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# **THE GEOGRAPHY OF THE CRISIS IN WESTERN EUROPE: NATIONAL AND REGIONAL IMPACTS AND POLICY RESPONSES**

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## **INTRODUCTION**

In the course of 2008, the countries of Western Europe began to experience the full impact of the global economic crisis. The financial crash was followed by a drying-up of bank liquidity and slowdown in trade. Every country saw a decline in GDP growth over successive quarters in late 2008 and the first half of 2009. During the latter part of 2009, most Western European economies saw the resumption of growth (notable exceptions were Spain and the United Kingdom), with varying predictions of the sustainability of the recovery in the course of 2010.

For much of the past 18 months, the attention of policymakers has been fixed on emergency measures to contain the effects of the crisis, notably to rescue banks in danger of collapse and to stabilise the financial sector. Various packages of crisis measures have been implemented across Western Europe, generally with the aims of stimulating consumer demand and investment and reducing the effects of the crisis on (un)employment.

For the most part, the policy measures in response to the crisis have been implemented on a nationwide basis. There is however an important territorial dimension both to the effects of the crisis – only gradually becoming apparent – and the policy responses. This chapter examines the geography of the crisis in Western Europe, discussing regional impacts and regional responses. It begins with a short review of the development of the crisis, the main differences in its impact across countries and the different types of policy measures implemented to contain the effects of the crisis. The chapter then investigates the different types of regional impacts – in particular on regional unemployment rates – and the geographical characteristics of policy responses by national and regional authorities.<sup>1</sup>

## **THE DEVELOPMENT OF THE CRISIS IN WESTERN EUROPE**

The origins of the economic recession lie in the financial crisis. Over the 2000-06 period, there was a huge rise in the use of credit instruments; according to some estimates, they increased 12-fold from \$250 billion to \$3,000 billion a year. These instruments became increasingly complex (so much so that they were poorly understood by the banks themselves and by regulators), with lending standards being lowered to enable financial institutions to make subprime loans, but without higher capital reserves. At the time, it was assumed that there would always be sufficient market liquidity for trading risk, and that the fragmentation and repackaging of debt was a source of

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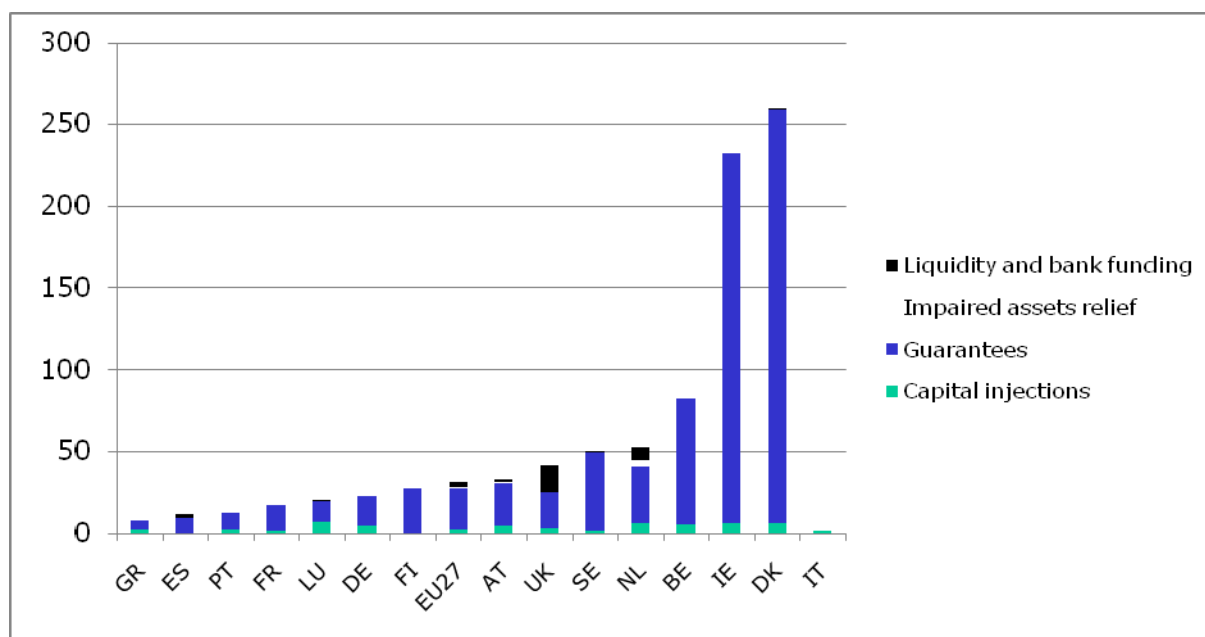
<sup>1</sup> The chapter is based on research undertaken in the context of the EoRPA research programme by the European Policies Research Centre. See in particular Davies *et al* (2009).

stability in the financial system. Credit rating agencies were trusted to provide a reliable guide to the creditworthiness of individual institutions (Tett, 2008; Taylor, 2008).

The rise in US interest rates in the mid-2000s led to growing default in mortgage loans and a bursting of the property bubble. Financial institutions found themselves over-exposed but often without a clear idea of the extent of exposure due to the complexity of credit instruments. Concern over the uncertain risks led to a collapse in confidence and a contraction in lending (especially in the wholesale markets) leading to the threat of insolvency for many companies dependent on borrowing. With the default of Lehman Brothers in September 2008, governments, central banks, regulators and financial institutions struggled to establish their exposure. Among Western European banks, it became clear that problems were associated with over-aggressive domestic lending or exposure to US debt (as in the case of several UK banks), or lending to East-Central Europe, South-Eastern Europe or the Baltic States (in the case of some German, Austrian/Greek, and Nordic banks respectively) (Davies *et al*, 2009; Goddard *et al*, 2009).

The collapse or threat of insolvency of financial institutions led to a rapid restructuring of the financial sector in many countries through a mix of mergers, acquisitions, bailouts and guarantees (Goddard *et al*, 2009). Banks were nationalised in the United Kingdom, Ireland, Germany and Portugal; mergers and acquisitions were managed by financial authorities in the Benelux countries, Germany and the United Kingdom; and capitalisation and liquidity funds were set up in virtually all countries to recapitalise banks or to enable illiquid assets to be swapped – in a few cases, with the establishment of so-called ‘bad banks’ (Ireland, Switzerland). Guarantee schemes were also introduced in many countries to safeguard the deposits of individuals and businesses up to varying limits. The greatest impacts were felt in Iceland where the inadequate reserves of the Iceland central bank led to three major banks (Glitnir, Landsbanki, Kaupthing) being placed into receivership.

**Figure 1: Public intervention in the banking sector in Western Europe (% of GDP)**



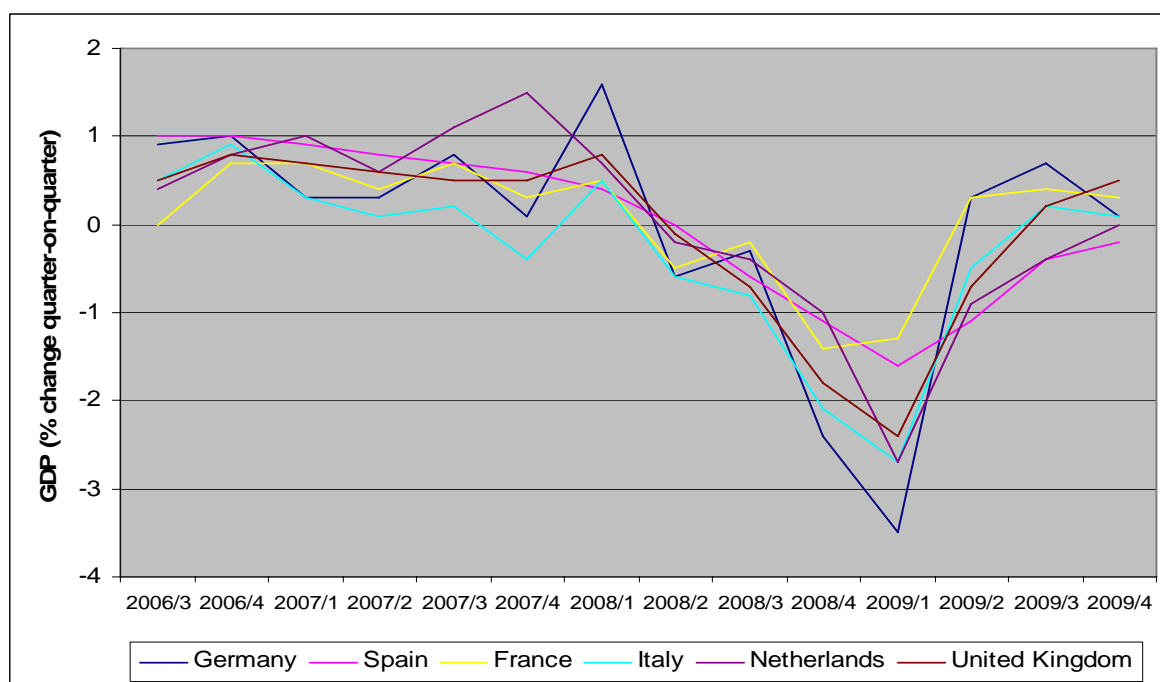
Source: European Commission (2009a)

The relative scale of these different measures relative to national GDP is shown in Figure 1 based on data compiled by DG Competition. These vary greatly between countries, with intervention exceeding 200 percent of GDP in Denmark and Ireland. Most support is in the form of state guarantees on bank liabilities (averaging almost 25 percent of GDP for the EU27 as a whole), but with significant liquidity support and extra bank financing in the United Kingdom (16 percent of GDP) and the Netherlands (7.5 percent), and sizeable capital injections of up to 5-7 percent of GDP in Austria, Belgium, Ireland, Luxembourg and the Netherlands (European Commission, 2009a).

The crisis in the financial sector rapidly caused wider economic problems. Bank lending fell dramatically, and the cost of borrowing rose, massively constraining the scope for firms seeking to invest or finance trade. Steep falls in European stock markets (by the end of 2008, financial sector stocks in the euro area had fallen by two-thirds compared to the start of 2007, and non-financial stocks by half) also made it more difficult for companies to raise equity capital and reduced the incentive to invest (Watt, 2008). Business and consumer confidence collapsed, leading to a steep decline in demand, investment and exports. The result was the deepest recession for the European economy since the 1930s, with real GDP projected as shrinking by some four percent in 2009 – “the sharpest contraction in the history of the European Union” (European Commission, 2009b).

However, the economic trajectories of Western European economies differ considerably, as shown in Figure 2. The graph shows quarter-on-quarter GDP (and GDP forecasts) from late 2006 to the end of 2009 for the six major EU15 economies – France, Germany, Italy, the Netherlands, Spain and the United Kingdom. Almost all countries went into recession at the same time but with different trends: a sharp fall, but also steep recovery for Germany; a flatter decline but also steep rise for France; and slower recoveries for Spain and United Kingdom, predicted as not emerging from recession until the end of 2009 or even into 2010.

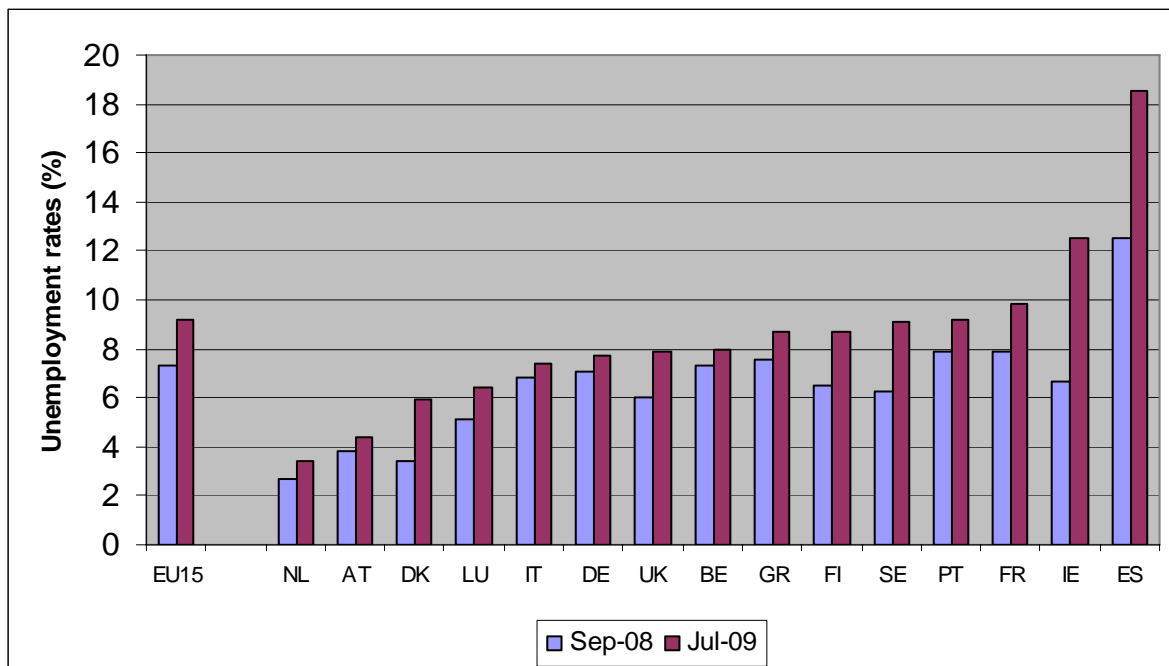
**Figure 2: Quarterly change in GDP and forecasts for major Western European economies**



Source: Eurostat; DG ECON, Sept 2009, *Interim forecasts*

The initial labour market effects of the economic crisis are shown in Figure 3, which presents the changes in unemployment rates from September 2008 to July 2009 in the EU15 Member States. For the EU15 as a whole, unemployment increased from about seven percent in late 2008 to over nine percent in mid-2009, with an expectation of unemployment averaging more than 10 percent by the end of the year. The biggest increases were in Ireland and Spain, in both cases the collapse in construction playing a major part: in Ireland, construction employment fell by some 10 percent, while in Spain, the sector accounted for 60 percent of the fall in employment (with workers being laid off quickly due to the widespread use of temporary contracts). By contrast, the growth in unemployment was relatively small in countries like Austria, Germany, the Netherlands and Italy due to the use of short-time working and related measures (Davies *et al*, 2009).

**Figure 3: Change in national unemployment rates, 2008-09 in the EU15**



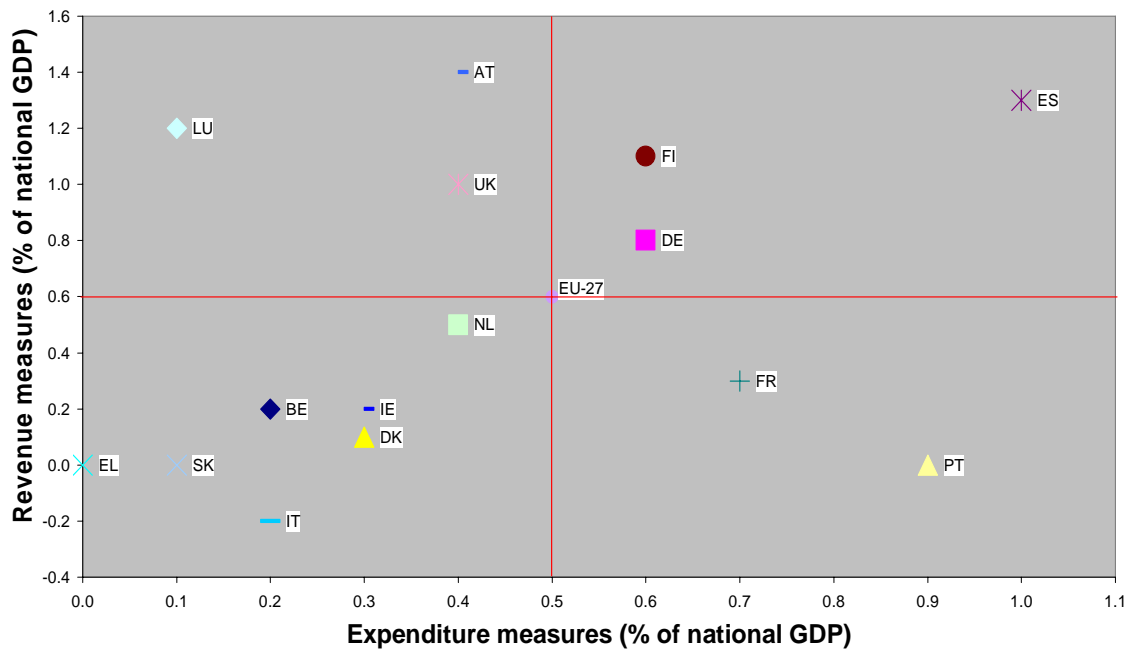
Source: Eurostat. 2009 data are April for Greece and Italy and June for the United Kingdom.

## GOVERNMENT RESPONSES TO THE CRISIS

In addition to the measures for the financial sector, Western European governments have undertaken a range of stimulus measures. For the EU as a whole, the European Commission calculated earlier in 2009 that governments had adopted or announced fiscal stimulus measures amounting to a total of 1.1 percent of EU GDP for 2009 and 0.7 percent for 2010 (European Commission, 2009c). An overview of the different combination of measures is shown in Figure 4; based on Commission data for Spring 2009, it divides the stimulus measures into revenue measures (such as tax cuts, reductions in social security contributions) and expenditure measures (labour market support, investment measures), as well as indicating the relationship with the average spending of the EU27 as a whole. The graph shows clearly the different approaches of individual EU15: very high levels of intervention in Spain, Germany and Finland in terms of both expenditure

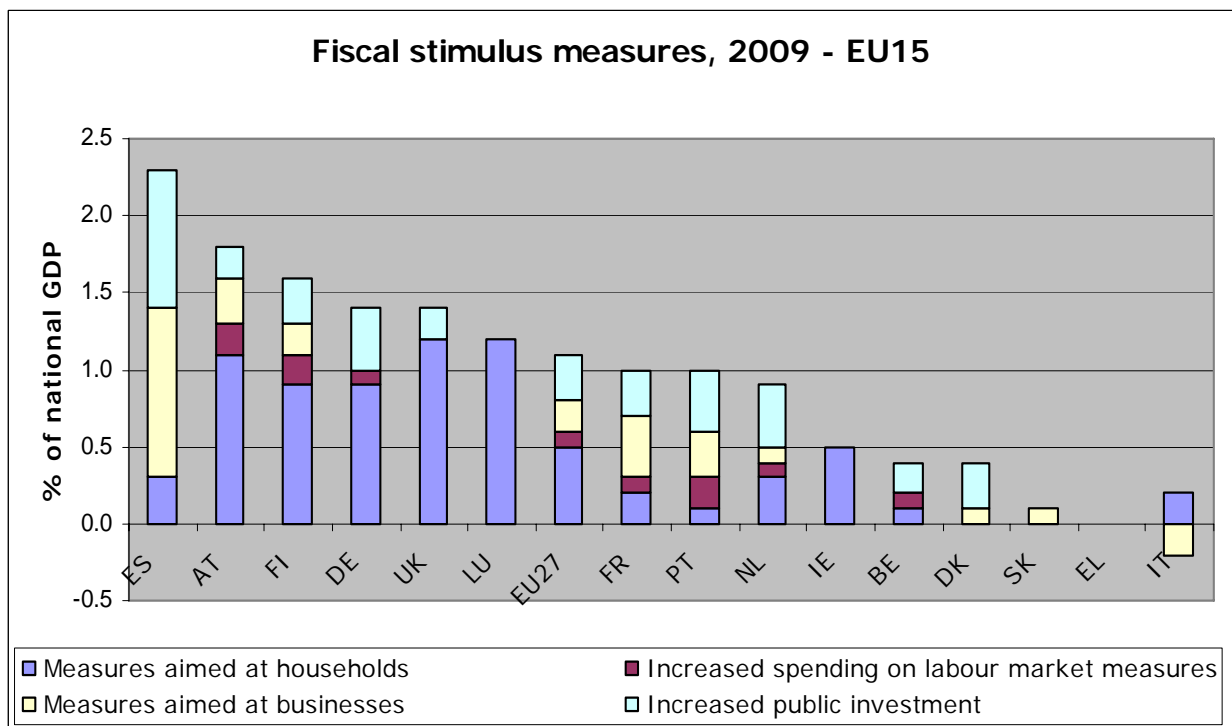
and revenue measures; a preference for revenue measures in Austria, Luxembourg and the United Kingdom; and a greater reliance on expenditure measures in France and Portugal.

**Figure 4: Member State recovery measures – April 2009**



Source: Based on data in European Commission (2009c)

**Figure 5: Fiscal stimulus measures in the EU15, April 2009**



Source: European Commission (2009c)

Further detail on the types of stimulus measures are presented in Figure 5. The main measures can be divided into four main categories: support for households purchasing power – reductions in taxes and social security contributions, and low income support; increased spending on labour market policies; measures aimed at businesses – state aid, tax breaks etc; and increased public investment, mainly on infrastructure. The chart shows a predominance of demand-oriented measures aimed at households in Austria, Germany, Finland and Ireland, whereas there is a much stronger focus on business support and public investment in Spain, France, Portugal, the Netherlands and Denmark. The use of labour market measures is notable in Austria, Finland and Portugal.

The first category of measures concerns changes to taxation systems. In many cases, these have involved the widespread lowering of rates under different taxes. Most common are reduced income tax rates, especially for lower or middle-income earners (Austria, Denmark, Germany, Ireland, Spain, Sweden, United Kingdom). In addition, there have been reductions in:

- value-added tax (VAT) reductions (Belgium, Portugal, Spain, United Kingdom);
- businesses taxes, accelerated depreciation (Denmark, Italy, Netherlands, United Kingdom); and
- specific taxes/allowances, such as a commuter allowance (Germany), stamp duty (Ireland), child allowance (Austria), housing assets (Portugal, Sweden), university fees (Netherlands), and social contributions and pensions (Sweden).

In addition to rate reductions, the tax changes have also involved targeted tax increases and restrictions on allowances, most notably affecting:

- higher rate tax payers (Ireland);
- capital gains and dividend taxes (France, Greece, Ireland);
- tobacco, alcohol and other excise duties (Finland, Greece, Ireland, Netherlands, United Kingdom);
- sectoral levies – on pharmaceutical companies (France), and on energy, banking and insurance (Italy); and
- an intensification of measures against tax avoidance/evasion (Italy, United Kingdom),

The second category of stimulus measures involves various forms of support provided to households and businesses. These encompass social welfare support for low-income earners, pensioners, and the unemployed (Belgium, Ireland, Greece) and labour market support for part-time employment or short-time work to avoid layoffs, especially of skilled workers (Austria, Denmark, Italy, Netherlands). Business aid and other enterprise support has also been made available for nationally important 'strategic sectors', especially for the automobile industry (France, Germany, Greece, Netherlands, United Kingdom) and tourism (Greece). Assistance has also been given to help small firms (Portugal), export development (Greece, Portugal), environmental projects (Denmark, Germany) and to help with access to finance (Finland, United Kingdom). Lastly, several governments have taken steps to accelerate payments to suppliers of goods and services (Belgium, France, Netherlands).



Third, governments have been allocating resources for public investment and employment support. This has been partly through investment in public services, such as education and research (Netherlands, Sweden) and healthcare (Germany). More common is infrastructure investment in energy, telecoms, school renewal, house building (Austria, Denmark, Germany, Netherlands, Portugal, Spain, Sweden). However, faced with the need to reduce public spending, there have also been cases of cutbacks in expenditure, such as wage freezes, pension levies on public sector wages and cuts in higher level salaries (Greece, Ireland), reductions to public sector employment (Ireland) and the rationalisation of public services (Finland).

## **THE REGIONAL EFFECTS OF THE CRISIS**

The main focus of policymaker attention has been on national-level challenges, as well as international dimensions – such as coordination of fiscal stimulus packages and the debate over future regulation of the financial sector. However, there are important regional aspects of the crisis, notably the differentiated exposure of regions to financial and economic impacts and the scope for geographically targeted policy responses.

The effects of the crisis on individual regions depend mainly on the national context but also their position at the outset of the crisis in terms of development strengths and weaknesses, and the degree of sectoral specialization (Davies *et al*, 2009). The immediate impacts in Western Europe were felt by regions dependent on export-oriented sectors, especially automobiles (Austria, France, Germany, Netherlands, Spain, Sweden), as well as logistics (Netherlands), computers (Ireland) and paper and pulp (Finland). These comprised a mix of dynamic regions and traditional industrial areas, for example:

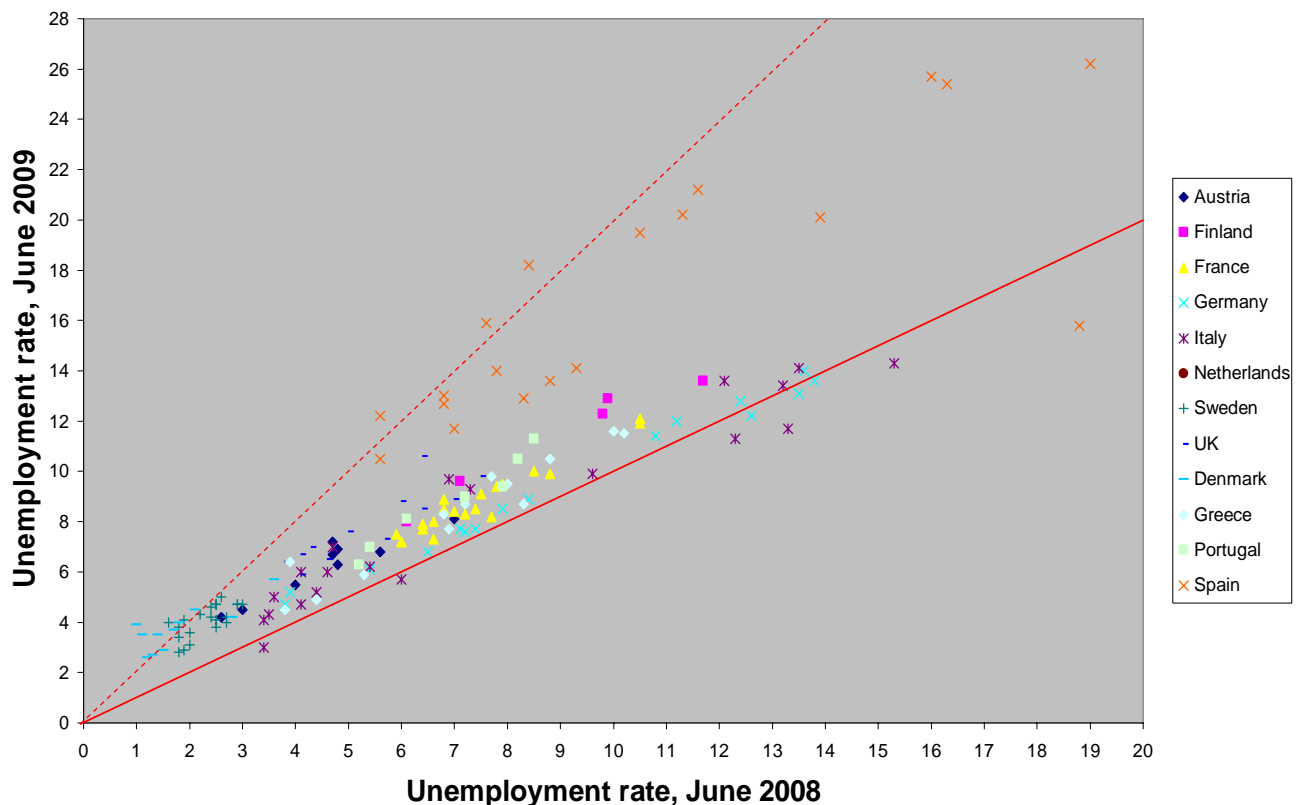
- Steiermark, Oberösterreich, Kärnten (Austria)
- Nord-Pas de Calais, Ile de France, Franche Comte (France)
- Baden-Württemberg, Bayern, Rheinland-Pfalz (Germany)
- Centre-North (Italy)
- Zeeland, Noord-Brabant, Limburg (Netherlands)
- Western Sweden (Värmland, Västra Götland), south/mid-east (Blekinge, Södermanland) (Sweden)
- West Midlands, North-East England (United Kingdom).

The effects spread quickly through supply chains to small and medium-sized suppliers nationwide, especially in sectors like automobiles operating with extended networks of suppliers of goods and services and working on the basis of just-in-time and similar lean production supply systems. Other regional impacts were felt as a result of the slowdown in construction, especially in urban centres in Spain and the United Kingdom, where there was a high level of speculative housing and commercial office construction. Regions specializing in externally oriented services were also affected due to the downturn in line in international trade (Amsterdam, Rotterdam) and changes in tourism patterns (Greece, Spain). In the short term, regions with a high proportion of public sector employment were

protected from some of the impacts of the crisis, but in the medium to long terms, cuts in public expenditure may have significant impacts on local authority budgets and service provision (e.g. in southern Italy, eastern Germany, northern England & Scotland, northern Sweden, northern Finland) (Davies *et al*, 2009).

An overall picture of the regional effects of the crisis is provided by changes in regional unemployment across Western Europe, presented in Figure 6. The figure shows the regional unemployment rates for NUTS 2 regions in twelve EU15 countries in June 2008 and June 2009, with transects showing a ‘no change’ position (unbroken line) and a doubling of regional unemployment (dotted line).

**Figure 6: Changes in regional unemployment in Western Europe, 2008-09**



Source: National sources of regional unemployment data (not comparable between countries). See Davies *et al*, 2009 for more detailed discussion.

The graph in Figure 6 indicates several important features of the regional unemployment situation:

- regions in Denmark and Sweden have experienced a doubling (or more) of unemployment rates, but from a very low base and with regional unemployment (in June 2009) still below five percent in most cases;

- many regions in Spain have also experienced a significant increase in unemployment, mostly by 50-100 percent), starting from a relatively high base and leading to rates of 12-25 percent by mid 2009;
- many regions in France, Germany and Italy have experienced a relatively small rise in unemployment rates, although several rates (in eastern Germany and southern Italy) were in excess of 10 percent at the outset of the crisis;
- most regions in Finland, Netherlands, Portugal and the United Kingdom are in an intermediate position - having seen a rise in unemployment but usually a change of under 50 percent and with some exceptions (mainly in Finland) remain under seven percent.

It is important to underline that the regional unemployment figures are based on national sources and rates cannot be compared between countries – therefore only country-specific changes are relevant. As such, the distribution of regions within countries on the graph does suggest that there has been relatively little change in regional disparities within countries over the period June 2008 to June 2009.

## **REGIONAL RESPONSES TO THE CRISIS**

Much of the governmental response has been national (and international) without geographical differentiation, involving changes to regulation of the financial sector, changes to personal or business tax rates and rules, and measures to ease the supply of credit. However, several aspects of the policy response have a geographical dimension. These can be divided into (a) the regional incidence of national measures; (b) national measures channelled through regions; (c) specifically regional policy responses; and (d) region-specific measures.

First, with respect to the regional incidence of national measures, some national measures have been designed with political awareness of specific regional needs. This applies particularly to France where the government has sought to include all regions in the national public investment programme, for example by identifying a list of specific regional projects, and providing a region-by-region breakdown of the stimulus funding being spent. Certain national 'sectoral' measures also reflect pressures from certain regions, such as: the Swedish support for the automotive sector which is being directed to the western Sweden regions; the support for employment, research and knowledge in the Netherlands which was partly proposed by, and benefits, mainly the south-east region; and the UK support for the automobile industry which is targeted at the West Midlands and northern England.

Second, there are national measures being channeled through the regions. Additional funding is being provided for investment by local or regional authorities in Spain by a central government fund for local public investment. In the Netherlands, 12 percent of the funding for stimulus measures has been allocated to municipalities and provinces; similarly in Denmark the national stimulus package includes municipal investment support equivalent to one percent of national GDP. The German government has made available €10 billion in investment grants to local authorities, and in Sweden additional funding worth €1.2 billion is being provided to local authorities and county councils over

the 2010-12 period. Flexible regional assistance is also available in Finland to support regions and local authorities with problems arising from factory closures.

Third, by contrast with the national support listed above, the role of regional policy has generally been marginal, although there are specific examples of additional regional policy funding being provided in Denmark, Germany and Sweden. The most significant case is Germany, where extra funding has been allocated by the federal government for regional policy support in structurally weaker regions (worth €0.2 billion), complemented by higher ceilings in the maximum amount that can be awarded through regional aid instruments and €3 billion of investment grants for structurally weaker local authorities. In Sweden, the regional policy response has been restricted to a small increase in funding for regional transport aid, while in Denmark it is anticipated that additional funding for regional training and employment support may be provided by the government.

A regional policy response to the economic crisis is also evident in the adaptation of the strategic priorities of regional policy programmes, as in the Netherlands and the United Kingdom. In the Netherlands, the regional 'Peaks in the Delta' programmes have been reoriented to prioritize investment and employment measures addressing the crisis, as have budgets of the English regional development agencies in the United Kingdom, where the eligibility criteria for regional aid have also been widened beyond structurally weak areas.

Running counter to the above measures are examples of regional policy funding being diverted to fund national crisis measures. In Italy, €18 billion has been cut from the Fund for Underutilised Areas, representing a reduction of some 30 percent. Similarly, in the United Kingdom, the budgets of the English regional development agency have been cut by more than 10 percent to finance construction support and other crisis initiatives.

Lastly, some measures have been initiated by regions themselves. A distinctive aspect of responses to the current crisis is the greater role of the regions, compared to the crises of the 1980s, reflecting the decentralization of responsibility for economic development through devolution and deconcentration over the past two decades. This is most evident in those regions with substantial budgetary autonomy and devolved responsibilities, and where major rescue packages have been initiated e.g. Vlaanderen (Belgium), Bayern, Hamburg, Schleswig-Holstein (Germany), Gelderland (Netherlands) and Scotland, Wales (United Kingdom). As with national initiatives, these regional packages have involved different combinations of measures to ease the flow of credit, support construction, invest in infrastructure, encourage energy efficiency/renewable energy, and support additional training and employment.

More generally, regions have sought to play a role through regional coordination of responses to the crisis. Summits or councils have been organized to discuss options and coordinate measures in:

- the United Kingdom (England) – creation of a national Regional Economic Council and monthly meetings of regional ministers with regional fora;
- Denmark - expansion of existing regional growth fora to include labour market actors;
- Netherlands – organization of regional mobility centres, as temporary public-private partnerships to facilitate job movement; and
- Sweden - appointment of regional coordinators in closure areas.

Regional responses have also been facilitated by the use of EU Cohesion policy resources. The European Commission has introduced a range of measures under the European Recovery Programme to provide more flexibility for Structural Funds programmes to support responses to the crisis. This has led to certain adjustments to the 2007-13 regional programmes, for example the front-loading (acceleration) of spending, some re-focusing of priorities to put greater emphasis on small firm development, job creation, training or investment and changes in co-financing, as well as taking advantage of the scope to make extra commitments under the 2000-06 programmes (extended closure). The impact of these EU measures has, however, varied greatly among countries and programmes; many managing authorities have preferred to maintain the long-term strategic focus of regional programmes rather than adapt them to fund crisis measures (Mendez and Kah, 2009).

## **CONCLUSIONS**

This chapter has discussed the national and regional effects of the crisis and policy responses in Western Europe, with an account of the development of the financial and economic crises and an overview of the main types of stimulus measures. It also examined the regional differentiation in the effects of the crisis and the various regional initiatives being taken. The regional dimension is, however, still developing and raises some important questions.

A first question is how the European map of regional economic development will change. The national data on regional unemployment rates presented earlier indicated that regional disparities within countries appear to have changed relatively little so far. Yet, as with the differentiation between countries in the trajectories of recovery, it can be expected that regions will also recover at different speeds. Indeed, it is likely that many regions will see unemployment continuing to grow for some time, for example regions dependent on public sector employment subject to cutbacks as public expenditure constraints bite. The future for regions specializing in sectors where there is overcapacity is also unclear—most notably with respect to automobiles (the current debate over plant closure/rationalisation by GM in Western Europe being a case in point) but also in other sectors like paper and pulp. It seems possible that a new phase of adjustment for industrial regions, comparable to the 1980s, may be underway.

This leads on to a second question of what kind of regional development strategies are needed to respond to the impacts and legacies of the crisis and the implications for regional policies. Insofar as the policy responses to the crisis have involved an industrial policy component, they have frequently focused on research, innovation and skills, and on environmental/energy issues. There is clearly a need to consider the future sources of competitiveness for Western (and Central/Eastern European) countries, and how the mixed performance in innovation can be accelerated, as well as the need to restructure much of economic and social life to meet the demands of a low-carbon economy. In individual countries, the crisis has prompted debates about the relevance and viability of economic models on which they have based their development, such as reliance on the financial sector in the United Kingdom, the attraction of foreign investment (Ireland) or the dependence on manufactured exports (Germany). For regional policymakers, at national and EU levels, the question is what role regional policies could and should play as part of these evolving policy agendas.

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