The Global Economy at the Crossroads of a Structural Crisis

Excerpt

International economic coordination – new frontiers

The year 2011 has already become a milestone in world economic history. The debt crisis in developed countries revealing the limitations of those countries' regulators, increased volatility on financial and energy markets, widespread slowing of business activity, less than desirable stability in the banking sector and the snowballing of social problems in the developing regions of pax economica – all of this points to the fact that *the institutional resources of the global economic system are approaching exhaustion*. The limitations of the effectiveness of regulatory institutions have been fully revealed both on the national level and on the international level (particularly in Europe).

The global economy, stalled at the same heights reached during the pre-crisis years, is in a state of structural crisis. During the second half of the past year this became quite clear. This is not a trivial situation, but it is also not without historical precedent. The most recent analogy is the Great Depression of the 1920s and 1930s, which in essence concluded with the emergence of a qualitatively new world economic system with the Bretton Woods agreement in 1944; and then following the collapse of the gold standard the correction of the international monetary system with the Jamaica amendments in the early 1980s and the parallel creation in the 1970s of OPEC, IEA and other international organizations and the expansion of the role of the IMF, World Bank and so on.

A common trait of all structural crises and the process of overcoming them is the transition of the global economy to a qualitatively new level in which the specific weight and 'seniority' of the main players and the 'delegation of labor' among them changes, new markets appear and along with them new sources of revenues. One of the substantial aspects of this process is the growing demand for international coordination of economic policy and, consequently, the emergence of

such institutions (for example, the G20) focused on the fundamentals of the global economy.

Strictly speaking, this is exactly what we have been seeing the past three years. The transition of the global economy to a new structure has not only begun (one of the signs of this is the specificity of coordinating decisions) but has also fully accelerated, passing, it seems, the point of no return. It is difficult to say how much time it will take to complete this process.

According to many foreign and Russian experts, the first phase will take no less than five to seven years. At the same time, one of the parameters of the intensity of movement toward 'new frontiers' is the implementation of the G20's agenda and changes in the balance of interests contained in its decisions. In this regard, the G20 meeting in Cannes on November 3-4 is quite noteworthy.

Of course, the results of the Cannes discussions were overshadowed by the most recent act in the 'Greek drama'. But it is already clear today that the subsequent events (the end of the push to hold a referendum on Greece's participation in the Eurozone, cabinet resignations and swearing in of new ministers) in Ellada and Italy, and finally the decisions coming out of the December 8-9 EU summit would not like have been possible without the 'spirit of Cannes'. This is confirmed by a number of other specific commitments taken on by European countries in the Cannes action plan, which in contrast to the Supporting Document coming out of the previous year's summit in Seoul is a public document.

With regard to Italy, it directly states that the country commits to achieve a close to balanced budget by 2013 and to rapidly decrease its debt-to-GDP ratio starting in 2012. In order to achieve this a 60 billion euro fiscal package will be approved, a balanced budget rule will be introduced to the constitution and Italy will implement, 'fully and swiftly', a comprehensive plan of growth enhancing structural reforms.

France has committed to decreasing its budget deficit to 3% in 2013 through tighter limits on central government and health insurance expenditure, better

targeted social transfers and lower tax expenditures. The necessary fiscal rules will be introduced into the Constitution.

The strict framework of the Cannes plan also affects G20 members Spain and Germany.

The Cannes action plan determines specific zones of responsibility for each of the g20 members (naturally, in accordance to their real weight in the global economy). Thus, the US ‘commits to the timely implementation of a package of near-term measures to sustain the recovery, through public investments, tax reforms, and targeted jobs measures, consistent with a credible plan for medium-term fiscal consolidation,’ which should deficit reduction of $4 trillion over 10 years. China will ‘rebalance demand towards domestic consumption’ via a strengthening of social safety nets, boosting of household income and transformation of the economic growth pattern. Such actions should be ‘reinforced by ongoing measures to promote greater exchange rate flexibility and to ‘gradually reduce the pace of accumulation of foreign reserves.’

India ‘commits to strengthening revenue mobilization through tax reforms, including a unified goods and services tax, and overhauling the personal and corporate tax code,’ while Japan will implement measures to promote private consumption and investment and also correct a number of taxes as a part of budget consolidation. Saudi Arabia will ‘continue playing its systemic role in stabilizing the oil markets in support of the global economy.’

Such examples exist both for separate countries and along the lines of the functional priorities of the G20.

Their number, of course, is very important, but of more importance in the larger picture is the fact that in the global economy a culture for making decisions and (we hope) fulfilling mutual commitments concerning short- and long-term economic policy formats. In such a manner, interdependence reaches another level.

No less substantial is the noticeable progress of the G20 in creating ‘contexts’ for implementing its own action plans, i.e. the corresponding adjustment of the regulatory environment and ‘conditions’ impacting market development.

Path No.1 – the specification of G20 decisions and timeframes for their implementation. The documents coming out of Cannes summit indicate that the SDR basket will be reviewed in 2015 or earlier. In the period from 2013 to 2019 the member countries apply the Basel III standards, aimed at bolstering bank stability in the face of financial and economic shocks. By April 2012 work should be completed on new standards for international financial reporting with regard to derivatives (including oil futures). By the end of 2012 proposals should be ready on easing volatility in global energy and food markets. During the upcoming year G20 aims to the Doha Round WTO talks, using 'fresh, credible approaches' (in this regard Russia's joining the organization seems quite timely).

Path No.2 – elaboration of G20's agenda, in particular with regard to 'strengthening the social dimension of globalization.' In 2012 the so-called financial G20 (i.e. the semiannual meetings of financial ministers and heads of central banks) could be joined by two additional regular formats – 'social' and 'agrarian' meetings. Labor and agriculture ministers have been tasked with preparing proposals on, above all else, improving employment policies for young people, guaranteeing income for certain vulnerable groups, raising transparency in agricultural markets and managing food security risks.

Path No.3 – 'reforming global governance for the 21st century' (as the Cannes G20 communiqué stated). This primarily entails the strengthening the potential and organizational foundation of the Financial Stability Board, which will assume a legal status and independent budget while maintaining its cooperation with the Basel Committee (Bank for International Settlements) and 'strengthening its coordination role vis-à-vis other standard setting bodies'. This may become a precedent for the logical development of the competencies of the G20 in other areas.

Secondly, the changes within the G20 itself represent a milestone in the transition of the global economy to a qualitatively new level. According to the report of British Prime Minister David Cameron at Cannes, the G20 while remaining an informal and leader driven group is a 'part of global governance' and

‘premier forum of international economic cooperation’. In order to bolster the effectiveness, it was decided at the last summit to formalize the ‘troika’, the past, current and future presidencies, for managing the G20 (in consultation with other members). It is expected that in 2012 a plan will be adopted to expand cooperation between the G20 and civil society.

Thus, this informal group appearing four years is becoming an ever more notable factor in influencing the development of the global economy and working to restore collective trust. At the same time, international economic cooperation must in the very near future take into consideration new long-term trends that are global in nature:

- the increasing share of developing countries in global GDP (by 2016 this share will reach 54%);
- growing unemployment (worldwide 200 million people are out of work);
- higher risks for global energy security and food security;
- redistribution of revenue and financial flows toward the developing economies and emerging markets
- strengthening of the role of transnational corporations (such corporations are often in better shape than national economies);
- the expansion of the ‘global middle class’ to 3 billion by 2030 (up from the current 1.8 million) and the resulting rapid rise in demand for resources
- the arrival of a ‘new wave of technology’ by the end of the current decade and the resulting likelihood of a massive devaluation of assets
- the reset in the international distribution of labor in the sphere of scientific research and innovation.

The new realities of the global economy, which during the crisis began its shift toward a reset of the regulatory and institutional environment, require an adequate balance in national strategies for changing economic models.

Effective use of resources – a reserve for Russia's positioning in the global economy

A characteristic trait of the present phase of globalization is the *toughening of competition between national markets and state institutions* (tax, financial and corporate jurisdiction, administrative regimes, etc.). Investment decisions, in particular with regard to long-term foreign investment projects, are made based on the regulatory arbitration environment, i.e. in relation to the 'comfort scale' in the business climate of various countries. At the same time, the progress of the global economy toward an exit from the current structural crisis will as time goes on become increasingly dependent on the results of two fundamental trends. Firstly, the increasing diversity in the socio-cultural and political environment in which market and government institutions function within the national borders (which often gives authorities an urge to do everything their own way, leading the county down a 'special' path in consideration of 'special' conditions and peculiarities). And, secondly, the standardization of various competing business and regulatory practices that have already become dominating in the activities of both formal and informal international organizations. For example, the recommendations of the Financial Stability Board on tax and budget consolidation, Basel III, new IMF rules for implementing mechanisms for supporting liquidity and emergency lending, and so on.

In this context, the Russian Federation is facing a transition to a new model of economic growth. The organic part of this process is Russia's progress toward a new positioning in the global economy and institutions of international economic coordination. Russia's entry into the WTO, expected joining of OECD in 2012, hosting of the APEC summit in 2012 and G20 summit in 2013 all open new opportunities to optimize these efforts.

The increasing complicated structure of the global distribution of labor is forcing economists to question the adequacy of the tradition division into the categories of developed and developing economies, as this division does not

adequately consider *the peculiarities of an entire group of countries*. Within the G20, such countries include Russia, Australia, South Africa, Brazil, Saudi Arabia, Indonesia, Argentina and, in part, Canada. Such countries characteristically have:

- a high concentration of natural resources, primarily energy resources, and (in most cases) agricultural industry;
- developed extraction industries and good prospects for further agricultural development;
- solid positions on the corresponding world markets for these products;
- a clear need for greater economic diversification and development based on the cluster model (for Russia this means the development of no less than 7-8 processing levels along the ‘chain’ from oil production to end products, special chemistry and pharmaceuticals);
- relatively stable financial systems and national currencies (for example, the Canadian and Australian currencies are second tier reserve currencies);
- notable disparity in regional development and the subsequent need to attract foreign capital;
- socio-economic development strategies focused on radically improving the effective use of resources.

A number of experts note that formation of informal groups of states (and the subsequent flexible formalizing of their interaction) according to ‘functional’ attributes is one of the trends which could determine the future contours of international relations. This can be seen in the BRICS, which appeared (initially without South Africa) as an investment analyst’s concept for the promising investment of funds. Several years later this phantom became a reality, impacting the distribution of IMF quotas, injecting real money into the European Financial Stability Facility, etc.

In the case of the resource based economies, this narrative could play out once again in a much shorter timeframe, as *increasing the effectiveness of the use of resources has become one of the dominant themes of the transformation of the*

global economy. According to McKinsey analysts, through 2030 approximately 3-3.5 trillion dollars will be invested annually in building a path out of the current structural crisis. A substantial portion of these funds will come in the form of direct investment forming a fundamentally new segment of the world's financial markets.

In recent publications of the IMF, the presentations of its leaders and the remarks of international experts and even some state official, we see a movement toward the assignment of 'special zones of responsibility' of to 'groups' of resource economies: as a minimum this entails financial stability with low inflation and a guarantee of international energy and food security. It is expected that, as the G20 engages issues of decreasing volatility on the world's energy and food markets, these trends will only strengthen.

With the aim of 'process management', it would be prudent to take charge of this initiative. In our view, it would be appropriate to put forward the idea of recognizing the resource economies as a separate segment in the global division of labor, for example, in the format of a 2013 initiative acting as the G20 country-chair. Naturally, this should preliminarily be discussed by the international expert community.

One of the options for the subsequent promotion of this idea could be the creation of an international organization (initially as an informal group under the auspices of the G20) not according to a single product principle (like OPEC or the gas exporting nations) but rather with the aim of coordinating the development strategies of interested countries with a particular emphasis on raising the effectiveness of resource use and development of standards in this sphere (this primarily concerns energy products, industrial materials, food products and water) of a status comparable to IFRS or Basel III. Progress along this trajectory is particularly topical in the context of the global trend toward new models of consumption, rebalancing of global demand and the development of markets within the developing countries (primarily China and India), which will lead to a more than doubling over the next 20 years of the global middle class with its growing demands, and so on.

The dynamic innovative development and diversification of resource extraction and associated sectors (i.e. chemical production) of the Russian economy is not likely to be possible without attracting foreign investment. At the same time, progress along the lines of increase the effective use of resources, such as the development high-value-added production capacity is already being slowed by qualitative limitations of on the domestic market. Often industrial facilities, due to their antiquated technology, are simply not able to capable of utilizing a great number of intermediary and end products in the production chain produced by the world leaders of the chemical industry. As a result, to put it mildly, investors are skeptical about the creation of high-tech industrial capacity in Russia. One of the most important reasons for the lack of motivation for the realization of such projects is the de facto active structural policy with regards to industry. A similar situation is seen in other industries as well.

Finding a way out of this apparent dead end requires a fundamental reset of all existing institutions of cooperation with foreign investors. What is needed is a transition from the general discussions about improving the business climate to *specific planning of the participation of foreign capital in the long-term development of specific sectors and their industrial complexes*. Dialogue with investors (first of all with transnational companies working in the resources and associated sectors) is an inherent part of a structural policy aimed at adapting to the new realities of the global economy.

With this aim, in our opinion, there is a need for fine tuning of existing institutions toward strategic diversification with external sources of investment. Pilot projects for establishing new relations with investors could include:

- formational of a new tax regime for the oil and gas sectors (given the present tax burden, approximately one half of proven reserves would be unprofitable to extract);
- a linking of the required investment volumes for the already adopted general plan for the oil and gas sectors to the plan for the petrochemical development and program for offshore hydrocarbon production.

– и взаимоувязка необходимых инвестиционных объемов по уже принятым генсхемам развития нефтяной и газовой отраслей, плану по нефтегазохимии и программе по добыче углеводородов на шельфе.

An important issue here is the socio-economic development of regions with high concentrations of natural resources. This should also be taken in consideration given the prospects of a large influx of capital. One of the possible pilot projects with regard to the Russian Far East (including Sakhalin) is the creation of the *APEC Bank for Regional Development* (which would be founded by the regional governments of interested countries).

At present is already clear that the 2010s will be the decade in which the share of developing economies in the global GDP and global financial market turnover will equalize. The shift of revenue centers and capital flows toward the countries with growth rates higher than the global average as they lay claim to an ever larger portion investment pie. Correspondingly competition for financial resources will also increase. And these resources are no laughing matter: according to the IMF, the volume of equity resources among institutional investors alone (excluding banks, sovereign funds and gold and currency reserves) stood at $70 trillion in the middle of 2011 while investors with leverage (i.e. those working on credit) have had around $8 trillion.

The growing competition for the reallocation of capital flows in the global economy implies a risk that Russia could be left on the periphery of this process, if it does not implement structural modernization of its own financial system in the next 5-6 years. The main benchmarks here are:

- ✓ reform of public financing (transition of the budget structure to a project principle of budget investing);
- ✓ creation of an International Financial Center with a developed national financial market;

- ✓ consolidation and increasing the risk tolerance of the banking sector, increasing the accessibility of financial services to business and consumers;
- ✓ structural reforms (primarily to the personal pensions savings system, insurance industry, stimulation of IPOs and SPOs of corporate securities, expansion of the private sector debt market) aimed at creating the conditions necessary for the emergence of ‘long’ money on the domestic market;
- ✓ development of the institution of state guarantees,
- ✓ increasing the financial literacy of the population and formation of its rational investment behavior

In terms of key objectives, it would appropriate to introduce into Russian practice financial regulation standards agreed upon within the framework of the G20.

Modernization of the financial system is not a artifice conceived by bored experts. To the contrary, it is a high priority requirement for positioning Russia in the global economy. Satisfying this requirement entails not only provision of macroeconomic stability but also effect use of the potential of external investment flows in the interest of the sustainable development of the Russian Federation.