somewhat birds-eye view on these issues.

In terms of innovation, we know that most companies (or economic units) innovate incrementally, learning from daily activities to avoid mistakes, waste materials and time, and finding slightly better, faster ways of creating products and services, or servicing clients.<sup>7</sup> What we thus need to understand is how do companies behave in different economies, what sort of routines are dominating within companies. Holm and Lorenz have utilised the European Working Conditions Survey – which is based on individual interviews with employees about working conditions – to come up with a taxonomy of organisations.<sup>8</sup> (Holm and Lorenz 2014) Their taxonomy is based on the way work is organised at the shop level: how hierarchical are decision making processes (for instance, when something goes wrong, who decides how and what should be done?); how complex are tasks; how much team work there is, etc. And they show that there are four key types of organisations: from discretionary learning based organisations over lean and Tayloristic organisations to simple organisations. Particularly the former are interesting for the purposes of the current paper as these organisations – called learning organisations hereafter – are geared towards continuous and incremental learning and innovations. (See also Holm et al 2010) To put it very simply: the more there are such learning organisations in an economy, the more innovative the economy is. If we plot productivity and learning organisations data from European economies, we get a surprising picture, see Figure 5.

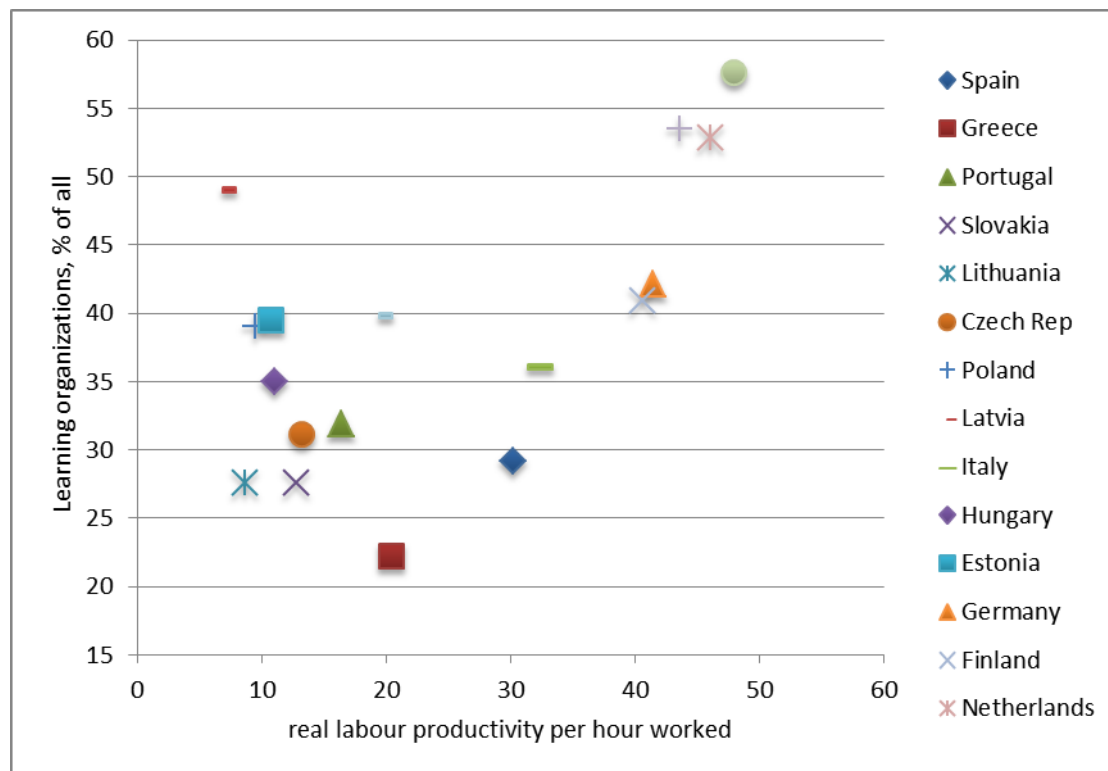
Instead of a linear catching up path – as labour productivity data would suggest –, we see rather a veritable valley of death as we proceed from low productivity countries towards high productivity countries. The gulf between low and high productivity countries is filled with countries where innovations are not that important for companies and where more hierarchical organisation types prevail. In other words, as Eastern European and Baltic economies are highly integrated with German and Northern European economies respectively, this is also reflected in their innovation profiles as these are converging, albeit without being accompanied by productivity growth. The channel for such convergence is, on the one hand, high share of foreign ownership (FDI, see next figure), and, on the other hand, tightly interwoven trade networks. Southern European countries seem to have distinctly different innovation profile and hence integration patterns.

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<sup>7</sup> Community innovation surveys periodically conducted in European countries offer ample empirical proof, see [http://ec.europa.eu/eurostat/web/microdata/community\\_innovation\\_survey](http://ec.europa.eu/eurostat/web/microdata/community_innovation_survey) for datasets and questionnaires. For a theoretical background, see Nelson and Winter 1982 and their discussion of various routines and capabilities.

<sup>8</sup> As there have been numerous waves of the survey, Holm and Lorenz's taxonomy is based on "33 187 interviews distributed across 81 country-waves". (2014, 5)

**Figure 5.** Learning organizations and labour productivity, 2010.

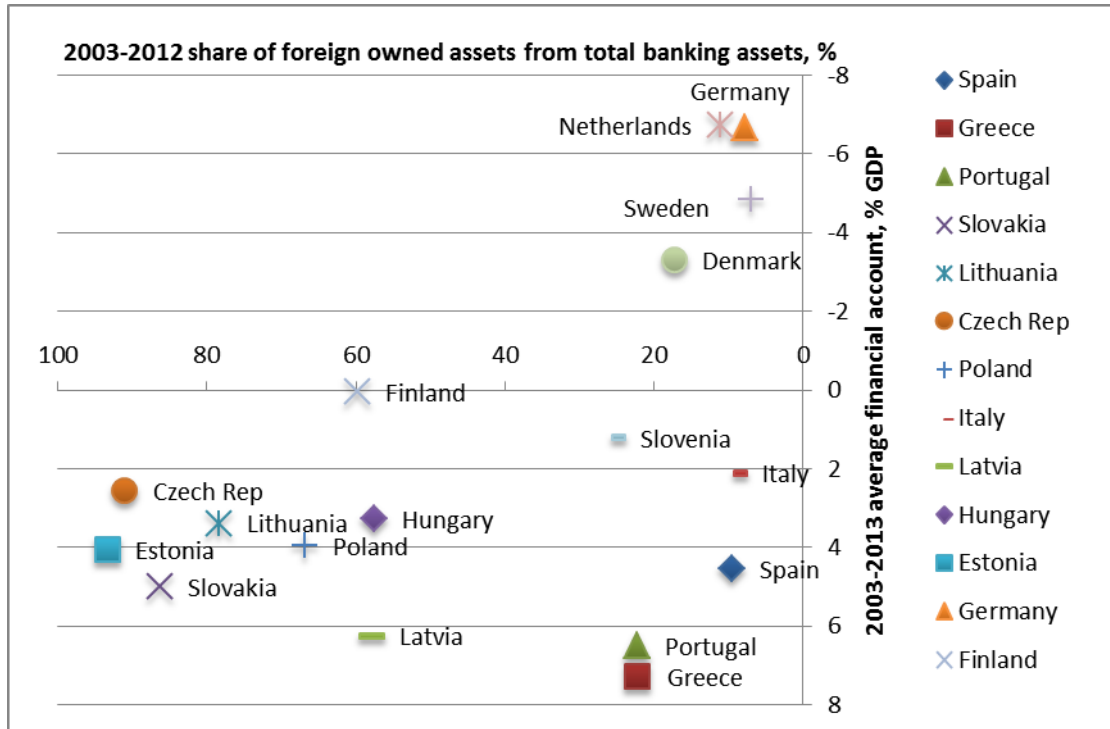


Source: Eurostat; Jacob Holm.<sup>9</sup>

In terms financial profile, Europe is in a rather unique situation as countries are strongly constrained in their fiscal policies and eurozone countries lack monetary policy entirely; in addition, free movement of goods and services means that simultaneously most countries are highly integrated with each other. Accordingly, in order to gauge country financial profiles, we can look at financial account (capital flows) and at foreign ownership of banking assets as proxies for where does financing come from and who makes financing decisions. Figure 6 does this.

<sup>9</sup> I am grateful for Jacob Holm for sharing his datasets. Holm et al 2010 have also calculated the share of learning organisations for 2005, differences are not large.

**Figure 6.** Financial account and share of foreign owned banking assets, ten year averages, selected European economies.



Source: Eurostat; ECB reports (2003-2007), ECB consolidated banking database (2008-2012); calculations by the author.

Also in financial profiles we see regions with distinctly different profiles: Germany and other Northern economies have low shares of foreign ownership and are exporting capital; South is the exact mirror image of the North as it has low foreign ownership and is importing capital; Eastern European and Baltic economies have extremely high shares of foreign ownership and massively import capital. Particularly latter two regions – Eastern Europe and Baltics – have financial profiles with extremely constrained financial decision making spaces: what gets funded is decided somewhere else.<sup>10</sup>

### III Location as destiny?

Looking at the European map, it is somewhat obvious to think that geography should play a crucial role, at least in some more apparent cases. Thus, for instance, it would come as a great surprise if Finland and Estonia (distance between capital cities – 80km) were not strongly integrated economically. What speaks for it even more is that these two countries share a long-term political past (both were incorporated into Tsarist Russia until World War I) and strong cultural affinity (both languages belong to the same language family).<sup>11</sup> On the other hand, it can be argued that entire point of economic policy making is to overcome disadvantages (e.g. remote location, or natural resource abundance) and utilise advantages

<sup>10</sup> One could also discuss here public investment programmes (into infrastructure, R&D, etc), however these are typically few orders of magnitude lower than financing of investments by private sector.

<sup>11</sup> See Boschma 2005 on different types of proximity.

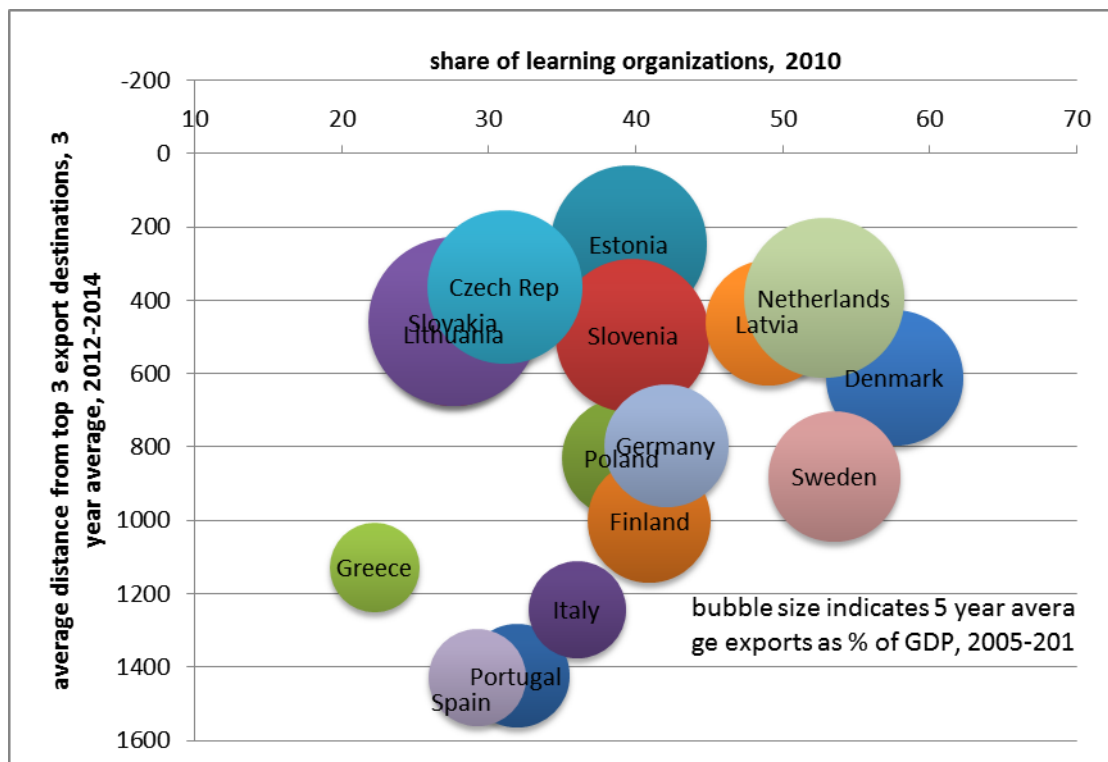
(e.g. vicinity to large markets, or highly educated labour force). What is interesting is how location and policy mix.

Famously, von Thünen's 19th century model showed that they do not: as argued by Reinert 2013 and Fujita and Krugman 1995, von Thünen's model indicates that the farther a location is from increasing returns activities of the city at the centre of isolated state, the more primitive economic activities become.<sup>12</sup> Conversely, Mukand and Rodrik (2002) have shown how in the Eastern European and former Soviet Union context policy ideas are copied with different earnestness: countries closer to Brussels tend to mimic policy ideas more closely (and gain according economic benefits) than countries in far periphery (who thus retain larger policy space and could potentially benefit from this), and those in the middle faring worst as they somewhat feebly attempt to mimic core countries without clear economic benefits.

If we add location as a variable to innovation and financial profiles described above, we get indeed a picture reminiscent of von Thünen's circles of decreasing returns. (It is important to note that in what follows dynamics within a country are not considered.) As a proxy for location I have taken a very simple measure: average distance to three top export partners (distance between capital cities; over past 3 years up to 2014).

Figure 7 shows innovation profiles with location figured in and Figure 8 does the same for financial profiles.

**Figure 7.** Innovation profiles and location, selected European economies



Source: Eurostat; Jacob Holm; calculations by the author.

<sup>12</sup> Fujita and Krugman 1995 model under what circumstance there will emerge another city, i.e another agglomeration of increasing returns activities.



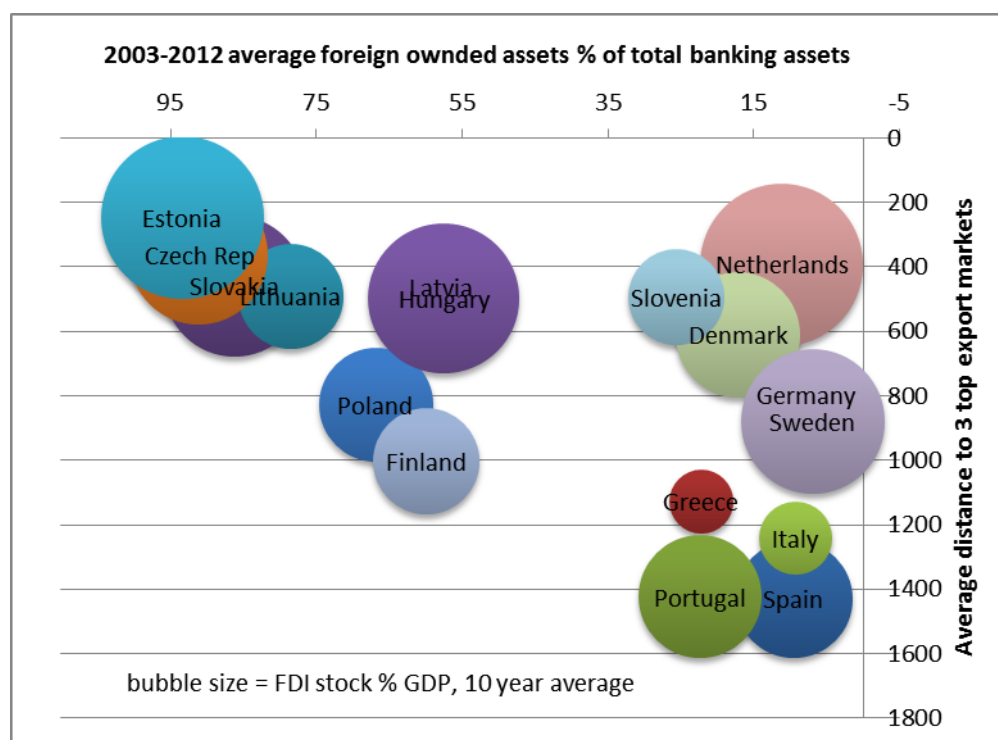
In the case of innovation profiles, we can in fact see modern version of von Thünen’s (half-) circles: in the core we have Northern European economies, closely surrounded by Eastern European and Baltic economies (first half circle), while the Southern economies remain at quite a distance (second half circle). In the case of financial profiles, we see again regional groupings emerging clearly and again distance making a big difference, in this case in the much higher levels of foreign financial ownership and levels of FDI stock (only outlier is Slovenia that groups with the Northern core economies). This leads us to venture that potential financial instability sources are quite different at the opposite ends of financial von Thünen’s circles in Europe: what threatens the South is not what threatens the East (see more below).

We can draw two tentative conclusions from these location based figures:

First, modern von Thünen circles in Europe do not express increasing distance from increasing returns activities but rather decreasing returns to integration: the farther a country is from core surplus and capital exporting economies, the less returns (in terms of companies mimicking innovation behaviour of the core economies) it reaps from integration. This is also expressed in lower exports and export potential as indicated through much lower FDI.

Second, under these circumstance it seems particularly non-sensical for countries farther from the core – the Southern European economies – to follow similar structural and other policies as those in the core and its Eastern and Baltic satellites as they likelihood of reaping economic benefits seems rather low (as Mukand and Rodrik 2002 predicted, albeit in a somewhat different context).

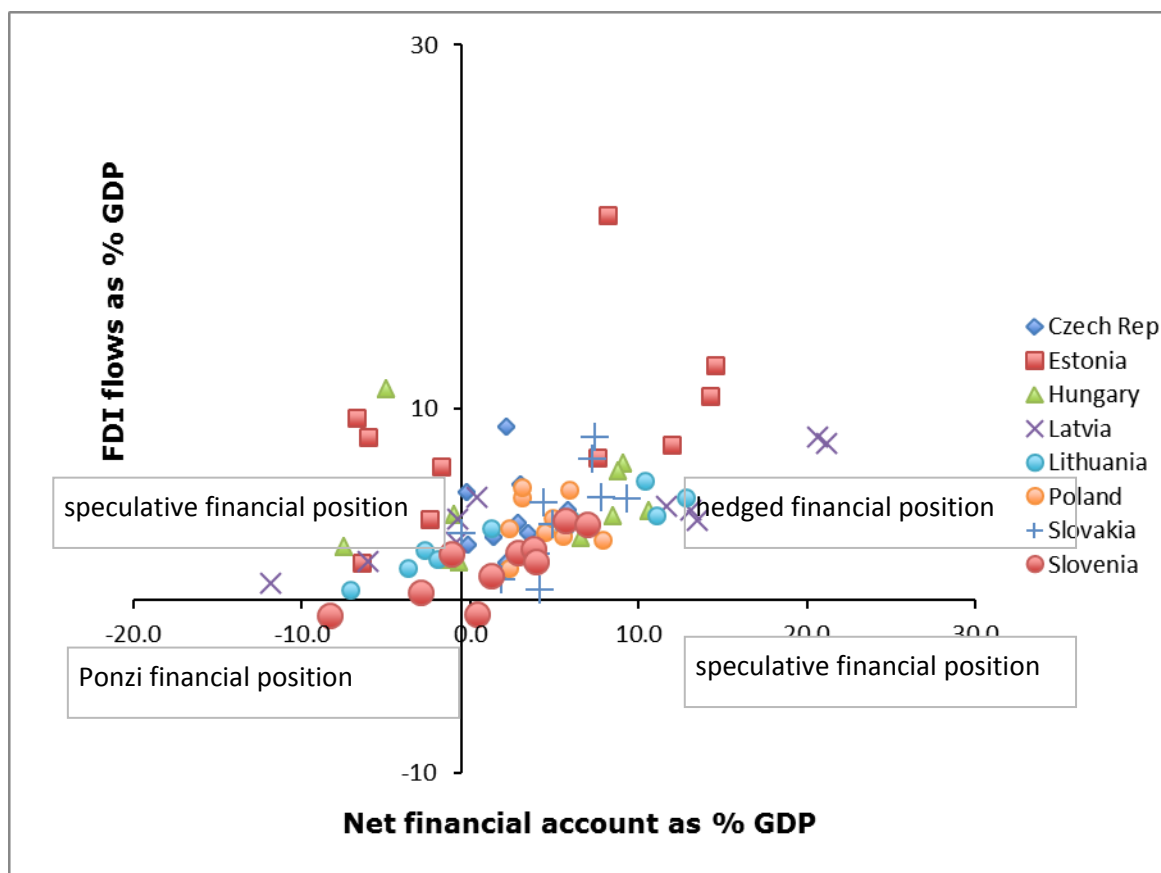
**Figure 8.** Location and financial profiles, selected European economies.



Source: Eurostat; ECB reports (2003-2007), ECB consolidated banking database (2008-2012); calculations by the author.

In the case of satellite economies of Eastern Europe and Baltics, it is interesting to observe that during the crisis they did not experience significant capital outflows (which would have doomed these economies to a severe shock). However, following Jan Kregel's work (2004), we can construct a simple formula to see how vulnerable these economies are to external shocks. Kregel argues that countries relying on foreign borrowing to pay for their imports – in other words, countries with large current account deficits, such as Eastern European and especially Baltic economies – can experience self-reversal of their growth strategies when the rate of incoming capital is lower than interest on existing foreign borrowing. If that is the case, these countries move into Ponzi financing position (as described above). Figure 9 does a simple exercise along these lines, looking at financial account and FDI flows in Eastern European and Baltic economies over the past decade.

Figure 9. Financial stability in Eastern Europe and Baltics, 2004-2013



Source: Eurostat.

As we can see, during most of the period, these economies oscillated between speculative and hedged financing positions. This suggests that while these economies are highly integrated into core European financial networks, reversal of capital flows can in fact quite easily happen. In other words, while innovation profiles of these countries suggests close mimicking of core countries' profiles, without increasing labour productivity (and translating it into higher wages and stronger domestic demand), Eastern European and Baltic economies remain in a rather speculative financing position: their growth depends on flows and stocks of capital that these economies themselves are not in charge of.

#### IV Implications

This brief note shows above all that in a world based on trade and financial openness and where development strategies are increasingly foreign savings based (in form of borrowing and exports), location –vicinity to main export partners – becomes to dominate innovation and financial profiles of countries and companies. In effect, policies become secondary. Success or failure becomes a matter of geographical accidents. Geography becomes destiny.

If this is halfway true then farther European periphery has hardly any realistic hope of converging with the core in terms of its innovation profiles – that is, in terms of its competitiveness. In essence, periphery in the South needs to overcome location bias forced upon it by rules of the game of the European Union. In other words, these economies need changes in the rules of the game. Given the EU's fiscal constraints on countries (meaning governments in the South cannot massively increase investments into the real economy and productive infrastructure), the most realistic option these countries have is to change rules governing their financial sectors and induce in such a way higher investments into the real sector.

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