

## How to find exit

### Why and how the global monetary and financial system is to be reformed

*On 23-24 May, the Kazakhstan capital hosted the 5<sup>th</sup> Astana International Economic Forum. The Forum was attended by about 7 thousand experts from many world countries. Other forum participants included incumbent and former heads of governments and international organizations, Nobel Prize winners in economics, and renowned researchers. On the eve of the Forum, the Eurasian Economic Club of Scientists ran a contest of best proposals for the forthcoming G20 forum to be held in Mexico. The contest was won by team of renowned researchers from Russia and Kazakhstan. Below are extracts from their report.*

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Recently leaders of the twenty major economies of the world met in Mexico. A child of the global crisis, G20, as a platform for working out coordinated crisis management policies, is designed to find a solution for redesigning the global financial and economic system. So far, the most renowned managers admit that none of the causes of the global crisis has been removed. Free emission of global reserve currencies leading to abuse by their issuers of their monopolistic position in their own interests at the expense of growing imbalances and destructive trends in the global financial and economic system. Existing mechanisms regulating operations of banking and financial institutions are unable to provide protection

against excessive risks and prevent financial bubbles. The reaching of its growth limits by the prevailing technological order and insufficient conditions for the rise of a new order, including the lack of investment for broader implementation of underlying technologies are also an important factor to be reckoned with.

The way results and factors of economic operations are currently exchanged between developed and developing economies is quite fairly perceived as unequal. While hugely benefiting from emission of global currencies, (e.g. ECB created more money within two LTRO\* rounds over 3 months than, say, Russia got from oil exports over 10 years), major Western economies still restrict access to their own asset, technology and labour markets by introducing yet new and new limitations.

Pursuing the status quo policy will doom the global economic system to a disaster. An avalanche-like growth of the money overhang is not adequate to the demand for money in the real sector. Still, the latter lacks money to switch to a new technological order, while long-term investment benchmarks disappear on the back of economic turmoil.

Large-scale investment in the development of facilities and infrastructure of the new technological order might re-establish the equilibrium. But the current resultant of prevailing economic interests is vectored in the opposite direction, i.e. building up short-term debt liabilities of speculative nature. The global financial system approaches a no return point where there will be no simple and good solutions (or even complex but rather good), but only super-complex and more or less bad ones. There are several such examples in the modern history when a way out to a new long wave of economic recovery was spontaneously found at the cost of enormous losses of human, productive and financial resources.

During former crises similar to the current one, the recovery from a depressive economy was accompanied by a surge in military expenses, with a significant part of them invested in the development of capacities of a new technological order. The concurrent escalation of military and political conflicts between the leading countries and those falling behind resulted, after the crisis of the 1930s, in the disaster of World War II, and, after the crisis of the 1970-80s, in the escalation of the arms race in the Space that undermined the economic potential of the U.S.S.R. In fact, a surge in government expenses acts as a trigger for structural rebuilding of the economy based on a new technological order resulting in a transition to a new long wave of economic growth. In the context of turbulence inherent in such times, the private sector is unwilling to make long-term investments in the development

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\* LTRO (Long Term Refinancing Operation) – anti-crisis measures of long term refinancing of commercial banks by central bank, which enable banks to receive long term funding (with their assets as collateral) at low interest rate.

of radical and quite risky technologies. Governments have to assume a significant portion of costs required for the transition to a new technological order, particularly those associated with exploration research, investment in infrastructure, and talent management. In assuming a substantial part of risks related to the implementation of state-of-the-art technologies, governments are not quite free in the choice of the formats of their involvement. In many respects, the choice is contingent on the existing practices and the structure of government institutions that has inherited the priority of military expenses from the Cold War era. This priority has not been offset by other public needs during the radical liberalization of economic regulation systems.

The current global economic crisis is also accompanied by worsening military and political tensions that burst out as ‘colour revolutions’ on the periphery of rival nations. Major nations usually encourage the transition to a new technological order by militarizing, and this brings on serious threats to the world. These threats get stronger as key reserve currency nations are trying to restrain other countries from attempts to change the existing system of international currency and financial relations that helps the former to finance their payment balance and national budget deficits at the expense of the latter, as well as dominate the global capital markets.

Should this inequality of the international currency and financial exchange persist, the countries of major global currencies will recover from the recession by laying their hands on resources and assets of other countries. To defend their independence, the strongest emerging countries will be compelled to protect their economies from raids by speculative capital fuelled by unrestrained emission of global currencies. This, in its turn, will aggravate the misbalance between the avalanche-like growing injection of global currencies and the limited demand for such currencies, which will increase the likelihood of a collapse of financial debt pyramids built by major economies and an uncontrollable breakdown of the existing global currency and financial system. Thus, the risk that key capital reproduction mechanisms of major world countries will collapse is increasing. Such a collapse will put the global economy on a verge of a systemic crisis, hinder the growth of the new technological order and result in a multiyear profound recession with disastrous consequences for many countries.

At the G20 meeting where the U.S. and some other major global currency issuers will try to talk their partners out of recurring to protectionist measures and preventing the financial system, created by them and gone astray. In G20 Document “The Global Plan for Recovery and Reform” (of April 2, 2009) it is said directly that financial protectionism is inadmissible, especially measures, which restrain world flow of capital particularly to development countries.

It would be appropriate to remind that the system itself is rather young. Mere 40 years have passed since the collapse of the Bretton Woods monetary system

following the actual default by the U.S. on its commitments to ensure free exchange of dollars for gold. Next year, the Fed itself, the source of the U.S. dollar, will celebrate its 100<sup>th</sup> anniversary. The modern ambitious historic experiment of making money out of nothing has proven to be way more successful than its version dating three centuries back (the project of John Law lived for 4 years). Today's central banks are much more cunning, so the 'trust in the system' stays much longer. But there are no guarantees that the giant debt pyramids they have built to support the existing global financial system would remain stable.

The whole world asks these questions:

- Is there a 'point of no return' past which 'every man's for himself' when the Fed will be unable to maintain the stability of the global money circulation;
- Does the currency system, in which the injection of trading and reserve currencies is unrelated to investment under development programmes and is only driven by public and private debt refinancing requirements, actually ensure sustainable economic growth in the longer run;
- Can household, business and government solvency issues be at all solved by simply 'pumping up liquidity';
- Does the global system of unlimited access to liquidity by some parties (mainly, by the banks of hard currency countries) and 'FX control' (link to the import/export of hard currency) for all the others offer fair exchange of products and factors of economic operations.

The answers to all these questions are all negative. Pre-emptive set-up of architecture and mechanisms of new world financial system, as it is seen by us, is as follows.

## **The shape of new monetary and financial system**

**Stabilization measures at the global market level are needed first of all.**

At the micro level, we need to change the corporate governance paradigm by reorienting managers towards profit maximization in the longer run, rather than fuelling speculative corporate stock price growth. In particular, we need to adopt regulations restricting the amount of fixed fees and distributions (earnings or dividend) on managed assets that the managers are allowed to distribute to themselves. Moreover, the bulk of such distributions needs to be linked to future income over long term. Besides, managers must be financially liable for losses caused by their errors in risk assessment, and by their abuse of trust and breach of law.

At all levels, we need to prohibit or delimitate the combination of positions that generate irresolvable conflicts of interests. This applies not only to operations by business entities, but also to issuers of global trading and reserve currencies who can carry the risks of their national currencies over to the international level. We

should establish a set of requirements to the issuers of hard currencies and introduce hard currency categories depending on the compliance by their issuers with such requirements. We also need to develop a global system of regulation standards with respect to financial, including foreign exchange, markets to monitor systemic risks.

We need to link the right to issue global trading and reserve currencies to the compliance by their issuer with its commitment to keep open its market of goods, services, workforce and capital, and maintain the free flow of technologies and capital. In such case, long-term mutual interest between the issuers of global currencies and suppliers of global resources (raw materials, cheap labour, etc.) will form a fair long-term framework for global sustainable growth.

To make issuers of reserve currencies more responsible, other currency issuers from G20 need to be given the right to carry out currency swaps with the former. As a result, the issuers of other currencies will get access to the 'cheap liquidity' they need. At the same time, this will balance capital costs and remove the adverse consequences of credit dumping by the issuers who have been maintaining negative real interest rates for a long time.

Subject to the global significance of the Internet, payment systems, payment clearing systems and other communication systems that support the global balance, we need to exclude their administration from national competence and adopt (as is the case in other vital global areas such as climate, shipping, etc.) international treaties and rules to rule out discriminatory access to such global infrastructures.

To minimize systemic distortions in the assessment of risks associated with market-traded assets in favour of any country, we need to work out international rating standards and standards governing the business of rating agencies, and to ensure unified international regulation of rating agencies. Once the IMF undergoes a reform that is necessary to ensure fair representation, the Fund may be assigned the task of certification and licensing of rating agencies whose ratings need to be recognized at the international level. The above also applies to the top 4 auditors.

### **Global reforms should be coupled with measures of national regulation.**

We need to develop crisis management facilities that are capable of offsetting the impact by external shocks in the context of a liberalized economy. We could take measures to limit speculative pressure on the market (short operations, leverage, etc.), as well as introduce buy-backs mechanisms and special institutions and special funds to be used for stabilization in the event of a crisis.

We need to enhance the role of refinancing facilities that can offer both - quick as well as systemic liquidity, and to expand internal national money supply sources.

Develop and introduce a flexible anti-cyclical system of national financial regulation ratios, including *size restrictions to leverage*: the ratio of total liabilities

of market players to their equity. Today only the banking sector is regulated by the government, while non-banking financial and investment institutions and other business entities may have any leverage that sometimes are hundredfold. We need to set universal rules for financing reporting (based on IFRS and Basel III) and audit for all market players, rather than only for banks. To this end, we need to adopt respective recommendations by G20 for national regulators.

National monetary authorities should be granted the right to defend their currency and financial systems from speculative attacks and to suppress related turbulence by triggering safety guards ('decelerators') with respect to financial operations and capital flows. In particular, such 'decelerators' might include: a) an institution of provisioning for FX capital flow; b) a tax on income from sale of assets by non-residents, with its rate depending on the asset possession time; c) Tobin tax (on foreign exchange operations). The rates (ratios) for all the three tools may be provisionally reduced to their minimums in favourable situations, and raised if financial turbulence to slow down capital inflow (or outflow).

**In our opinion complementary regulatory measures for the Russian market are needed.**

Refinancing rates and mechanisms must play a real and continuous role to make the Russian financial market more robust. Refinancing needs to be both short- and long-term. In the crisis aftermath, all developed nations expand the long-term resources for their economies (the operation twist programme by the U.S. Fed that provides for longer treasury papers in the Fed's portfolio; LTRO by the ECB providing for 3-year fixed-rate refinancing based on a long list of pledgeable assets; the refinancing programme by the Bank of Japan providing for acquisition of assets that include not only treasury papers, but also private instruments (corporate bonds, etc.) at minimum rates).

To turn the policy rate into a real functional tool that determines the pricing in the financial market, the money base needs to be formed not from FX proceeds only (as is the case today), but also from the 'domestic' component to a larger extent. This implies creation of money supply based on internal mechanisms and tools that reflect the domestic demand for money by both - the public and private sectors – which are used as collateral.

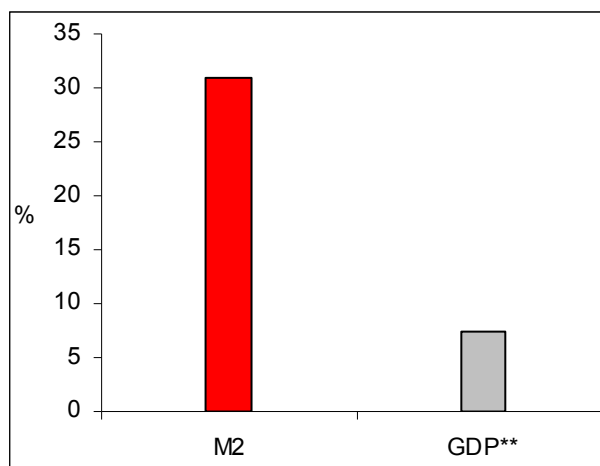
Capital flows need to be thoroughly monitored, not only outflows, but also, which is as important, inflows. But there is no place here for formal principles such as 'any investment is good' and 'the more the better'. In a modern context, especially on the back of excessive global liquidity that seeks for niches to be invested, we need to pay attention to capital quality, terms, nature and purposes for which it is used, while aligning these parameters with economic priorities. It is also important that the terms of repatriation should minimize the destabilizing impact by a quick capital outflow.

A recovery from the crisis into a new wave of sustainable economic growth can be achieved if we take at a time measures to stabilize the financial situation, enhance regulation of the financial market, banking, financial and investment institutions, encourage the development of the new technological order and advanced structural changes.

## **Money overhang is out of line with the real economic growth**

### **Growth of money supply (M2) and GDP in major economies\***

**in 2007-2010 (December on December, %)**



\* Euro zone, US, UK, Japan, China, Russia

\*\* Nominal GDP growth

Source: based on data by Eurostat, US Fed, BEA, Bank of England, Bank of Japan,

National Bureau of Statistics of China, Bank of Russia, and Russian Federal State Statistics Service.