



NEWSLETTER

International Centre for Local Credit

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A BIG CHALLENGE FOR THE BANKING SECTOR

Because of its international impact, the current financial crisis is without any doubt the most serious crisis since the thirties of the last century. Adequate intervention of governments and central banks has prevented a collapse of the international financial system. By now the confidence on the markets has recovered to a great extent. The liquidity has returned in most financial markets, the credit spreads have declined and share prices have risen. The economy is growing moderately in most countries. Despite the improved market sentiment we can't afford to sit still. There is much work to do!

A reform of our financial system is inevitable. The system has to become more robust, so that it can better cope with future crisis. Banks will be exposed to new regulations, which will be more severe and also dependent upon the business cycle. The new regulations contain higher solvency in terms of risk weighted assets and off balance positions, reducing leverage and enhancing the liquidity and transparency of financial derivatives. The new regulations will be introduced gradually to avoid

adverse consequences to the economy.

Another big challenge of the current financial crisis is that governments have to economize and reform. The question is which choices will be made and what consequences these choices will have for the society and the economic activity and last but not least for the clients of ICLC member banks.

Fortunately most public sector banks have endured the financial crisis fairly well, so can be read in the article about the results of the survey of ICLC banks in this Newsletter. The main consequences were felt in the funding policy. Most member banks did not suffer any losses on their lending portfolios. The lending volumes declined, but a credit crunch could be avoided. The interest margins went up and the duration of the loans was shorter than normally. However, some member banks were hit more seriously. Adjusting the corporate strategy to the new regulations will be a big challenge to all banks. The secretariat of ICLC therefore choose "New banking regulations planned by the EU" as



theme for the next staff meeting which will be held in The Hague on April 6th and 7th, 2010. Bank Nederlandse Gemeenten will then be your host.

On behalf of our bank I invite the CFOs of all ICLC member banks to attend this meeting.

Hans Leenaars
Member of the Executive Board,
Bank Nederlandse Gemeenten

THE INTERNATIONAL CENTRE FOR LOCAL CREDIT'S CONFERENCE AND GENERAL ASSEMBLY TOOK PLACE IN BRUSSELS ON OCTOBER 15TH AND 16TH 2009

With the topic, "The impact of the financial and economic crisis on banks specializing in public finance and on their local partners: How to overcome current and future challenges?", this annual meeting has been a unique opportunity for the twenty-three members of the organization to discuss the impact of the financial and economic crisis on public financing and local governments.

"The entire sector of the municipal lenders business has been through a major turmoil. It's time now to go back to basics. We are all currently working at developing close relationships with our clients through more transparency and efficiency, in a new economic context where the local public sector is a key lever to end the crisis" said Pierre Mariani, ICLC General Secretary and Dexia CEO.

"Banks play a vital role as intermediaries (...). The Belgian Government has made every effort to defend the banking and financial system and to keep the big banks and an insurance group afloat. (...) It is well understood, though, that state guarantees do not necessarily result in higher deficits and more debt. (...) I am confident that history will judge us kindly", said Belgian Prime Minister Herman Van Rompuy during the meeting.

AGENDA & SPEAKERS

Speakers during the conference were, in order of appearance. All presentations can be found in the Conferences section of the ICLC website, www.iclc.eu.

Day I The global scope
The public finance banks experience
 Chairman: Pierre Mariani, ICLC General Secretary, Dexia CEO.



Pierre Mariani

Welcome Speech
 Pierre Mariani, ICLC General Secretary, Dexia CEO
 Stefaan Decraene, Dexia Bank CEO

Rudolf Niessler, Director of Policy Coordination, General Directorate of the Regional Policy, European Union

The collapse of globalised finance
 Anton Brender, Chief Economist Dexia Asset Management

ICLC survey: Impact on the banks
 Marie-Alice Lallemand-Flucher, Dexia, ICLC Secretariat General
 Juliana Pigey, Urban Institute

Round table
 Moderator: Tomas Werngren, President and CEO Kommunist i Sverige

Panellists: Guido Ravoet, General Secretary of the European Banking Federation
 Hans Leenaars, BNG Board member

Laurent de Mautort, Director Lending Operations Western Europe, BEI
 Pierre Mariani, ICLC General Secretary, Dexia CEO

The local sector experience
 Chairman: Pascal Poupelle CEO
 Dexia Credit Local

Boosting local investments
 Keynote speaker: Raphaël Alomar, Governor, Council of Europe Development Bank

ICLC survey: impact on the local sector
 Marie-Alice Lallemand-Flucher, Dexia, ICLC Secretariat General
 Juliana Pigey, Urban Institute

Round table
 Moderator: Pascal Poupelle, CEO Dexia Credit Local
 Panellists: Jeremy Smith, General Secretary, Council of European Municipalities and Regions

Ottar Gudjonsson, Managing Director, Municipality Credit Iceland
 Stéphane Rio, Head of Product and Portfolio Management, Deutsche Pfandbriefbank AG, Member of Depfa Board

Day II The Belgian scope.
Politik and economic presentation of Belgium
 Chairman: Stefaan Decraene, CEO Dexia Bank

Welcome
 Stefaan Decraene,
Financial crisis and local investments: credit crunch?
 Address: Herman Van Rompuy, Belgian Prime Minister
 The Belgian local public sector and its

financial situation
 Keynote speaker: Frank Lierman, Chief Economist, Dexia Bank



Herman Van Rompuy

Round table
Is PPP still a solution for public sector investments?
 Moderator Dirk Gyselinck, Member of the Management Board of Dexia Bank

Panellists: Johan Vande Lanotte, Extraordinary professor of constitutional law & international human rights law, Minister of State: presentation of the Datio in Solutum-Media-center Project

Luc Asselman, Chairman of OCMW/CPAS (Public Centre for Social Help) Merchtem, Chairman of the Board of Directors of Vlaamse Maatschappij voor Watervoorziening (Flemish company for water supply): presentation of the Merchtem – Building of service flats.

Eric Van Cappellen, Director Distribution Public Finance, Dexia Bank
 Damien Legrand, Head of guaranteed PPP, Deutsche Pfandbriefbank AG

Concluding remarks
 Pierre Mariani, ICLC General Secretary, Dexia CEO
 Stefaan Decraene, Dexia Bank CEO

“IMPACT OF THE FINANCIAL CRISIS ON THE PUBLIC FINANCE SPECIALIZED BANKS AND THEIR REGIONAL AND LOCAL PARTNERS”

The main results can be split up into three levels: the banking sector as a whole, the entities and the sub-national governments.

For the banking sector the loss of confidence is more apparent where the financial crisis hit the hardest. Larger banks suffered more. The main concerns are focused on sophisticated financial products and banks' solvency. State guarantees have enabled banks to avoid a credit crunch. But overall lending and capital available for risk taking have been reduced. Short term lending has been one immediate result of new financing conditions.

Basel II and international regulation are crucial, but more coordination and commitment are needed. The banking industry has been hit by some major structural changes such as withdrawal of competitions, turmoil of large banks, more non bank specialized financial institutions, mergers of banks. Credit margins have increased sharply from +40 to +120 basis points due to higher funding margins. Also spreads went up. New offers and products will be more transparent and simple plain vanilla offers are back. Consulting services must be developed.

According to the impact on the entities as such the confidence issue was quite different. Most banks did not suffer from a loss. Those who were facing such a loss reacted by increasing their presence and strengthening their relationship with core clients. Public relation actions have been reduced substantially. The financial portfolio philosophy has been changed in some banks: more risk averse, limited exposure to foreign banks, focus on government bonds and on core public clients, lower maturity on loans and a more selective investment policy. The funding strategy in 10 banks did not change because the liquidity base was still solid, there is already diversification and flexibility, they enjoy of a competitive advantage, they do have a reasonable match between assets and liabilities and they focus only on local financial market. Those which adapted their strategy intend to increase disintermediation financing, to transform assets into AAA vehicles to obtain cheaper funding,

to look for longer term funding via state guarantee and to receive funding from multilateral banks. Most banks increased their prices to take into account the higher risks and give more attention to all the aspects of each deal. Project finance activity is still alive even if banks are more cautious about existing and new covenants, due diligence, debt service and income ratios and contract duration. The impact on the organization can be summarised as follows: rationalisation, reorganisation, HR optimisation, stricter internal reporting, reduction of global credit volumes, focus on core clients, activities limited to a smaller geographical field.

The impact on sub-national governments is very diversified. Some register no major impact: Scandinavian countries (except Iceland), Morocco, Israel, South Africa. Others report funding problems. There is no credit crunch, but it is clear that credit spreads increased, durations are shorter and new borrowing has been postponed. Local government have been helped by the national government through subsidies, rescue plans, loan packages, exceptional allowed deficit, redefinition of tax distribution, EU or IMF or EIB grants or loans. Local and regional governments are playing a counter-cyclical role thanks to central government measures as well as action taken on their own. Cost cutting, rationalisation programs, stimulation of employment are some examples.

Some countries expect new financial needs such as social support, social housing, new infrastructure, loan repayments, green energy, etc. Other countries do not believe that and refer to the investments which are held back, the cost cutting and the debt divestment. The local finance regulatory framework has not been changed in most countries. If changes took place they had the form of exceptional short term treasury lines, permitted higher deficit, allowed to finance recurrent spending with capital income and financial sources. In a lot of countries the customer financing practices changed: decline of credit enhancement activity, short term versus long term funding, funding diversification via more bond and commercial paper issues.

SOME OF THE MOST IMPORTANT LESSONS LEARNT

- ▶ A confidence crisis is more apparent where the financial crisis hit the hardest, however no real “credit crunch” has been reported notably thanks to state guarantees.
- ▶ Short term lending, higher margins and spreads as well as the return to simpler financial products have been an immediate consequence of the crisis on the banking activity.
- ▶ The crisis stressed the importance of Basel II and international regulation.
- ▶ Major structural changes in the banking industry have occurred since the beginning of the crisis (turmoil of large banks, withdrawal of competitors etc.)
- ▶ In the mainstream, banks have focused on their core clients and limited their activities to some countries / on some products.
- ▶ Given the increased lending rates, and more stringent lending conditions, banks are also making efforts to inform and reassure their core client base.
- ▶ Banks report their concern about a good match between funding and lending.
- ▶ The effects of the crisis on sub-national governments are diverse: those countries with a low exposure to the international financial market do not report an immediate impact as well as Scandinavian countries (except Iceland). On the other hand, countries which were largely exposed to the crisis report – or at least forecast – difficulties for sub-national entities.
- ▶ Local and regional authorities are playing a counter-cyclical role thanks to central governmental measures as well as actions taken on their own.
- ▶ Facing the economic crisis has particularly involved for sub-national governments cost cutting and rationalization programs as well as programs to foster employment.

INTRODUCTION

1 Many sub-national governments are facing financial difficulties as a consequence of the global crisis. These difficulties could lead to a reduction in the quantity and/or quality of public goods and services provided, as well as cuts in planned investments, precisely at a moment when public action is considered crucial for recovery. Sub-national governments (SNGs) represent on average, 15% of GDP, 22% of public revenues, 31% of public spending, and are responsible for about 66% of public investment in OECD countries (*figures 1 and 2*). Their decisions therefore have a great impact on the chances of success of any recovery plan. If they reduced their spending in order to balance their budgets (as most States have done in the US in an effort to balance their 2009-10 budgets for example), this necessarily hampered central governments (CGs)' efforts to stimulate the economy. This is why most national fiscal stimulus plans included measures to support SNGs.

2 This article is based on the information provided first, by a questionnaire prepared by the OECD Network on Fiscal Relations across Levels of Government, filled by 18 countries in June 2009; and second, by OECD related events during the first semester of 2009 where this issue was discussed. It therefore presents the immediate reactions of SNGs to the crisis (until the second quarter of 2009), measures that CGs implemented to help them and support recovery strategies. It stresses the importance of good coordination between central and SNGs' reactions to make sure that the financial stimulus efforts are as effective as possible in terms of stimulating sustainable growth and employment. This study should be completed with the assessment of the actual implementation of the announced stimulus measures and their results.

SUB-NATIONAL GOVERNMENTS' IMMEDIATE REACTIONS TO THE CRISIS

3 The crisis has a large negative impact on most SNGs' finances due to a "scissors" effect, and this impact is likely to get worse in the years to come ("lagging" dimension of the crisis):

Their revenues have fallen sharply as a consequence of the fall in activity, but as many SNGs' revenues are based on previous years' activity (shared taxes, equalisation transfers, etc.), most SNGs are expecting

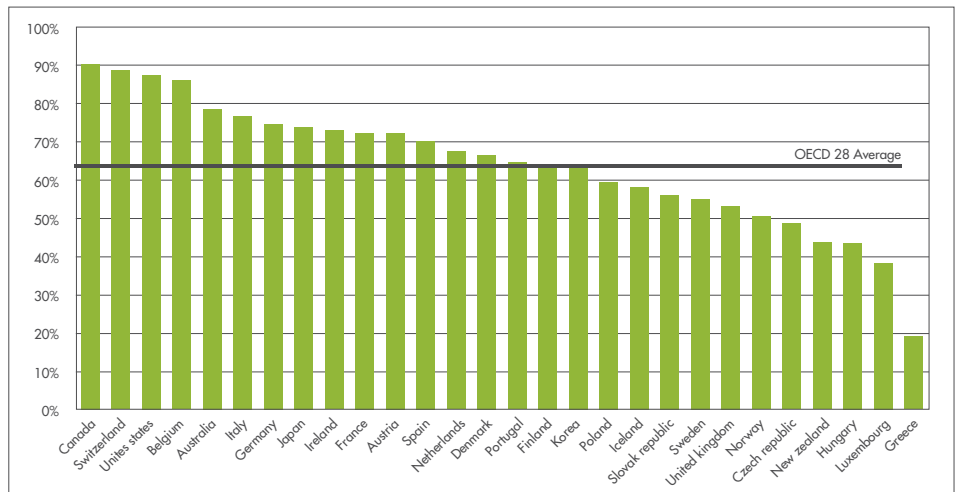


Figure 1. Share of sub-national governments in public investment (2007)

Source: OECD National Accounts - This figure uses Gross Fixed Capital Formation as a measure of public investment.

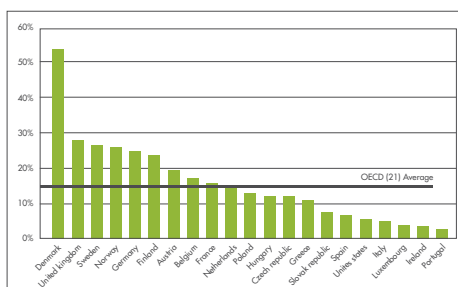


Figure 2. Sub-central governments' share in general government revenues and expenditures (2006*)

Source: OECD National Accounts; US Bureau of Economic Analysis *Or latest year available. **Excluding transfers received from other levels of government; ***Excluding transfers paid to other levels of government.

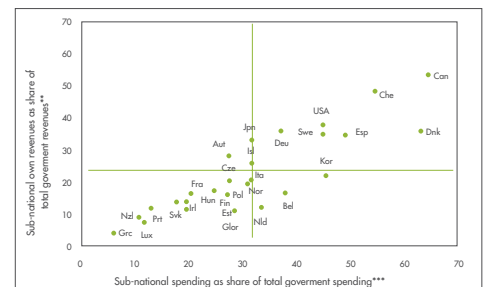


Figure 3. Share of welfare spending in sub-central expenditures 2007.

Source: OECD National Accounts database

this decline to worsen in 2010-2011.

The rise in SNGs' expenditure will also come with a lag, as people who lost their jobs first benefit from unemployment insurance, which is a CG responsibility, before moving to social welfare programmes, which often involve SNGs. On average, welfare transfers represent about 16% of SNGs' expenditure, but they range from less than 5% in Portugal to over 25% in Norway and the United Kingdom, with a record at more than 50% in Denmark (*Figure 3*). Given the large impact of the present crisis on unemployment, social protection and welfare expenses are increasing.

4 Of course, the overall impact of the crisis on SNGs' finances depends both on the type of revenue sources they rely on (and their sensitivity to the economic cycle), and on their spending responsibilities.

5 Like CGs, SNGs had three main fiscal options to face the crisis (*Table 1*):

- ▶ (i) **Pro-cyclical policy**: to balance their budgets by reducing spending (cutting jobs and investment) or by increasing revenues (raising taxes, when politically feasible),
- ▶ (ii) **Passive policy**: to take no active policy measure, letting the automatic stabilisers act. This policy could result either from a lack of sub-central autonomy to implement active policies (as in Korea), or from an institutional framework which allows for the automatic stabilisers to act without explicit policy decision (as in Denmark).
- ▶ (iii) **Counter-cyclical policies**: to increase investment and/or lower tax rates, eventually exposing themselves to increased levels of deficits and debt.

PRO-CYCLICAL REACTIONS (such as raising tax rates, cutting expenditure or investment, etc.)	PASSIVE POLICY (relying on automatic stabilisers)	COUNTER-CYCLICAL REACTIONS (such as decreasing tax rates, increasing investment, etc.)
Finland France Italy Slovak Republic Sweden United Kingdom United States	Australia Korea Denmark	Austria Belgium Canada Japan Norway Portugal** Spain Switzerland

Table 1. Examples of SNGs reactions to the crisis*

Source: Country responses to a questionnaire prepared by the OECD Network on Fiscal Relations across Levels of Government, June 2009 [COM/CTPA/ECO/GOV(2009)5/ANN]. * In Germany, the Länder are cutting operational expenditure and increasing capital expenditure, which leads to an uncertain overall effect. In Italy, sub-central governments had little room for manoeuvre due to the Internal Stability Pact, but have redirected resources towards support measures such as support for enterprises, increasing unemployment insurance and vocational training for workers affected by the crisis, public infrastructure. Structural funds have also to some extent been redirected towards investments with higher immediate impact on the crisis. **Sub-central reaction decided by central government and approved by National Parliament.

6 The United States is probably the most notable case of pro-cyclical immediate reactions from SNGs: 49 states have balanced budget rules (stated in their own constitutions), so any reduction in revenues must be compensated by an equivalent reduction in spending. As the crisis has considerably reduced states' revenues, these were forced to take important measures to balance their budgets (laying-off workers, cancelling investment projects, etc.). In Canada on the contrary, the provinces have implemented very early on their own stimulus packages, which include both tax reductions and spending increases. These sub-national stimulus packages represent 2.1% of GDP over the 2009-2011 period (CAN\$ 33 billion in total), and will mainly be spent on infrastructure (70%).

CENTRAL GOVERNMENTS' MEASURES THAT AFFECT SUB-NATIONAL GOVERNMENTS

7 The great majority of CGs has introduced discretionary, transitory measures to help SNGs. In the United States for example, an important share of the federal American Recovery and Reinvestment Act (ARRA) stimulus plan was directed to the States. Stimulus funds covered roughly 40% of the revenue shortfalls in the 2009-10 budgets, implying that for the first time, CG's transfers became the largest single source of revenue for states and local governments (Forum of Federations, 2009).

In most OECD countries, CGs' measures comprise a wide variety of instruments, ranging from increasing general purpose and earmarked grants (Table 2) to less conventional incentive mechanisms, regulatory measures, etc.

	General Purpose Grants	Earmarked Grants		TOTAL
		Current Expenditure	Capital Expenditure	
Australia	-	-	56%	56%
Canada	-	6%	78%	84%
France	-	-	27%	27%
Germany	-	-	29%	29%
Japan*	33%	-	18%	51%
Korea	-	-	28%	28%
Norway	7%	2%	30%	39%
Portugal	-	-	22%	22%
Spain	-	1%	72%	73%

Table 2. Example of share of grants to SNGs as percentage of total national stimulus spending.

Source: Country responses to a questionnaire prepared by OECD's Network on Fiscal Relations Across Levels of Government; and OECD Interim Report (March 2009). * Japan's initial strategy of giving large general purpose grants to SCGs was modified by the new government in fall 2009.

► **Increasing discretionary grants.** In most OECD countries, grants to SNGs represented a large share of the national stimulus spending (Table 2). In most cases, those were earmarked grants for investment. Spain for instance created a "State Fund for Local Governments", which distributed €8 billion (or 0.7% of GDP) to local councils (on the basis of population), to finance investments for urban planning projects, to be completed in the first quarter of 2010.

► **Conditionally accelerating payments due to sub-national governments,** if SNGs committed to maintaining or increasing their previous investment levels. In France for example, the CG made an early payment to SNGs in 2009 of the FCTVA ("VAT Compensation Fund") due in 2010, provided these committed to increase by at least one euro their level of investment, as compared to the average of the years 2004-2007.

► **Accelerating the roll-out of anticipated infrastructure projects** aimed at fast implementation, as the studies and procedures which are necessary to create new investment projects were already completed. For example, the European Commission accelerated the disbursement of funds for already agreed projects, by advancing payments to the 2007-2013 programs.

► **Simplifying procedures for approval and disbursements.** Many countries, such as France, Spain or Canada, have introduced these in order to speed-up the starting of projects, to provide liquidity to the private sector.

► **Facilitating borrowing** has been allowed, either by providing (sometimes subsidized) loans (Canada, Switzerland), or by providing explicit guarantees to sub-national loans (Australia, Korea, Spain).

► **Temporarily increasing sub-national governments' share of tax revenues.** This is the case in Finland, where the corporate tax apportionments to local authorities was temporarily increased by 10 percentage points from 22 to 33% for the period 2009-2011.

► **Temporarily easing budget constraints** increased SNGs room for manoeuvre and thus reduced the pressure to carry out pro-cyclical policies. In Austria for example, the "Internal Austrian Stability Pact" was revised, allowing for higher sub-national deficits.

CONSEQUENCES OF THE CRISIS AND FUTURE CHALLENGES

8 The importance of coordination between levels of government. Given the weight of SNGs in the national economy, coordination between levels of government has been and will be crucial in addressing the crisis and consequent challenges through aligned strategies. Effective coordination across levels of governments is needed to ensure that all investments are tailored to local needs, while being consistent with national strategies, thus having the greatest impact on wealth. This has led some countries to create or reinforce institutions aiming at facilitating the dialogue between levels of government (such as the Council Of Australian Governments – COAG – in Australia, or the "regional coordinators" in Sweden).

9 In most OECD countries, CGs and SNGs have taken fast measures to address the crisis. However, the actual implementation of the recovery strategies and their results are still to be assessed. Beyond the immediate impact of the economic and financial crisis on SNGs' finances, this crisis will also have long-term implications on the relations across levels of governments:



▶▶▶▶ ▶ **Consolidating budgets.** The first challenge for both central and sub-national governments will be to consolidate their budgets, as deficits and debt levels are rising to very high levels, due to the effects of the crisis and the cost of stimulus packages. Consolidation might be even harder for sub-national than for central governments, as the discretionary transfers they receive from central governments will most likely be reduced and their other revenues are likely to keep falling (lagged effect of the crisis). SNGs' debt levels are therefore likely to remain high for some time (at least in those countries where sub-central governments are allowed to borrow).

▶ **Increasing the effectiveness of SNGs' spending.** Consolidating budgets in this context of falling revenues and increased welfare expenditure, without compromising the quantity and quality of public services requires increasing the effectiveness of spending ("to do more, with less"). This

crisis has thus sparked a broad reflexion on the need to reform relations across levels of government in order to increase effectiveness (for example by reforming territorial organisation or the fiscal incentives of SNGs).

▶ **Impact of the crisis on the reform agenda.** But if the crisis has revealed the need for reform, its immediate impact has rather been to delay or to scale down some previously planned reforms (such as the revision of the transfer system in Finland). Indeed, crises can be catalysts for reforms by highlighting the shortcomings of the existing system, but in most cases, they tend to delay or cancel reforms, as reforms tend to be expensive (need to compensate losers, etc.) and increase uncertainty (which might not be acceptable in crisis periods). In the present situation there was a broad consensus on the need to take action quickly, which is not the case of structural reforms, which require a long time for preparation, and for implementation.

▶ **"Rebuilding" the economy.** After the short-term reactions to the crisis, it is important to think about the longer term policies, and therefore, about how to prioritize public investment in regions. Regional development policy has for a long time been a way to prioritise public investment in regions through co-funding arrangements. To restore growth, many countries are implementing this type of approach by selecting local investment projects to be supported by the central government (OECD, 2009c). This approach is supported in particular by the European Commission and EU member states, who have agreed to reorient cohesion funds towards strategic sectors.

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EUROPE'S TOWNS AND REGIONS IN THE STORM OF THE ECONOMIC CRISIS

Patrizio Fiorilli, Head of press and communication Council of European Municipalities and Regions (CEMR)

Throughout the second half of 2009, at the Council of European Municipalities and Regions (CEMR) kept hearing conflicting views on the economic and financial crisis. On one hand, well-respected international bodies were sending strongly optimistic signals about the future with references to the "green shoots of recovery burgeoning in 2010", "the worst of the crisis being behind us", "the economy is showing signs of recovery", etc.

However, at the same time, most of our members (national associations of local and regional authorities) were reporting financial difficulties for their own members (towns, provinces and regions from about 40 European countries) and wide pessimism about the future.

These contradictory statements prompted us to conduct an extensive survey about the impact of the crisis at local and regional levels, and last summer CEMR sent out a detailed questionnaire to its members to assess the current situation and mood among our towns and regions. 32 associations¹ replied, which enabled our study to cover every part of Europe: Scandinavia, Western Europe, Central Europe, and Southern Europe.

As the responses started piling up, it became obvious that EU and international institutions statements that 2010 will see an economic and financial improvement had visibly not been heard by Europe's local and regional authorities who, in their vast majority fear that 2010 will be as difficult as 2009 or even worse.

Our survey shows that 76% of local and regional authorities feel that the situation has worsened over the last 6-9 months whereas only 6 % perceive a slight improvement (in Portugal, Sweden and Wallonia). When asked about the prospects for 2010, only associations representing only 6% of the population covered by the survey (Cyprus, Norway, Portugal and Sweden) expressed optimism, whereas 44% expected 2010 to be worse and 50% did not foresee any improvement at all in the coming year.

Though interesting in itself, the overall mood of local and regional authorities is only one factor, and to be really useful our survey needed concreated, measurable data. Therefore we asked our members what the situation was in terms of access to investment resources. And the findings

were spectacular: respondents representing 90% (!) of the population of Europe stated that access to borrowing for investment had worsened or not improved since our first survey in April 2009. This almost unanimous response is extremely worrying; given the crucial role of public borrowing for sustaining economic development and infrastructure investments, this might result in a long-term local development slowdown for a large proportion of Europe's population.

COMBINING BUDGET REDUCTIONS AND INCREASED EXPENSES

According to our survey, local and regional governments also find themselves caught between decreasing budget income and increased demand for expenditure. In 63% of the countries own-source tax revenues have decreased and so have government transfers and grants (56%). At the same time, expenditure has increased or remained the same for Europe's local and regional authorities representing 75% of the covered population. In short, our towns and regions face additional expenses while their budget contracts.

Of course, we tried to find out why our towns and regions face additional expenses. No real surprise here: the effects of the crisis on European citizens have led to an increase of public services provided at local and regional levels for local and regional authorities representing 80% of the population covered by the survey. These have had to adapt the volume and range of public services provided, more specifically around social services such as social and welfare allowances, housing support, support for unemployed and homeless persons, financial or debt advisory services, mental health services...

The overall outlook is thus bleak. So much so that in its foreword to the survey, CEMR secretary general Jeremy Smith stated that *the overarching trend, visible throughout the whole survey, leads to an inescapable conclusion: the economic and financial crisis will not spare Europe's public sector in 2010. Even if and when the economy picks up to some extent, the extent of public sector debt and continuing unemployment in many places, will place acute pressure on Europe's local and regional governments.*

In order to make sure that our findings were correct, we asked the CEO of Gallup Europe, Robert Manchin, to write a contribution based on our survey. His conclusions matched ours since he wrote that according to Gallup's survey on the crisis European citizens are only now starting to really feel the full blow of the crisis. In a somewhat gloomy statement, Robert Manchin concludes his contribution with these words: *Ironically, while citizens believe that concrete answers to the crisis are more likely to emerge from the local level than from national or international actors, local authorities may face in 2010 a combination of both drastic budget cuts and increases in the demand for more social services. Needless to say that if local authorities fail to deliver because of a lack of resources while experts keep talking about the end of the crisis, a growing disconnect between citizens' and experts' perceptions of reality is to be anticipated, possibly coupled with a feeling of injustice that the seeds of economic recovery should be so unequally divided.*

This conclusion, in a way, also explains what CEMR tried to achieve with this study: It was important to make it clear to our leaders, both at the national and European lev-

els, that despite what some may clamour, the crisis will directly affect of our citizens' lives in 2010 (and very likely beyond), and that these first and foremost turn towards their local authorities for help. If these local authorities are not in a position to address their citizens' need due to lack of resources, the repercussions could have longer lasting effects than the crisis itself.



Patrizio Fiorilli

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¹Countries covered by the survey: Albania, Austria, Belgium, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Iceland, Latvia, Lithuania, Luxembourg, FYR Macedonia, Netherlands, Norway, Portugal, Slovakia, Slovenia, Spain, Sweden, Switzerland, Ukraine and the United Kingdom

LOCAL GOVERNMENTS AND THE FINANCIAL CRISIS: THE CASE OF EMERGING AND DEVELOPING COUNTRIES

Thierry Paulais Cities Alliance¹

The financial and economic crisis that started in the United States has finally impacted all urban communities and investment financing systems around the world. The landscape of this financing sector is currently one of devastation. Policies have to be reformed and tools and mechanisms, restructured or overhauled. While the magnitude of these problems varies from one regional grouping to another, it seems that post-crisis recovery will be a lengthy process, perhaps more so in the least developed countries.

Local governments grappling with the crisis face a number of constraints which, though disparate in nature, have a cumulative effect. This phenomenon has created a number of extremely difficult situations. In general terms, the consequences of the crisis can be felt on four levels: Revenue—either generated by local governments or derived from State transfers—which may be subject to sharp declines; Expenditures, which are rising because of the slowdown in economic activity and the corresponding increases in unemployment and social welfare needs; Financing capacities, which are shrinking owing to the difficulty in obtaining loans and the increase in the cost of money; and Foreign investment, which has declined; operations underway, which have been put on hold in many instances; and projects, which have either been cancelled or delayed.

The two major financing systems, bond issues and banks whether specialised or not, have been heavily impacted. Governments have adopted different measures depending on political and institutional environment. However, the common feature of these measures, whether they entail the bailout of financial institutions, stimulus packages, or recovery plans, is that they are more geared toward central or deconcentrated governments than toward local governments. Their impact in tangible terms, run the risk of being relatively minor or, in the case of investment programs for example, delayed, inasmuch as they require time for implementation. Regardless of what happens, beyond these short-term measures, in-depth reforms will be needed to improve the situation facing local governments. In many countries, the very nature of the relationship between the State and local governments hangs in the bal-

ance. The architecture of financial systems everywhere has been greatly undermined.

THE IMPACT OF THE CRISIS ON LOCAL GOVERNMENTS

Sharp decline in revenue. The situation differs greatly from one country to another. In some institutional contexts, local governments are relatively sheltered while in others, they are exposed. In terms of assets, local governments that can invest their funds in the market have been directly affected by losses in capital. In general terms, the slowdown in global economic activity is also impacting local budgets in both the emerging and the most developed countries. Lastly, many local budgets have been adversely affected by the decline or delay in state level transfers, given that states are also facing budgetary constraints. This is the case in particular in a number of east European countries or some of the least developed countries that are facing plummeting commodity export revenue, a significant decline in foreign remittances, and a paucity of own resources at the local government level.

Difficulty gaining access to borrowing. The deterioration in local government accounts is often one of the factors constraining the ability of these governments to borrow. The lack of liquidity of the financial system, the precarious situation facing many financial or banking institutions, the general lack of appetite for investment, and the increased cost of money are the other factors affecting local governments, to varying degrees, depending on their borrowing philosophy and the structure of their local financial systems. Clearly, in a number of emerging countries where local governments are not allowed to borrow directly, or in the least developed countries where local governments have never had access to borrowing (as is the case in the majority of Sub Saharan African countries), the situation has not changed drastically.

WHAT ARE THE SOLUTIONS TO THE CRISIS?

Emerging economies. Information on the provisions that the governments of emerging countries could have put in place to support their local governments is still scanty.

It appears that those that planned special interventions implemented stimulus packages at the local level, which were deemed in general to be best suited to support employment. This approach presents a dual challenge: On the one hand, funds have to be quickly channeled, requiring efficient and reliable administrative networks, and on the other hand adequate local capacity is necessary to execute the plan within time frames consistent with its urgency. These two conditions are not easily met. In this respect, countries with instruments such as municipal development funds or urban development banks are better equipped than others. This type of institution is in principle well suited to this kind of exercise. It also has the advantage of being a good recipient for financing from international donors that are not short of liquidity, at least not in the unsubsidised or barely subsidised segments of their array of financial products. However, they seek tried and tested programs and implementation vehicles. Opportunities exist for countries that possess this category of tools and are wrestling with a decline in liquidity on their market and a contraction of external investments and PPPs. The People's Republic of China, which is banking on a recovery at the local level to counter the economic slowdown, selected an innovative option: the launch of a US\$30 billion bond issue on international markets. An allocative key will be used to redirect these funds to the local governments through urban development and investment corporations (UDICs). These particular entities were established at the initiative of the Government in the late 1990s (Wu, 2009). They are owned by the local governments—which are not authorized to borrow—for which they hold assets and liabilities. They mobilise financing for infrastructure through bank loans, PPP arrangements, or real estate appreciation (building leases, etc.); they delegate project management of new investments and supervise the operations of existing investments. They are therefore used as vehicles for the implementation of a stimulus program at the local level, to be financed at the country level.

Least Advanced States and Fragile States. Cities in least developed countries are in danger of being among the hardest-hit victims of the crisis. Already facing a

¹The views expressed in this paper are those of the author and do not necessarily reflect the views of Cities Alliance. This paper is an extract from "Local Governments and the Financial Crisis: An Analysis", available at www.citiesalliance.org.

substantial reduction in their resources, they are also grappling with public budget hardships. External investments and PPPs, from which they were already receiving very limited direct benefits, are still on the wane. Governments and the international community have mobilised around other sectors or around undeniably worrisome issues such as the food crisis. The food crisis and the effects of global warming could exacerbate the migration or social pressures that are already having an impact on the majority of these cities. In addition, a number of countries have in recent times initiated significant decentralization reforms. The progress of these reforms, the implementation of which regularly encountered difficulties in the area of taxation and public finance, could be undermined by the effects of the economic crisis on public finances. While countries in Africa in particular have enjoyed substantial budget surpluses in recent years, 2009 will not signal the end of an average deficit on the order of 5 percent of GDP. The international community initiated a number of support programs for African economies that were affected in particular by the decline in revenues from export products. However, cities are rarely included in the top priorities addressed by these action plans, and local governments could miss out on many of their direct benefits. Developing countries with export revenues could draw on the Chinese example to redistribute to their local governments investment and activity support programs in rural areas. However, the institutional framework and implementation tools are lacking in most cases. A specific initiative aimed at supporting the local governments in these countries should be given consideration.

NEW FINANCING, NEW FINANCIAL INSTRUMENTS?

Climate change has led to the establishment of new types of financing instruments, such as those derived from carbon financing in the area of mitigation, and funds or initiatives in the area of adaptation. However, with respect to local governments, particularly those in developing countries, a gap remains between needs and financing. These financing instruments are inadequate, fragmented, and relatively poorly adapted; they are often complex and costly to use and, for the most part, target sovereign borrowers rather than local governments. These local governments primarily need advisory services and support, not only with respect to

the technical aspects of dossiers, but also in order to tap into financing opportunities from various sources and place themselves in a position to use them in parallel (which is difficult owing to reasons such as financial features, timetables for use, administrative constraints, cumbersome directives, etc.). For some time, there has been a resurgence of the concept of renewable funds, which, in some measure, addresses these concerns. This model was used in the 1980s in the United States, where subsidies were provided by a federal agency for environmental protection. States created renewable funds (states revolving funds) within which subsidies were combined with market resources to establish heavily subsidised loans for environmental investments. The Jessica (Joint European Support for Sustainable Investment in Cities Areas) fund, which was recently established by the European Community and targets urban renewal operations, allows for the blending of subsidies from the European Economic Community, State aid and transfers, the local governments' own revenues, private sector investments, and loans or guarantees provided by the European Investment Bank (EIB) and other banking institutions. The fund has its own unit that provides support to cities in the area of implementation. A number of financial tools and initiatives that were recently proposed in various parts of the world are similar to this model,

TOWARD POLICY CONVERGENCE?

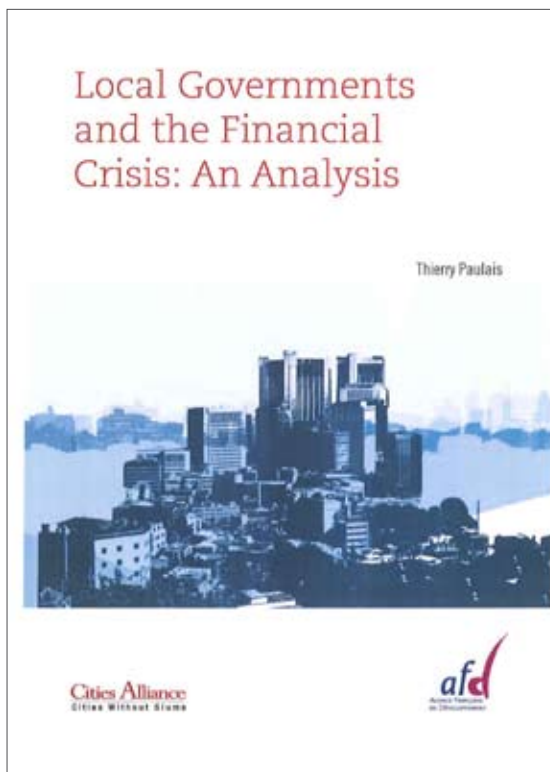
The effectiveness of the recovery from the financial crisis at the local level will be contingent on the type of reforms and measures that central administrations will have succeeded in promoting. In the final analysis, this crisis will have called into question the

paradigms that had been governing the sector for several decades. It had been claimed that the modernisation of systems called for the exclusive use of structured financing, financing on the markets, and public-private partnerships. This claim has been debunked. However, it would be a mistake to believe that these techniques and tools are outdated. They remain a fundamental

component of the various solutions that have been devised to restart the production mechanisms of sustainable cities. These solutions reflect a certain level of pragmatism, especially by applying the economic concept of semipublic status, but in a renewed spirit that will make full use of the gains achieved in recent decades. In view of the stagnation and even

the relative decline in international aid and the parallel growth in needs, this approach appears to be even more critical for the least developed countries. Financing of sustainable urban investments will, more than ever in the post-crisis period, depend on the mobilisation of local savings, the promotion of investments particularly in housing and construction, land and real estate appreciation, and second generation public-private partnerships.

Thierry Paulais



The Dexia Crédit Local “Economic Outlook”, published on 24th November, reviews local finances in France.

2009 is a most unusual year for the French local governments as it takes place in a quite singular economic context (economic crisis, worsening of public finances) leading to a downturn in some of their resources, a rise in their social welfare expenditure, not to mention their contribution to the economic recovery plan. These features are combined with trends specific to local governments such as the municipal election cycle or the competency transfers slowdown.

In 2009 the local governments’ operating budget balance registers a drop for the second consecutive year (-4.6% versus -3.8%) while still remaining at a high level (37.3 billion euros). Although local governments have increased their tax rates by 3.6%, all taxes and local authorities included, and also benefit from a dynamic tax base, a reduction in the financial margins leeway can be observed. The four direct taxes steady growth (69.8 billion euros, +7.7%) still does not offset the existing constraints on resources and expenditure.

Operating revenue (184.3 billion euros, +2.7%) is faced with a significant drop (26%) in real estate transfer duties output (7.0 billion euros), when the capital expenditure grants (45.8 billion euros) register a limited evolution (+0.8%).

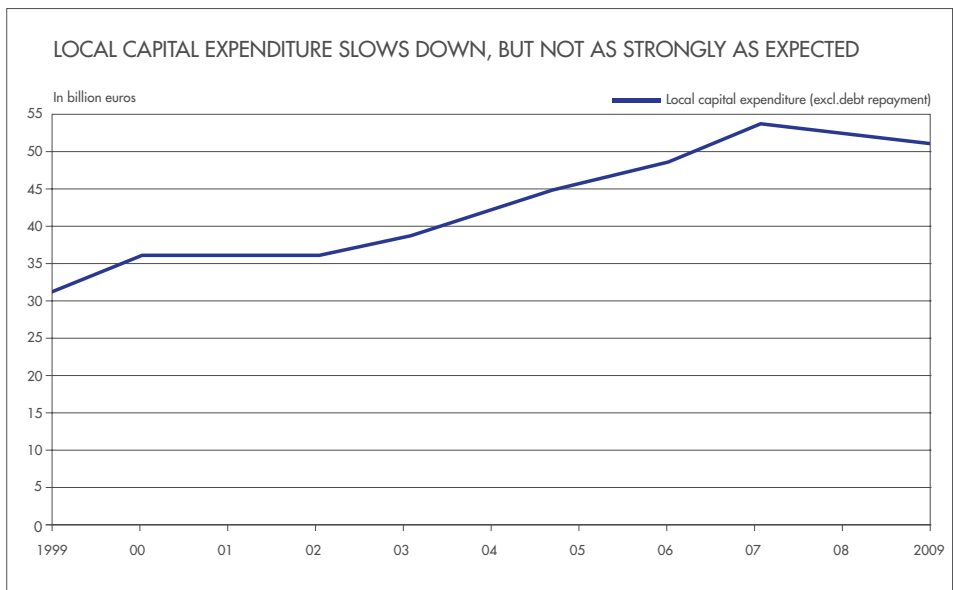
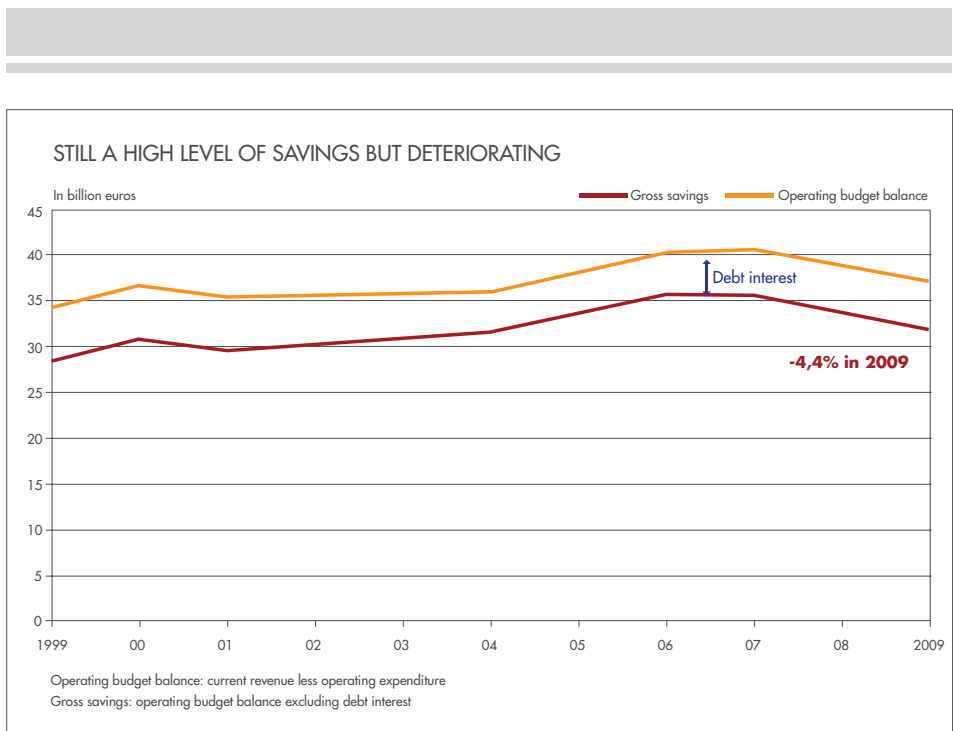
The cutting back in competency transfers as part of the decentralisation process (about 600 million euros in 2009, essentially staff transfer, versus 1.7 billion euros in 2008), leads to a slowdown of the increasing operating expenditure (147.0 billion euros, +4.7% versus +5.2% in 2008), and clearly conceals the boost in paid-up transfers and other expenditure (48.3 billion euros, +5.2% versus +3.3% in 2008), the latter due to an increasing demand for services and social welfare, in a deteriorated economic context.

Gross savings, 32.1 billion euros, also slows down, -4.4%, but takes advantage of the debt interest rates drop (5.3 billion euros, -5.8%), owing to the short-term rates collapse since October 2008. Self-financing, completed with capital expenditure revenue (excluding borrowing) (15.6 billion euros, +40.6%), particularly buoyant due to the VAT advanced repayment as part of the economic recovery plan, finances up to 90% of the capital expenditure revenue.

Local capital expenditure (excluding borrowing) slows down (50.9 billion euros, -2.7%), in phase with the municipal election cycle, but not as strongly as expected, the economic recovery plan softening the drop.

Its financing is completed by a net debt flow of 5.1 billion euros, versus 7.7 billion euros in 2008. The local governments’ debt will therefore reach 132.1 billion euros by the end of 2009, a 4.0% increase compared to 2008. The debt will represent 6.9% of GDP, thus 0.7% less than 10 years ago.

Dexia Crédit Local
Research Department



KOMMUNEKREDITT NEW ORGANISATION

Kommunal Landspensjonskasse (KLP), the National Local Government Pension Fund, purchased Kommunekreditt Norge AS (KKN) from Eksportfinans as of June 24 2009. KKN is a financial institution solely engaged in supplying long term credit to Norwegian counties and municipalities and it is the second largest credit provider to the local government sector in Norway. KKN's core business, supplying loans to the local government sector, will be carried on by the company KLP Kommunekreditt AS following the change of ownership. The lending activity of KLP Kommunekreditt AS will

be based on covered bond funding and a short term funding program. KLP Kommunekreditt AS is fully owned by KLP through its subsidiary bank KLP Banken AS.

The Ministry of Finance granted KLP concession to acquire all outstanding shares in Kommunekreditt Norge AS as of June 23 2009. On June 19 2009, the Storting (the Norwegian Parliament) unanimously approved the Central Government's acquisition of KLP's 20 per cent ownership of Kommunalbanken AS. Kommunalbanken is now 100% owned by the Central Government.

KLP provides pension, financing and insurance services to the local government sec-

tor and the state health enterprises, and is the dominant public pension provider for both sectors. The mutual ownership model of KLP group implies that its customers are also its owners. 60 per cent of KLP is owned by Norwegian municipalities while 30 per cent is owned by state health enterprises. KLPs owners, on a pro rata basis, are liable for any group pension scheme deficit and they are obliged to pay equity contributions in so far as this is necessary to provide KLP with satisfactory financial strength, according to Articles of association.

Arnulf Arnoy
Managing Director

INFORMATION

NEW MEMBER CAIXA ECONÔMICA FEDERAL - BRAZIL

CAIXA AND ITS COMMITMENT WITH BRAZILIAN DEVELOPMENT

Caixa Econômica Federal was founded on January 12th, 1861, by Dom Pedro II, Brazil's emperor.

CAIXA was created based on development vertex, extremely modern for that era, which linked the economic development to the social development. CAIXA was the first financial institution that has developed, in practice, economic policies with social mark.

With the announcement of the Republic in 1889 CAIXA continued strongly exercising its role. In 1934, based on a definition issued by the federal government, has assumed the exclusivity of the loans under pledge. CAIXA has actively participated in the urbanization and industrialization process of Brazil, and was always considered as one of the country's social asset, serving the national development.

In 1961, CAIXA obtained the exclusivity of the federal lotteries which resources are fun-

damental for the development of the public policies in Brazil.

In 1986 a huge quantitative jump occurred in the life of the institution with the incorporation of the Dwelling National Bank (BNH) becoming the largest national agent for house acquisition funding and important funding institution of the urban development.

Caixa is one of the most relevant public Brazilian entities in terms of resource administration. It is experiencing an exponential growth, not only as main agent of the Federal Government public policies but also as a strong commercial bank with more than 48 millions accounts holders.

Today, CAIXA also supports several cultural, educational and sport initiatives, loyal to the commitments with Brazil's social and economic development.

As the third major bank asset in the Brazilian market and most important operating agent of the Federal Government income transfer programs, in addition to the benefit transfer

public policies, CAIXA is achieving its ambition to contribute as a protagonist in the social and economic development of Brazil.



Maria Fernanda Ramos Coelho, President

The total outstanding public finance loans detained by CAIXA in december, 31th of 2009, was approximately 4,45 billion euros.

UPCOMING MEETINGS

STAFF MEETING ON "NEW BANKING REGULATIONS"

6-7 April 2010, The Hague

EXECUTIVE COMMITTEE

29 April 2010, Paris

CONFERENCE

23-25 March 2011, Marrakech

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The Newsletter contains information about the ICLC affiliated institutions and about topics related to the local sector. Contributions to the newsletter are very welcome. Please direct questions and comments regarding the newsletter to the secretariat.

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