Published in journal "Dengi I Credit", #7, 2012

(the journal is founded by the Bank of Russia)

GLOBAL CURRENCY AND FINANCIAL SYSTEM

On 18 and 19 June 2012, Mexican Los Cabos hosted a summit of G20. The summit participants signed a final communiqué emphasizing the need to support global economic growth, adjust budget consolidation programmes and address fiscal deficits.

In the run-up to V Astana Economic Forum (22 to 24 May 2012): *Global Economic Transformation: Challenges and Outlooks of Development*, 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 a team of renowned researchers from Russia and Kazakhstan. Below are the extracts from their report containing proposals for G20.

Reforming the Global Currency and Financial System and Bolstering Economic Growth

Sergey Glazyev*, Member of the Russian Academy of Sciences, Deputy Secretary General of EAEC, Moscow*
Saylau Bayzakov*, Doctor of Economic Sciences, professor, the scientific head of the Institute of Economic Research of the Ministry for Economic Development and Trade of the Republic of Kazakhstan, Astana*
Mikhail Ershov*, Doctor of Economic Sciences, Senior Vice President of Rosbank, Moscow*
Dmitry Mityayev*, Candidate of Economic Sciences, President of OOO Centre for Systemic Forecasting, Moscow*
Gleb Fetisov*, Correspondent Member of the Russian Academy of Sciences, Chairman of the Council for the Study of Productive Forces (CSPF) of the Russian Ministry of Economic Development and Russian Academy of Sciences, Moscow*

PROPOSALS FOR G20

1. Economic stabilization and structural reforms as the basis for economic growth and employment

The authors of this report believe that stabilization in its narrow sense (i.e. purely financial) and currently proposed, often technical, reforms of the financial system are unable to secure long-term stability and consistency of global economic growth: we need to consider an entire range of interrelated changes to the world order at the micro-, macro- and global levels. Driven by this concept, we suggest the following measures to be taken:

1.1. To ensure economic stabilization, we need to change the corporate governance paradigm at the micro level 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.

1.2. To ensure macroeconomic stabilization, we need to prohibit or delimitate the combination of positions that generate irresolvable conflicts of interests at all levels. 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 that the global community (in particular G20) may impose driven by the global development and cooperation interests. In addition, it would be good to introduce hard currency categories depending on the compliance by their issuers with such requirements.

Macroeconomic stabilization also requires a global system of regulation standards with respect to financial (including foreign exchange) markets to monitor systemic risks (see Section 2 of the Proposals, paragraphs 2.1 to 2.4).

1.3. The way results and factors of economic operations are currently exchanged between developed and developing economies is unequal and unfair: 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 further limitations. We need to link (in the framework of G20 or the UN) the right to issue global trading and reserve currencies to the compliance by their issuer with its commitment to keep open its commodity, services, labour and capital markets, and maintain the free flow of technologies. In such case, long-term mutual interest between the ‘producers’ (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.

1.4. We should run the long overdue reforms of the WTO, IMF, ILO, and other international organizations to establish uniform rules of the game in global commodity, labour, capital, resource and technology markets, while preventing monopolization of both the markets themselves and the procedures for working out and establishing the rules of the game at such markets (quality standards; exchange, insurance and audit standards; regulation rules for intellectual property turnover, etc.).

1.5. Subject to the global significance of the Internet and other communication systems, 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 regulations to rule out discriminatory access to such global infrastructures. The role of G20 as a correct format (i.e. a round table for all major global players) is indispensable in this respect for working out common rules and reforms.

2. Strengthening the financial system and developing financial integration to buttress economic growth

The role of the global financial system in driving economic growth (as well as recessions) can hardly be overestimated. The experience of the 2008 crisis shows that problems faced by major individual banks can immediately transform into global problems. Therefore, major global clubs (G8 and G20 in the first place) urged a reform of that leading (and actually controlling) element of the global order at all their meetings.

However, while during the first two post-crisis years even some G8 leaders stood for the reform, in the recent 18 months 'the wind returned on its circuits', with global policymakers self-calmed, as central banks issuing hard currencies have actually taken over the main responsibility for stabilizing the global currency and financial system. But to preserve its foundations, they have opted for the easiest solution to the insolvency problem (accumulated government and private debt): by pumping liquidity into the market.

We must admit that the global financial system has stabilized over the last three years primarily as a result of accelerated injection of major global currencies, i.e. US dollar, Japanese yen and (especially this year) Euro, rather than as a result of recovery. Thus, since 2008, the U.S. Fed balance sheet (QE1, QE2, Operation Twist), has almost tripled, that of the ECB (LTRO 1 and 2) grew more than twice and a half, while the balance sheet of the Bank of Japan has almost doubled over the two last years alone.

Almost all this unprecedented liquidity settles down in the reserves of the banking system that are kept on accounts with the same central banks; the credit multiple stays close to zero or is even negative (with each new dollar of debt generating less and less GDP growth), while employment levels remain actually flat. In fact, the large-scale forced liquidity injection covers the exponential growth and the increasing monetization of G7 public debt by camouflaging their inability to handle structural issues (including the long needed technological upgrade of the economy).

But this policy comes at a price. Since 2/3 of US dollars injected in the economy circulate outside the US to support global trading and speculative turnover, over the last 10 years the real exchange rate of the US dollar acting as the principal global and reserve currency has been declining and offering its holders an ever decreasing purchasing power. This way inflation is exported to the rest of the world (primarily to Asian growth economies and BRICS countries) translated into a multifold growth of prices for hydrocarbons, commodities and food, with remaining and growing global disproportions in balances of payments and trade.

As a consequence of the policy of permanently postponing the reforms of the global financial system and its endless ‘renewal’ under obsolete rules, the system-wide risk begins to build up. This risk can be primarily measured by assessing the ratio of off-balance liabilities owed by major, mainly US, banks to the size of their balance sheets, which has grown from pre-crisis 30x to 50x.

Thus, the strategic instability (latent system-wide risks) of the global financial system has yet been only growing; the operation of a number of leading public finance systems (US, Japan, PIIGS countries in Europe) is mostly driven by money creation (e.g. in Japan, each yen of tax proceeds accounts for almost two yens issued to cover debt growth; in the US, each dollar of tax income accounts for another dollar issued to meet treasury liabilities; some European countries

almost fully depend on the inflow of liquidity from the ECB and external lenders). In fact, issuers of global reserve currencies have switched to a bubble-type principle of public debt growth, which dooms the entire global financial system and national systems of public finance, social, health and pension security of developed countries to self-destruction in the near future.

The actual strengthening of the global currency and financial system implies a number of systemic reforms outlined at a number of international forums, including G20. But no consensus on these (sometimes quite painful) changes has been reached so far, with the election cycle in major Western countries pushing politicians to recur to short-term measures and 'passing the buck' to their central banks and the IMF. To prevent the disastrous self-destruction of the global financial system, we suggest the following measures to achieve real reinforcement of the global financial system and switch to a fair global economic order as a platform for sustainable global growth.

2.1. We should develop crisis management mechanisms able to offset the impact by external shocks in the context of a liberalized economy. These measures should to a greater extent apply to the stock market and banking industry as the quickest to respond to a crisis, and the overall economy. We could take measures to limit speculative pressure on the market (short operations, leverage, etc.), as well as introduce buy-back mechanisms and special institutions and funds to be used for stabilization in the event of a crisis.

2.2. We need to reinforce the banking sector as the backbone of the national financial system and bolster its capitalization growth. It is important to enhance the role of refinancing facilities that can offer both quick and systemic liquidity, and to expand national money supply sources. It would be reasonable to simplify access to refinancing resources for players of the financial market so as to support its stability.

2.3. Develop and introduce a flexible anti-cyclical system of global and national financial regulation ratios. When markets are overheated and financial bubbles start to appear, the ratios will be tightened to facilitate smooth deflation of such bubbles. We need stricter ratios to regulate the amount of corporate external borrowings. At the same time, we should set up internal market conditions and mechanisms to generate sufficient financial resources within a country.

On the contrary, the ratios should be milder during crises. For instance, in the context of a lending boom, the collateral coverage of a loan should be raised to 2x or 3x to constrain debt multiplication.

The key innovation in building a new financial architecture consists in the restriction of the leverage size. In fact, the ratio of all liabilities of economic agents to their equity is an indicator of the debt multiplier at the macro level. Leverage mainly grows as a result of the creation of the two-sectoral financial and economic system where only the banking sector is regulated by the government, while the non-banking sector is actually uncontrolled. Non-banking financial and investment institutions and other business entities may have a leverage reaching several hundred (the problem of a 'shadow financial system').

This results in tremendous debt multiplication. The leverage of banks is restricted by prudential regulation ratios and is significantly lower than that of investment banks, hedge funds, investment companies and real sector businesses.

As such, we need to set universal rules for financing reporting (based on IFRS and Basel III) and audit for all market players, rather than for banks alone. To this end, we need to adopt respective recommendations by G20 for national regulators.

2.4. Refinancing rates and mechanisms need to start playing a real and permanent role to give central banks tangible influence not only in the debt and financial markets, but also in the entire economy (as is the case in major economies). 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 asset swap 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).

2.5. 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 from the 'domestic' component. This implies that money supply should be primarily based on internal mechanisms and tools that reflect the domestic demand for money. We need to emphasize not only the use of budget tools (while gradually reducing their role), but also a

parallel increase in the use of private sector instruments as collateral, as widely practiced by major central banks in recent years.

2.6. 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.

2.7. We need a sharp cut-down of speculative currency risks. This lies in the interests of both G20 countries, and individual business entities. Similarly to banks, all business entities must be compelled to maintain an open FX position limited by a percentage of their equity.

To make issuers of reserve currencies more responsible, other G20 countries need to be given the right to carry out currency swaps with the central banks of G7 to raise the 'quality' of other currencies (including regional) closer to the major currencies. As a result, G20 countries will get access to the 'cheap liquidity' they need. At the same time, this will balance capital costs (by actually removing the adverse consequences of 'capital dumping' by countries who can afford maintaining negative real interest rates for a long time).

2.8. We need a targeted systemic policy to generate and manage money resources in the economy in a post-crisis context. Such policy should rely on a broad range of mechanisms and instruments capable of dampening external shocks and generate financial resources in line with the objectives of post-crisis recovery and economic growth resumption to efficiently funnel capital where it is needed. It is also important to have in place mechanisms and efficient tools to establish and regulate a price of financial resources that would reflect the actual demand for liquidity by the economy and market players.

Such policy should mainly rely on internal sources and mechanisms of resource generation, which is of particular importance on the back of global instability. External funding sources should be gradually replaced with internal ones.

2.9. Capital flows need to be thoroughly monitored, not only outflows, but also 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.

2.10. National monetary authorities should be advised to put in place a system of safety valves ('decelerators') for financial operations and capital flows to protect their currency and financial systems from speculative attacks and to suppress related turbulence, where necessary. 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 gets stronger to slow down capital inflow (or outflow).

2.11. We would need to encourage a transition to international settlements in trading and investment operations in SDR (Special Drawing Rights) to reduce the dependence of the global currency and financial system on the issuers of global reserve currencies. According to the definition of SDR, the exchange rate of a national currency to SDR is set as an average rate with respect to a basket composed of four hard currencies (US dollar, euro, British pound sterling, and Japanese yen). In the modern context, for SDR to be used a supranational currency, the range of currencies in the currency basket used to assess the SDR exchange rate must be expanded. G20 currencies should be included in the basket at the first stage. The transition from the current global quasi-currency (the former SDR) as a relatively narrow and non-representative 'SDR basket' to a wider 'G20 basket' (new SDR) determining the course of global development assumes a comprehensive reform of the IMF on the basis of a number of principles listed below.

3. Improvements to the international financial architecture in the context of globalization

We are proposing the following measures to improve the international financial architecture based on the above.

3.1. Subject to the objectives of improving growth quality, maintaining its rates and diversifying the market, we need to consider expansion of functions of G20 central banks (as in a number of major economies where they are charged with economic growth and employment support apart from the currency exchange rate and prices). As a result, countries will be able to apply domestically advanced mechanisms of refinancing growth needs of their national economies by using the whole range of the financial and economic management theory and practice rather than

obsolete ‘currency control’ models for inflation targeting. It should be remembered that the real background inflation level is higher in developing economies in structural transformation than in post-industrial countries and stands at 5-7% (if we exclude inflation export due to the super-mild monetary policy conducted by G7 countries).

In general, in building long-term approaches to the development of their national economic policies, G20 countries should target stronger purchasing power of money and higher real value of their national welfare rather than follow the performance of prices for goods and services.

3.2. The financial sphere should be viewed by monetary authorities as a single regulation target. Activities of national central banks need to be closely coordinated with other financial market regulators (ministries of finance, stock market commissions, etc.). If global financial risks are counteracted by uncoordinated efforts of regulators in discrete market segments, they are unlikely to be successful.

3.3. We need to continue setting up an economic and legal environment for the creation of international financial centres in a number of major cities (Moscow, Astana, etc.) to build new global economic pillars and secure currency and financial stability.

A ‘polycentric’ architecture of the global financial system will take excessive burden off the current two or three global capital turnover hubs and help set up a more competitive environment of infrastructure market entities (exchanges, clearing houses, audit and rating agencies, and so on). We would also need to create universal infrastructure organizations of the EAEC: a development bank, a rating agency, an audit chamber, an insurance union, etc.

Joined efforts of several centres will make the entire global architecture more robust.

3.4. ‘Shadow capital markets’ (offshore zones, OTC derivatives, etc.) need more transparency. To this end, we suggest expanding the membership and powers of the Financial Stability Forum, and communities of financial intelligence units and other financial market regulators.

3.5. The new global architecture should be founded on a fair framework (a strategic agreement) within G20: ‘weights’ in the IMF, in the global financial system as a whole and in the future global currency (SDR as a G20 basket) must be distributed on the basis of several criteria:

● the country's share in global GDP in terms of purchasing power parity (PPP) taken as an average value for a certain number of years;

● the country' share in global trade;

● the country's territory share (as an integral indicator of the natural, resource and climate weight or potential) in the global territory;

● the country's population share in the global population;

● the country's share in the existing global currency and financial system measured based on the parameters of the country's reserves and on the use of its currency in international settlements and reserves.

At the time being, the IMF partially takes into account only the last criterion in the SDR basket. This fact prevents from addressing the unfair and inefficient nature of the global financial system.

The identification of specific parameters and algorithms for integration of the above criteria in the universal G20 basket is an important theoretic and practical challenge that can be addressed by developing a relevant Roadmap.