BOOK SYNTHESIS

THE VIRTUAL CURRENCY WE LIVE FROM

By Jean-François Serval and Jean-Pascal Tranié

With a preface by Christine Lagarde, Finance, Eonomy and Industry Minister of France

March 30th 2011

The book gives a description of monetary, accounting and financial mechanisms which, by delaying the adjustments of economical unbalances, caused the 2008 crisis. The threat of a global bankruptcy has been avoided only by a fast, coordinated and strong action of the governments of the major countries in the world (G20). However, structural reforms must be implemented to restore trade and financial equilibrium and to deflate the debt bubble that affects households and enterprises in most developed countries.

Currency plays a key role in the slide, because countries have lost control of it. The regulations developed in the 19th century were able to control the functioning of the banking system and to allow the emergence of bank money. This contributed to the success of the industrial revolution. This regulatory arsenal became progressively ineffective in the last 20 years with the accumulation of US dollar balances outside the western world due to the US trade deficit, the internationalization of exchanges (transactions done in currency but not cleared through the banking system and therefore avoiding the attention or control of the relevant central bank), the appearance of new kinds of exchange instruments as the various financial instruments derived from the securization process (that is, converting illiquid assets into tradable instrument and then allowing them to be traded without clearing payment) and electronic money (opening the way to advanced forms of barter), and the general excessive share of the financial sector in the economy. The excessive accumulation of reserves outside the US central bank allowed the refinancing not only of a shadow banking system but also of the still existing system itself. The accounting standards innovations (that legitimized ex nihilo monetary creation by reevaluation of balance sheets through the use of fair market value) also contributed to the collapse even as no one is able to determine which, how and to what extend the values in the balance sheet have been changed. Everyone believed or wanted to believe that a new manna was going to finance the colossal trade deficits and budget deficits of most of the old industrial countries (especially the US dollar) while in reality the recycling mechanism (monetary, accounting and financial) were just hiding the growing depth of the abyss that had to be filled. A report to the Commission of the US Congress on the causes of the financial crisis without certifying the figures gives a 73 trillion dollars at the eve of the 2008 collapse as the refinanced amount from the shadow banking system and an ultimate lag of 2 trillion dollars in the US regulated banking system. These figures compare with a US GNP of 14 trillion dollars and a worldwide

GNP of 57 trillion dollars, giving an idea of the limitations the authors think the Basel and Solvency Committees regulations for the banking and insurance sectors have to be looked at to prevent a new collapse or simply a continuation of the current sluggish economical environment.

This situation is closely linked to the success of the market economy model, which is accompanied by the increasing sophistication of financial innovations and the continuing internationalization of economies. Transactions now escape regulatory bodies. The transformation of receivables and other assets through the securitization process creates new instruments missing only a first tier guarantee to become money. It is what brings the private system of CDS's that are an alternative to the central banks signature and allow private economic agents to take over the money issuance mechanism. The effects have been amplified with the systematic posting at "fair value" (or market value) of these instruments in the balance sheets of enterprises, without any consideration of the financial capacity of the underlying actors and thus of economies to reimburse them, creating suspicion about their relevance.

In the past, we already saw other speculative crises, from Netherlands tulips to the French railroads and the bank "law " system based on the trading of future profits..

However, this new one is specifically troubling because of its geographical scope and the monetary basis for exchanges extended for other money issued by sovereigns or they central banks. A substantial share of manufacturing capacity has been transferred to Asia due to the delays in taking corrective actions. To addition too big a part of human resources have been dedicated to the finance sector, manufacturing being now the privilege of countries where people accept to become industrial engineers, foremen or workers.

The authors do not deny the progress brought by the financial innovations that justify some regulatory flexibility. Nevertheless, flexibility should not mean "laissez-faire". The democratic institutions have to engage and should not fully delegate the standard setting to so called "independent bodies" as is the case in the accounting field with FASB and IASB.

The book gives some recommendations and ideas to be considered. Especially it offers its support for the institutional projects of both the G20 and the European Council for a systemic risk surveillance supervisory body. It recommends abandoning the Fair Value concept for a return to cost accounting with a separate analysis of the evolution in value of financial instruments and commitments in order to better assess the risks. A reconciliation of figures through the "comprehensive income" that includes both realized profits and potential ones between equity at cost value accounting and at fair market approach as FASB projected reform is the book's proposal. This approach defers from the FASB project by only viewing Fair Market values as an informative process on potentially deferred losses or profits while with FASB the financials set at Fair Market value have the same level of tangibility as with cost accounting.

It proposes a monetary convention to define and follow a “enlarged” money, called M5, with a tool that observes drifts in value, called “M6”, and their complements, M5’ and M6’, that would include off balance sheet commitments based on corporate financials, that is to say, from national accounting systems and not from bank systems which cease to constitute the favored passage way of money. Accordingly to the authors, this approach is the only one to allow the implementation of coordinated measures to fix the international macroeconomic imbalances which Basel III and Solvency do not address. This new enlarged money “M5” and “M6”, covers all means of settling transactions and includes all enterprises submitted to book keeping obligations, including financial institutions. Thus, the need for regulation (Basel III and Solvency), very much criticized in the book, would be limited. On the contrary, the control of money issuance would be restored with a mechanism through a system completing the already begun reform of derivative market places. This system would cause derivative financial instruments to lose any legal effect with third parties when they are traded without any registration on a regulated market place (as is already the case, for instance, with unregistered real estate transactions).

The authors state that a modernized information system would reduce the needed volume of money supply to have the economy running; allow minimum centralized debt regulation; increase the possibilities of such regulation to be decentralized among countries. The transparency of information at the world level would cause nations to be more responsible about their own macroeconomic balances. The macroeconomic surveillance of the money would not be concentrated on inventories, but would also include the conversion of the risks and rates through rates, duration and guarantee “swaps”. A reform of the legal system applicable to finance is also required to provide sufficient guarantees to a globalized system of exchanges.

The authors finally conclude that the imbalances between the West and Asia cannot continue and they recommend that nations freeze public debt and then restructure the debt against structural action commitments.

Current events on this subject demonstrate the relevance of this book, which was started before the first symptoms of the crisis were observed. It goes beyond finance and also raises the issue of a different structure for P & L s in America than in Asia. The currency exchange adjustments claimed by the western world will only be a preliminary solution, if ever they occur in time. Labor productivity, the place allowed to tangible and intangible investments (in research for instance) in P & L's and in the split of GNP s with finance are the questions with which nations must deal in future years. The lost visibility due to mistakes in the standardization of accounting standards and of the organization of national statistical institutions being restored, the authors are quite optimistic about the capability of nations to share between themselves a common sovereignty on currencies. The link between prosperity and liberty being a proven axiom allows one to say that security in money to be

used for exchanges is the condition to their existence and that it has to return to the arena of sovereign in order to avoid excess in decentralized regulation.

In Paris March 30th, 2011