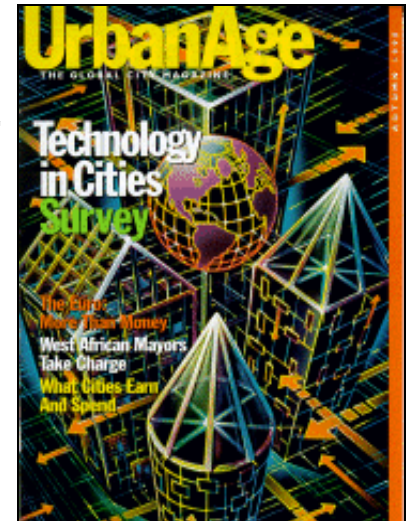




## Urban Development

### The Euro Age By Giovanni Padula

Next year, the European Monetary Union (EMU) will become a club powerful enough to change the world economy. Its 11 members will host 263 million consumers in a trading zone estimated at US\$7 trillion. Its gross domestic product will be nearly 80 percent that of the United States and 50 percent larger than Japan's. On January 1, 1999, the 11 EMU countries will adopt a single currency—the Euro—which will replace national currencies in day-to-day transactions by July 2001. The EMU will have a single central bank based in Frankfurt—the European Central Bank (ECB).



In addition to its profound effect on the European and world economies, the EMU will also have an impact on the future growth and development of European cities. A unique institutional experiment, the EMU may catch many cities and regions off guard if they do not prepare for the consequences of its deeper economic integration. A case in point is the surprising announcement last July that the London and Frankfurt stock exchanges plan to team up to create the forerunner of a Pan-European stock market. It is a move that will boost the financial and banking industry in those two cities while leaving the Paris Bourse out in the cold. The real challenge for these European cities can be summed up in one word: mobility. The EMU's monetary integration may trigger a much higher mobility of investments, capital and labor in Europe—a process strengthened in the last decade between the 15 European Union countries. The size and direction of these movements are still difficult to predict, but different hypotheses are emerging.

#### Concentrating Specialization

Two important economic forces could be triggered by the EMU and the disappearance of economic borders in Europe. The first is that certain activities may benefit from what economists call "agglomeration effects," which means that companies could reap rewards by clustering in cities—normally big cities—that have developed an industrial specialization. The second idea is that the Euro could lower the cost of doing business in smaller cities. Economic activities that were too expensive, except in larger cities, to carry out before a single currency could now spread across smaller urban centers. The balance between these two forces will help determine the cities that win or lose in the investment game.

The agglomeration effect plays a crucial role in industries that predominate in big cities today: mostly tradable services like finance, insurance, media and entertainment. These high-value-added services can be traded faster and more effectively, thanks to spectacular innovations in telecommunications and computers. A report published last May by Cambridge Econometrics—a British consulting and research company—anticipates that the EMU will remove some key barriers to trade in these industries. Tradable services in Europe will therefore become more concentrated. This has already happened in the United States, where New York emerged as the financial and banking giant, Chicago as the center of futures trading, Hartford as an insurance city and Los Angeles as the entertainment mecca.

"In some instances, the EMU will accelerate trends already evident in the single market," says Dino Pinelli, an economist at Cambridge Econometrics. "In others, the impact of the EMU on cities will become more evident when companies, especially large ones, decide to relocate from one European city to the other. Such movements can have dramatic effects on cities, especially if they involve key activities like research, financial services or transport." Pinelli thinks that, overall, this process of relocation in Europe won't be a zero-sum game, and will create more winners than losers. But, he warns, "If a city keeps itself limited only to traditional industries, it is

bound to join the losers."

If the agglomeration effect became the dominant force, some experts suggest that Europe's industry structure will gradually become more similar to that of the United States, where many industries tend to be concentrated in specific cities, regions or districts. Paul Krugman, an economist at the Massachusetts Institute of Technology, suggests that the push toward agglomeration can edge Europe toward a monocentric trend. "The most ambitious bankers will keep going to London and the best aeronautic engineers will concentrate in France around Toulouse," says Krugman. The monocentric order could also emerge in high-tech industries where external economies and a pool of skilled labor are crucial factors. The rapid success of Silicon Valley in California, which in the decade between 1983 and 1993 replaced Route 128 near Boston as the engine of the U.S. software and computer industry, shows how powerful agglomeration forces can be. Krugman admits, however, that "It may require much stronger agglomeration forces to destroy the polycentric order that exists in Europe."

### **Lowered Costs**

Other experts downplay the importance of the agglomeration forces and the monocentric trend. They maintain that the single currency will lower transaction costs across the EMU countries. That means that the red tape, fees, and high administrative and legal costs which are the result of having so many currencies and different regulations will disappear. Standard solutions for contracts will prevail from Germany to Spain, from the United Kingdom (when it joins the EMU) to Portugal. Therefore the cost of doing business, which today makes London or Munich attractive places for companies, will be lower also in Lisbon or Bilbao. "Differences in transaction costs will be reduced by the Euro," says Robert Koll, an economist at the IFO Institute in Munich. "Besides that, there is a limit to how big cities can grow. After a certain level, the office cost and the land cost can rise too much and discourage investments."

His view is shared by some European city officials. London, Paris or the Rhine region in Germany are already badly affected by traffic and congestion, according to David Weissert, the chief economist of the Berlin government. "When a city or a region reaches a high density, the negative inefficiencies of the agglomeration begin carrying their weight and prevent further growth," Weissert says. An indirect effect of the growth limits of big cities, according to Weissert, could be the strengthening of a trend that is already taking place in Germany: the growth of the urban areas that surround the core city or that are located between two big cities.

Recent trends in the geographical pattern of investments in Europe offer a good gauge for their future directions in "Euroland." Undoubtedly, many traditional manufacturing industries will continue to abandon Europe, heading toward emerging markets and developing countries where low labor costs prevail. Some of them will relocate in the countries at Europe's periphery. But the high end of the manufacturing industry, where research and highly skilled labor are crucial competitive factors, will still be located in and around European core cities. The deeper economic integration of the EMU, however, will reinforce the battle between competing cities to attract key players in the high-tech industry.

### **Competition for Investment**

A precise assessment of the city economic profile and the know-how for marketing the city internationally will be the strategic tools in this battle. Cities that have already fine tuned these policies will probably be ahead of the game. Berlin is a case in point. On the one hand, a good proportion of its recent growth has been fueled by public funds to prepare Berlin for 2000 when it will become again the German capital. The city is spending an estimated \$12 billion for its facelift. On the other hand, independently from its official role, Berlin is recruiting companies in the media, communications, biotechnology and medical equipment industries. The city is also hosting a total of 12 technological centers—incubators for start-up companies that offer cheap rents and tax breaks to entrepreneurs. And world-renowned architects are involved in hundreds of construction projects that have completely erased the old borders between East and West Berlin.

Many other core European cities such as Cardiff, Birmingham and Glasgow are also trying to retain or attract high-tech activities and an advanced manufacturing base. Munich—already a major center for financial, research and aerospace companies—is also strengthening its position in the information, environmental and medical technology industries. Turin in Italy, and Lyon in France—thanks also to funds provided by the European Union and their national governments—are developing science and industrial parks to attract high-tech companies in the telecommunications, environmental and biotechnology industries.

Cities at the European periphery have also been able to attract investment. Dublin has been a magnet for computer companies and telephone call centers. Many of these investments have flowed to Dublin, often from the

United States, in anticipation of the EMU. Many cities in Spain and Portugal have also benefited from the relocations of mature industries from abroad and from European core areas. Barcelona, Lisbon and Dublin have all built robust infrastructure and transportation, and nourished a skilled labor force, in order to attract investments. These "peripheral" cities have already succeeded in creating the conditions to attract external capital and now seem well positioned to preserve their advantages under the EMU.

### Potential Downside

However, after the introduction of the new currency, many economists expect the EMU countries to maintain an even more severe policy of fiscal restraint, which in turn could lead to a cut in public transfers and a drying up of funds that might affect cities in the less developed regions of Europe in Greece, Southern Italy and certain zones in Portugal and Spain. One important consequence of the single currency and the single central bank is that the EMU countries will not be able to devalue the currency or lower interest rates to boost investment and employment at home. If an external shock, such as an outflow of investments due to a recession, hits one of these regions, there are few options. Workers can either migrate to other European regions and cities, or jobs and wages in the area could go down to attract new business; this process has traditionally taken place in the United States. But traditionally, the European labor market has been much more rigid than that of the United States, and labor mobility has been limited by factors such as differences in culture and language.

These areas could actually end up even worse off in Euroland if they are unable to attract new business. In theory, economically disadvantaged areas should be able to attract investments thanks to relatively lower labor costs. But EMU members have domestic labor market regulations that often prevent wages in their backward regions from being lower than wages in advanced regions—a consequence of the centralized negotiations that take place in many industries. Wages in the chemical industry in Northern Italy, for example, don't differ very much from wages in the same sector in many backward areas in Southern Italy.

Regions and cities affected unable to offer modern infrastructure and a skilled labor force risk losing their position as magnets for investments. "In Brussels, the concern is palpable about some of the consequences if an economic polarization trend follows the EMU; we may observe an outflow of capital and activities from the periphery to already advanced economic regions, a trend that can badly affect cities located in backward areas," says Giuseppe Bertola, an economist at the European Institute in Fiesole, near Florence.

The uncertain outlook of these regions is a reminder that the future welfare of *all* urban areas in the EMU will still be heavily influenced by the decisions of central governments and European institutions. The cities that thrive in this new economic powerhouse will be distinguished by their ability to attract and retain business and investment in a climate where labor, capital and investment will all be searching for new markets and opportunities.

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