Towards a change of model in international economic relations?

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The answer to this question is certainly relevant in both its conception and consequences, so it needs to be given from different approaches and regarding different areas. A return to the situation prior to the crisis is not likely as some of its then essential ingredients cannot be recovered in the medium or long term. Abundance of capital will not be back before many years from now as the crisis is adjusting excess liquidity that was not based on asset value but on expansive speculation with these assets, multiplying their value to an unsustainable extent.

The direct effect of the situation created by the financial crisis has forced governments to contribute capital to buy toxic assets, recapitalise banks, intervene in them or in some cases nationalise them. Due to the extent of this aid, this has created a budget deficit as it had not been seen for years, which in most Western democracies amounts to 5-10% of GDP in 2009 and definitely not less in 2010.

This deficit has increased due to direct aid to branches in crisis such as the car industry or programmes to recover economic activity and foster employment, whose only effect so far has been to create more distress in government budgets that were heavily in the minus anyway. The most immediate consequence of this situation is that the increase of housing value and thus demand in the real estate branch has disappeared for years from now, which has been aggravated by excess offer that finds no way out in a saturated market in the short and medium term, though it is true that in some countries like Spain demand for social housing is high and related offer insufficient.

The Spanish and Catalan finance sector are less affected by the real estate bubble as they have given mortgages at asset prices above real ones, once the speculation effect of recent years has disappeared, but they have not created any derivative products multiplying their base value in an excessive and speculative way. It is true that there are many building companies and developers that went bankrupt in order to deal with mortgage payments that are excessive today and, as a consequence, creditor banks had to keep with real estate property supporting their credit. At current prices, this has caused losses to banks and not lesser immobilisation of their resources that have led to restrict credit conditions, but losses were not as high as in the US, the UK and all European banks taking part in the derivatives market, in which financial packages purchased and sold had a very far-fetched relation with any minimally realistic economic assessment, but were highly profitable and bore thus a very high risk, as reality eventually proved.

The statutory mandate of the Bank of Spain to create general, anti-cyclical provisions in order to take on delinquency in times of crisis also has contributed to the relative solidity of the Spanish financial market. Together with a more strict control of debt subordination in subsidiaries, this has contributed to keep the balance of banks at their value, though with some losses, and to avoid extreme reductions of own funds almost all European and American banks suffered from.

There are currently eight banks in the UK, sixteen in the US and three in Germany with state intervention or having received significant capital aid from public funds. In Spain there is only one, though it is likely that there are more in the future, which sustains an irrefutable fact: the Spanish financial system has endured the crisis better, without any need of emergency recapitalisation as in the United States and many EU countries to avoid the collapse and default of their financial market, which if it had occurred, would have had serious, very long-term consequences for the world economy.

Once this has been acknowledged, it needs to be said that it is in the productive sector where Spain and Catalonia are in a more unfavourable position than the European Union and the United States.

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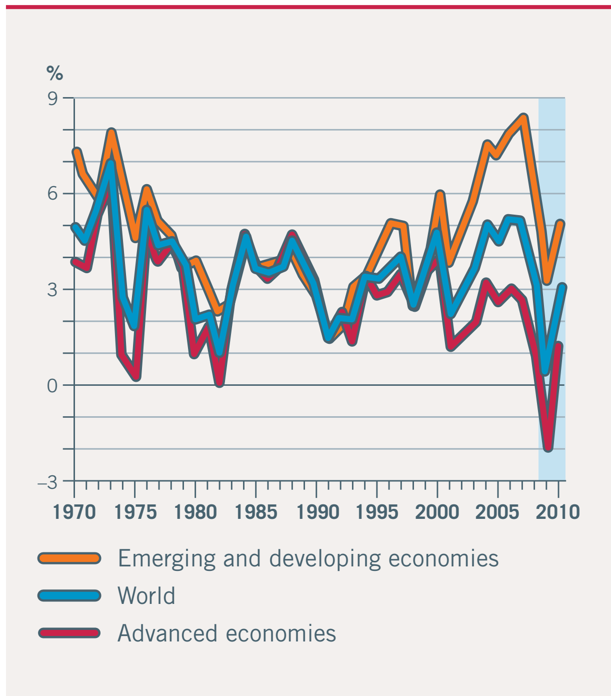
The building and car industry – which together amounted to 23% of GDP and 22% of employment, excluding associated services, which are altogether more than 35% of GDP and employment – are not the driver of our economy anymore, which has meant a direct strike on economic activity that has amplified the effects of the financial crisis in all productive areas.

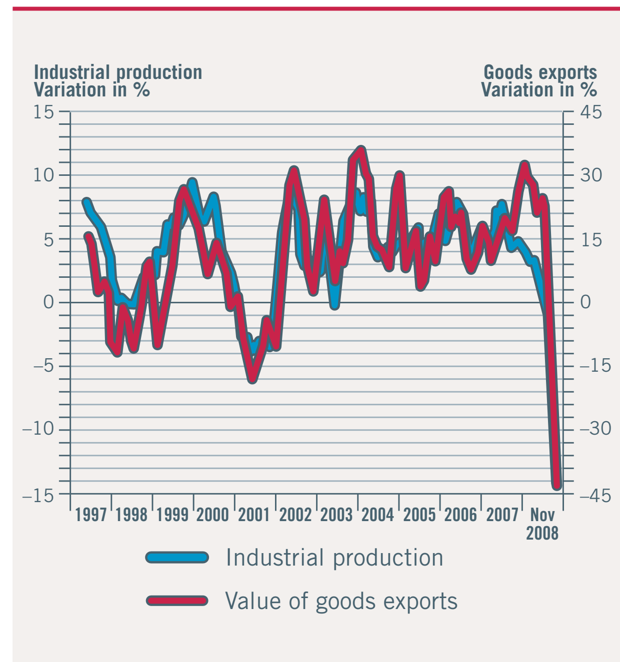
***Graph 1.* GDP growth**



Source: Estimates by IMF technical staff

The GDP growth rate clearly reflects the present crisis.

***Graph 2.* Growth of industrial production and goods trade**



Source: Haver Analytics and estimates by IMF technical staff

The production crisis is severe and requires change in the productive and business system.

The first consequence of this situation has been the reduction of bank loans that has affected companies either directly or indirectly, leading them to reduce their degree of activity, as well as families as sudden increase of unemployment has left many without job and all with fears of losing theirs. This has caused a reduction of domestic consumption that went down between 20 and 50% according to each branch and country.

In the EU, the economic effect is mainly derived from the financial crisis and has spread progressively to different sectors as the lack of working capital is affecting them and demand is shrinking. However, in spite of this, most economic areas are keeping their productivity intact. This is the reason why countries with a more solid and relevant industry in their overall economy such as France and Germany are suffering less from the crisis than others like the United Kingdom and Ireland, where economic activity is rather based on services and real estate.

Spain's current account deficit, i.e. imports minus exports, is the highest of the world as of GDP – 9.5% against 3.8% in the USA and 0.7% in the EU – and the second in absolute terms – against €550 billion in the USA. With a currency we cannot devaluate as it is shared, lack of productivity shown by this deficit can only be balanced if we reconvert our economy and make it more competitive.

The consequence is tough, simple and straightforward: to recover economic activity in the medium term, if we really want to reach the degree of activity we had before the crisis, we need to find new productive sectors and improve productivity in the present ones. The challenge is not easy at all.

Improving productivity means to improve the value of what is produced and reduce its production cost; if salaries are not lowered – whose impact amounts to 10-70% of the production cost – this needs to be done out of technological innovation, i.e. design, performance and quality, which means to reengineer processes by increasing the value or reducing the cost of what is produced. None of both ways, which need to be gone in parallel and simultaneously, is neither easy nor short. Both require policies in support of and to create incentives to such modernisation and improvement, as well as investment that will not yield immediate return.

It can thus be concluded that the US and the EU have a big financial problem, the size of which is still unknown, and that the financial crisis is of lesser extent in Spain and Catalonia, but the productive crisis is severe as it is structural and requires deep change in the productive and business system.

The solution regarding the financial system does not seem to require to purchase toxic assets, although it is being done directly (Paulson Plan under the Bush Administration) or through private investors to whom the government lends money with this purpose (Geithner Plan under the Obama Administration). It does not seem so because the loss this would generate in the public sector, i.e. the final surety of the operation if its final value turns out to be below that paid, can be very high without being sure that the finance sector is eventually cleared nor especially that credit is opened to third parties as opposed to current heavy restriction. What can be stated is that this is more expensive than nationalising banks. Joseph Stiglitz estimates that of the two government funds issues to banks made in the USA, only 70% of the first and 25% of the second actually reached the real economy, i.e. companies and consumers. It makes therefore probably more sense to recapitalise banks in troubles and maybe intervene in them to have them lend money to those needing it and able to justify its payback, only resorting to nationalisation if the level of public aid is above private capital. The reason is that there is no certainty that the private industry is able to handle finance activity better than the public sector under current circumstances and it is fair that part of public efforts to rebuild the financial system is also born by shareholders – the owners – of the organisations having caused the problem.

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Urgent reconstruction of the financial system is done to prevent collapse of the world economy, which cannot survive without a minimum degree of liquidity allowing productive and commercial activity. It therefore makes sense that strong liquidity inputs into the system with public funds provide the guarantee that financial activity will recover swiftly. If this is not the case, due to opacity and uncertainty of real loss, the risk this may mean for banks or for any other reason, it should imply that governmental presence goes down to control of banks, which has to be temporary until normality is back in capital markets, as this is the decisive point in finding the way out of the crisis.

Such accelerated reconstruction of financial systems in the EU and the US, with governments standing surety for banks (there will be no second Lehman Brothers), has led to a capital drain from emerging countries, which will right now create an imported crisis due to the lack of liquidity in their financial systems as a consequence of capital being transferred to the US and the EU. Thus the crisis becomes really global and mechanisms to help also these economies need to be found.

Europe features one weakness the US does not: balance of power between the Union and the states. In Europe there is a Central Bank with no state giving support and one currency is

shared, but not the policies or rules regarding the financial system, which are national. When policies need to be envisaged, which have to be uniform and common, difficulties come up due to differing legislation and independent and sovereign authorities and decision-taking centres.

Hence it will be more difficult to set up measures in Europe to correct the present situation with the same stringency, visibility and speed as in the US. If the financial crisis does not reach its bottom in an immediate future and current problems become worse, this can lead to internal distress in the market and the single currency, with two potential outcomes: either a relapse regarding progress made in the Union – single market and free circulation of persons, goods and services – or most probably reinforcement of a Union built with time and effort that has already produced positive results for member states and citizens in general but is still imperfect and insufficient. It is in times of crisis when certain decision-taking centres still kept at national level can withdraw in favour of the EU if it becomes clear that solutions the European financial system needs can only be found globally and together.

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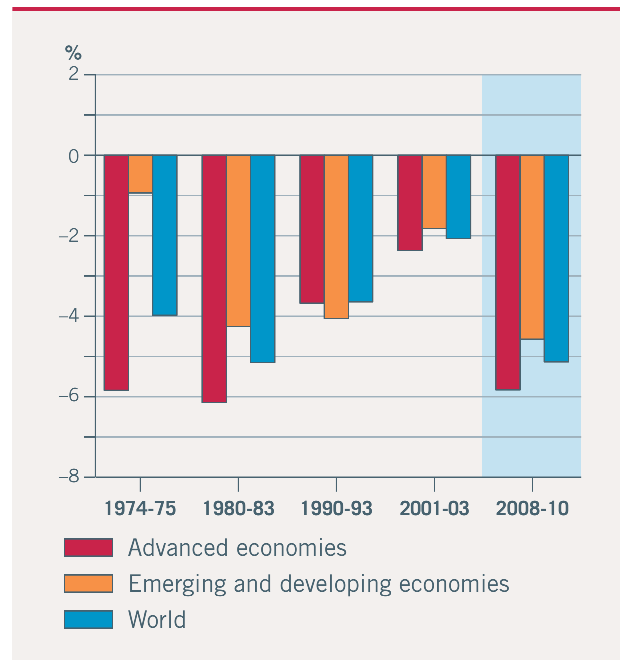
However, it is probably true that solutions to problems affecting all can only be found at global level, as globalisation and world capital flow are today more intense, swift and free than ever. No country has envisaged a return to protectionist policies as economic, commercial and financial interrelations are beyond the point of no return; and if this were the case, such action would probably isolate that country causing great damage on its own economy. If most states of the world fell into a protectionist

Graph 3. **Cumulative loss of production related to potential production during global economic slowdown**



Source: Estimates by IMF technical staff

▲ Deceleration leaves a large portion of potential production capacity unused.

spiral, the crisis could become so much worse that its consequences would be disastrous, albeit difficult to assess.

It is obvious that neither the EU nor the US will ever accept economic and financial policies dictated from across the Atlantic, so action taken needs to be parallel, simultaneous and very similar if it is to keep its efficacy, for there is no perspective by which two such intertwined economies may propose opposite or unaligned solutions that would only render reform ineffective.

The position of the EU and the US is becoming increasingly clear and defined. The US wish a strong injection of governmental funds into the financial system to recover credit capacity as a first priority, while the EU wants first to regulate markets as Europe, under strong influence

of Germany's position, still remembers the disastrous effect of excessive public leveraging with uncontrolled inflation having appalling economic, social and also political consequences in the 1930s.

There is no doubt that the financial scheme created in Bretton Woods in 1944 has become outdated because capital movements were then mainly governmental, planned and foreseeable, while today they are mostly private and subject to a changing and unpredictable market rationale, global wealth is distributed in many different ways and consumption and especially production centres have moved to countries that were virtually non-existent from an economic point of view fifty years ago.

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The present G-20 conferences, though being a progress with respect to the G-7 as their number of participants is larger, are not enough neither in their format nor in their preparation to introduce necessary change into the international financial system as well as for similar reasons for which the London summit in spring 1933 failed. It is unlikely that G-20 summits will ever reach stable and detailed agreements as they are not technically or politically well prepared. It seems obvious that the Bretton Woods format should be recovered, which took over two years of previous preparation and negotiation, as it is still today the most important international agreement ever reached in economic matters.

Also, the US dollar was the exchange and capitalisation currency half a century ago. Today, apart from the increasing relevance of the euro, many countries that used to depend on the dollar as the universal currency have now capital markets that are large enough to avoid distress from having assets in one currency, their own, and liabilities in the exchange currency, which created the inevitable unpredictability in quantifying foreign debt. This is the case of China and India but also Brazil and Southeast Asia.

Reformulating the IMF and the World Bank will require firm and deep political will, and this will create suspicion on behalf of the countries controlling them today.

This new situation and the new magnitude of worldwide economic change require a reformulation of the International Monetary Fund (IMF) and the World Bank, whose size and financial capacity is not enough to satisfy the needs of the world economy if they are to serve as financial market regulators. Who shall be able today to control financial surplus and deficit if we are to avoid another crisis like the one we are suffering? It seems that a newly established and recapitalised IMF should take on this mission especially through the special giro rights as proposed, that is, the creation of funds at international level economically solid countries could yield to the weakest under IMF inspection and control.

George Soros says that $250 billion a year could be generated through this mechanisms as long as the crisis lasts. This liquidity controlled by the IMF, administered taking moderate interests, would certainly help many countries that are now reaching the limit of their own leveraging capacity in the markets. But it is also necessary to change the current country balance in the IMF, allow emerging countries in such as China, India, Brazil and Russia, that the big markets are kept in their own currency and that these may fluctuate against reference currencies. All in all, it is about allowing that, just as the 1907 crisis was solved by a private bank, JP Morgan, and the 1933 one by a country, the United States, in future it is a global economic body that regulates the financial system to set

the general rules for its functioning, so when the next crisis arrives, which will be inevitable, there are enough funds to find the way back to balance.

It is obvious that reformulating the IMF and the World Bank will require firm and deep political will, and this will create suspicion on behalf of the countries controlling them today. But the severity of the current crisis and its global dimension pose a challenge only such a solution can solve. It is true that problems have been created by lack of national financial legislation that is rigorous enough in its formulation and implementation, but once we have got here and to avoid what could become the potential big crisis of the next twenty-five years, it needs to be accepted that it will not be feasible to prevent it if such regulation is followed by the EU and the US only. China, India and the rest of emerging economic powers need to take part in it as they will become the main economic powers of the world within this period of time.

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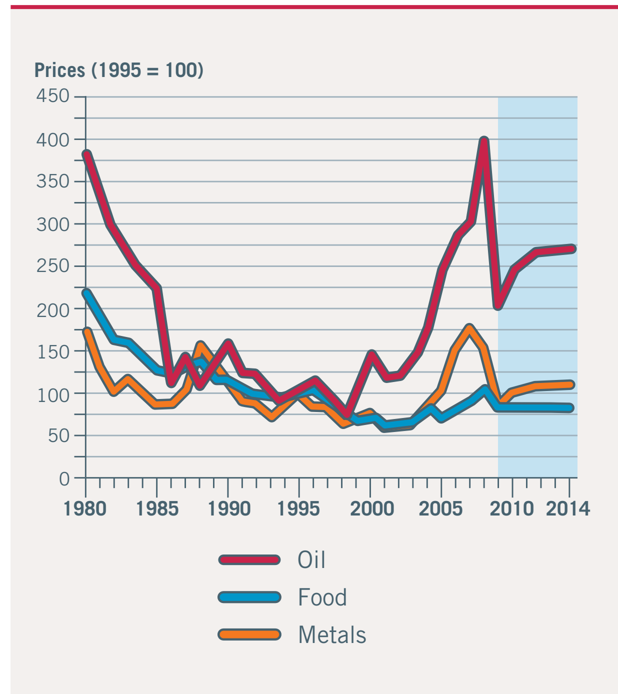
Once the risk of collapse of our financial system will have been prevented, which still has a long way to go, it will be necessary to decide what policies need to be deployed to help industries in crisis and citizens increase consumption again.

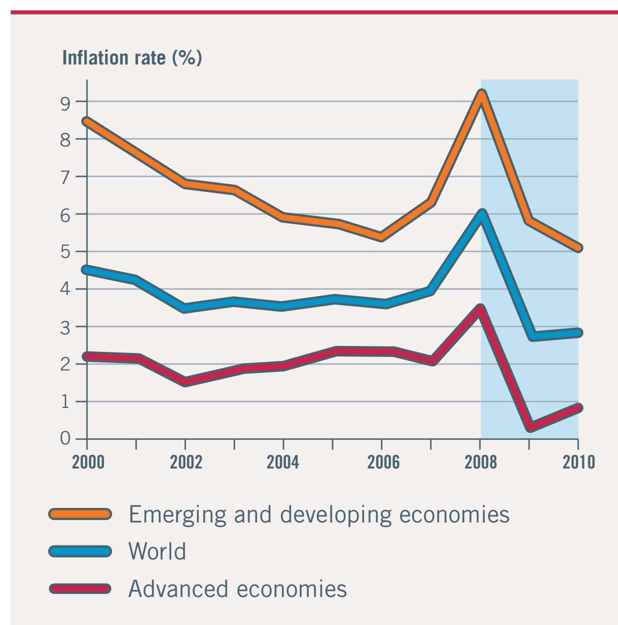
The liberal view of the problem is that there must be no aid for industries, e.g. the car industry, as it is up to the market to decide what companies will survive the crisis. There is a current of opinion in the United States led by the Republican Party that challenges the economic need of rescuing for instance General Motors if its past policy has led the company to lack of competitiveness compared to its competitors and thus to bankruptcy.

Graph 4. Real raw material prices



Source: Estimates by IMF technical staff

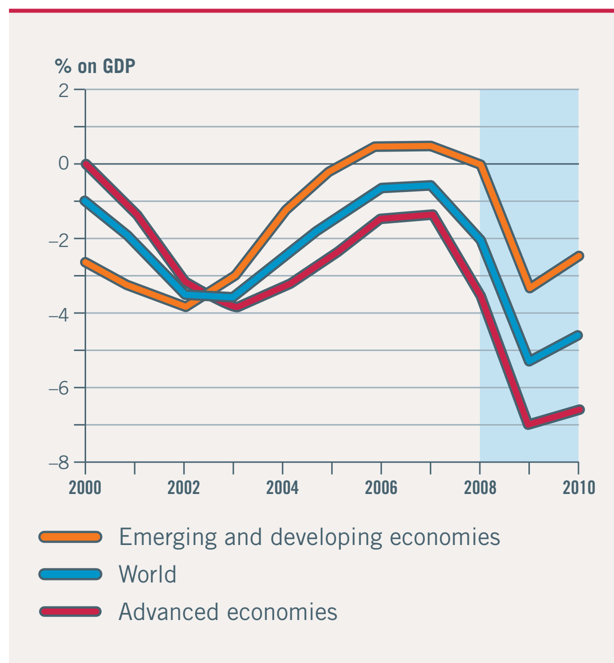
Graph 5. Inflation



Source: Estimates by IMF technical staff

▲ The increase of energy and other raw material prices caused a rise of the inflation rate.

Graph 6. Tax balance of national governments



Source: Estimates by IMF technical staff

▲ To find the way out of the crisis, governments have implemented expenditure programmes increasing their tax deficit.

This view advocated by opinion leaders such as *The Economist* has two shortcomings. First, it does not consider the social consequences such a decision implies, that is, the loss of thousands of jobs and thus sudden unemployment among a number of workers who cannot be hired in other industries, which will have severe social consequences. Nor does it consider the destruction of industrial value based on intangible assets of companies that are much higher than the value of their assets and that will gone lost if the company disappears.

Industrial aid policy can therefore not simply start from financing loss but it has to address transformation and modification of a company's products and processes.

Governments have already implemented programmes aimed at meeting these goals. If they are well done, they can lead to economic transformation of mature business areas in the EU and the USA.

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In Catalonia, these long-term industrial transformation policies were started with the National Pact for Research and Innovation, signed by all political and social stakeholders, as well as the Industrial Policy Act, currently submitted to Parliament. But these initiatives will largely lose their power if there is no simultaneous change in university funding and governance by means of amendments to the specific regional law (LUC) as it is a fact that more than 50% of research in this country is being done now at universities, so the efficacy and efficiency of an old-fashioned, excessively endogamous and corporative institution needs to be radically improved regarding research and development to better serve the economic needs of business as well as regarding teaching to better serve society.

The budgetary capacities of the Government of Catalonia have allowed to do few short-term direct policies to mitigate the effects of the decline in economic activity and its most direct and negative consequence: unemployment. However, the Spanish government has not implemented policies that are visible, encompassing and deep enough to halt and counteract this situation, but it is true that the same occurs in most EU countries.

The question posed in the beginning has an answer that seems obvious and unchallengeable, both at global and at Catalan and Spanish level: the present change of cycle is so deep that it takes us inevitably to a change of model, but this means time as it requires to set out and agree solutions not only at branch or national but

also at global level, and this requires negotiation and consensus to reach a balance valid for all stakeholders.

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It may be necessary to remind that the crisis triggered in 1929 was tackled in an ample and inclusive way only in spring 1933. Therefore, despite present economic phenomena being faster due to the effect of globalisation and the pace and inclusiveness of communication, it is unlikely that measures to regulate and recapitalise markets and economic areas to be set out, agreed and implemented have an effect before we are well into 2010, which would raise a scenario of hardship and economic crisis for the next two years. There is a lot to do, but it is true that solutions come in every case through consensus and negotiation. The alternative, as occurred in the 1930s, is a worldwide catastrophe.

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