M. Ershov

World Financial Crisis.

WHAT'S NEXT?

M. Ershov

World Financial Crisis. What's next? – Moscow: Economica, 2011. – 295 pp.

About the book of M. Ershov " World Financial Crisis. What's next? "

What are the main reasons behind the most powerful crisis in the newest history? Who won and who lost as a result? Why the efficiency of the modern financial capitalism (particularly its "US- version") was not enough to save its main players (investment banks etc.)? What risks lie ahead?

It's clear that measures used against crises helped to avoid collapse of the system but did not eliminate its core roots. Moreover, some old and new risks start to re-emerge again.

What are the real in-depth reasons behind the events that can be seen "on the surface" - stock market fluctuations, "currency wars", risks of sovereign defaults? Will they lead to major shifts in global economic and political power as well as change the role of forces and players that remain 'behind the scenes'? Who will take over in the post-crises era?

All these questions are being addressed in the book.

The author explains why his previous forecasts happened to be correct. He also gives some new forecasts about the main risks of the global economy and of its main players.

CONTENTS

INTRODUCTION (FROM THE AUTHOR)

Crisis (ancient Greek κρίσις) –
judgment, decision, turning point

In the 21st century, the global economy has come to face principally different geo-economic and geo-political situation in its history. The financial crisis in the United States was followed by crises in other countries. All this made developed countries radically revise their regulation methods and take large-scale relief measures, while the overall situation caused to talk about a crisis of the modern model of financial capitalism.

When the situation appeared to have started to gradually normalize, a crisis broke out in the euro region, which also required emergency support measures to be taken by relevant governments. This not only seriously undermined the position of the euro itself, but also essentially challenged the efficiency of the most important mechanisms of European integration, making the foundation of the economic system more precarious and escalating the threat of national defaults.

A radically different environment is taking shape in the aftermath of a financial crisis which was unprecedented in the post-war period.

Stable global finance support 'pillars' as well as financial stability centers are being succeeded by new sources of global financial resources and centers of politico-economical influence. This urges the modern world to form new mechanisms of economic architecture mechanisms and new rules of the game, which become increasingly relevant with an aggravation of recessionary trends in developed countries.

It has long become obvious that the problems that accumulated in the global monetary and financial sphere will inevitably cause large-scale disturbances. In 2000, we forecasted that "the global monetary system is facing a real prospect of a large-scale currency crisis and the possibility of … preventing its destructive consequences for the global economy as a whole will

depend on how adequate and coordinated would be the measures taken by leading nations."[1] Later, we pointed out that the global currency system "will have to undergo serious transformations to regain systemic stability and avoid an extensive systemic crisis. It should consider the realities that arise in the context of globalization, which are associated with a substantial growth in cross-border operations, the flow of financial resources, and the involvement of an increasing number of countries in global processes"[2].

> "The global monetary system is facing a real prospect of a large-scale currency crisis." (M. Ershov, 2000).

> "The global monetary system will have to undergo serious transformations to avoid an extensive systemic crisis." (M. Ershov, 2005).

Soon afterwards—some years later—a deep financial crisis broke out in the global economy. It affected all the main market participants and made some of them terminate further activities. The depth of decline of the US stock market was one of the greatest in the entire history of observations (Figure 1).

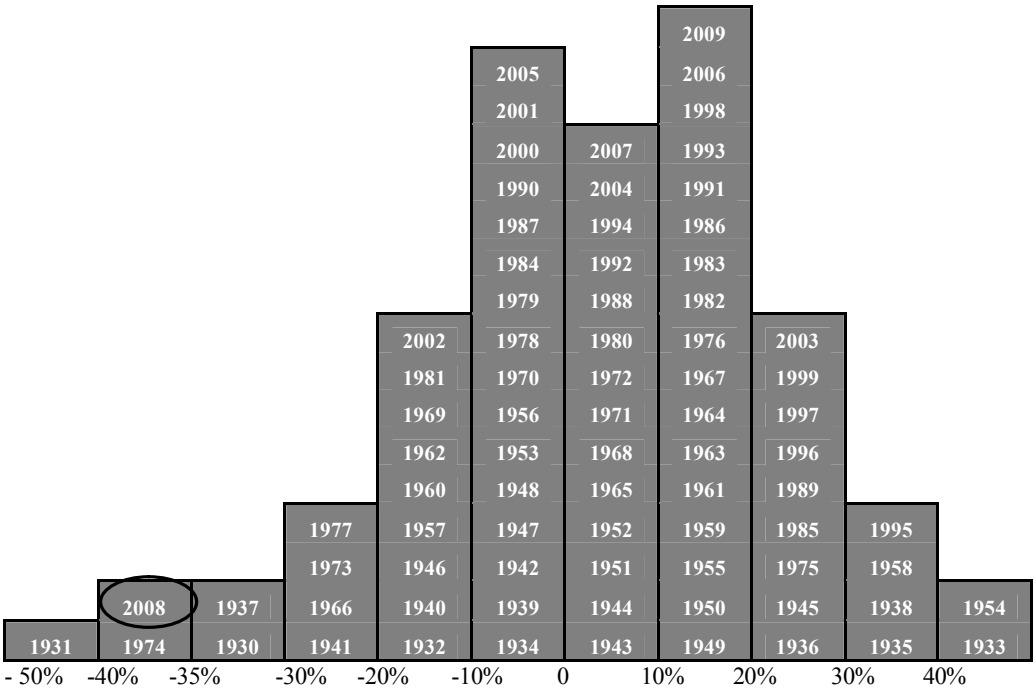


Figure 1. Dow Jones performance in 1930-2009*

* Rate of increase; in real terms of chained 2000 dollars.
Source: calc. based on NYSE data.

[1] M. V. Ershov. Monetary and Financial Mechanisms in the Modern World (crisis experience of the late 1990s). M.: Ekonomika [Economy], 2000. P. 45.
[2] M. V. Ershov. Economic Sovereignty of Russia in the Global Economy. M.: Ekonomika [Economy], 2005. Pp.72–73.

It is obvious that the imbalances that steadily formed in the global economy and manifested in constant deficits in the balances of payments and budgets of developed countries, with an accompanying creation of national currencies that was not matched by any GDP growth or adequate stabilizing mechanisms (including international reserves), deprived the global financial system of the required points of support. Given the fact that even in the "old" economic environment caused massive failures (such as the 1971 US default on international obligations taken by this country, which brought about a collapse of the Bretton Woods System), in the new environment, with the global markets and with the underdeveloped regulatory system that was not adequate for new risks, the threat of a massive crisis was becoming real. In its worst-case scenario, the situation may become irreversible.

Given the fact that even in the "old" economic environment caused massive failures (such as the 1971 US default on international obligations taken by this country, which brought about a collapse of the Bretton Woods System), in the new environment, with the global markets and with the underdeveloped regulatory system that was not adequate for new risks, the threat of a massive crisis was becoming real. In its worst-case scenario, the situation may become irreversible.

The crisis that eventually happened was so massive and the regulatory stabilizing measures were so unprecedented that all this made it possible to essentially question the efficiency of the financial model of capitalism (primarily, its American version), its self-survivability and viability in the global market environment.

Some key foundations of the financial system have incurred irreparable damage. The system itself, being unable to function in its previous form, was partially nationalized or brought under public control.

Some key foundations of the financial system have incurred irreparable damage. The system itself, being unable to function in its previous form, was partially nationalized or brought under public control.

As a result, the government's role in the economy substantially increased, resuming talks about models of state capitalism in the global economic environment.

In this connection, the anti-recessionary measures only stabilized the situation for a while, without eliminating its core causes that had given rise to the crisis. That is why, even with the resumption of growth in the market, the probability of a "second wave" of the crisis remains high.

In this environment, there arises a historically unique situation where participants of the global economy, primarily Russia, can lay new basis for a new development model that endorse their national interests and can ensure sustainable development in the global post-crisis environment.

To find balanced solutions for such a complicated and urgent problem, it is necessary to realize what were the reasons of the observed recessionary events and **what can one expect in the future**.

What are the causes that gave rise to the crisis and aggravated its development?

What measures should be taken to prevent similar events in the future?

What shall Russia do to strengthen its positions in the uncertain and highly volatile situation in the world where high risks persist?

How high is the probability of a new phase of the crisis and how can Russia mitigate its effects on economy?

Russia should find accurate and well-balanced mechanisms that can ensure its efficient development in the post-crisis world. While retaining the general policy for further economic integration into the global economy, Russia should also consider the broader objectives which imply strengthening its positions as a serious sovereign participant of the world economy. It is obvious that a successful solution of this issue will determine the nature of Russia's development for many decades to come.

This book offers several approaches that should be taken into consideration while solving such complicated and large-scale problems.

The conclusions made by the author are bases on his 20-year practical experience in the financial sphere, participation in international negotiations, official meetings, numerous discussion of issues-in-question with many leading Russian and international economists, bankers, scientists, and politicians.

This work generalizes some of the conclusions made by the author in his earlier published books: *Currencies in the World Trade* (M., Nauka [Science], 1992, 145 p.), *Financial and Monetary Mechanisms in the Modern World (crisis experience of the late-1990s)* (M.: Ekonomika [Economy], 2000, 319 p.), *Economic Sovereignty of Russia in the Global Economy* (M.: Ekonomika [Economy], 2005, 280 p.)[3].

Some forecasts made in the above books with regard to the future of the foreign exchange and stock markets, exchange rate trends, banking system trends have proved to be correct. In this work, we will explore the main causes of the occurrence of such events and offer several new assessments for the future development of this situation.

[3] For further details, see www.ershovm.ru

We will focus on those approaches that Russia will need in the future to strengthen its economic positions worldwide in an environment where the international economy is recovering after a large-scale crisis and where new risks that can be of destructive nature, emerge[4].

You can find main approaches of the author at website: www.ershovm.ru

[4] In this work, the author expresses his personal opinion that should not be identified with the opinion held by the institution that he represents.

1

GLOBAL FINANCIAL CRISIS OF 2007

In September 2009, a year passed since the date of announcement about the bankruptcy of the US bank Lehman Brothers. Amid the growing imbalances and distortions that accumulated in the global economy, this event triggered the beginning of large-scale systemic market corrections, fundamental changes in regulation approaches, and a revision of the basic principles of modern market architecture and the market ideology itself.

This crisis was one of the most acute and protracted ones in the contemporary history (Fig. 1.1).

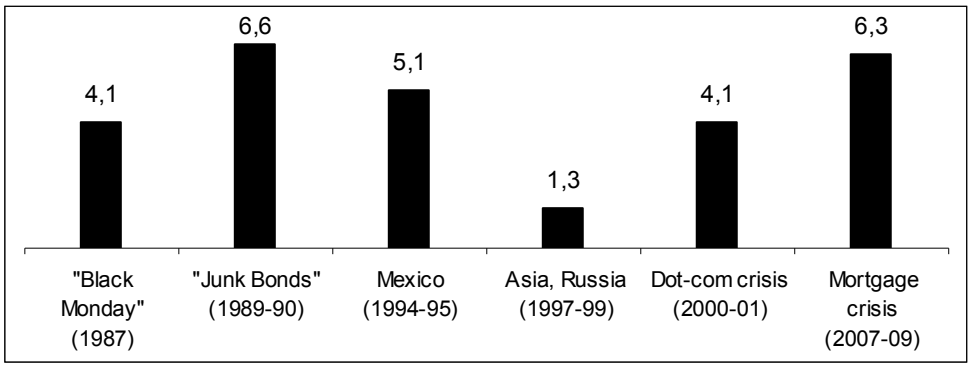


Fig. 1.1. Duration of crises (number of quarters)

Sources: Global Europe Anticipation Bulletin, Morgan Stanley, NBER, 2008, 2010.

The losses that accumulated during its development also exceed the losses caused by many of the post-war crises (Fig. 1.2).

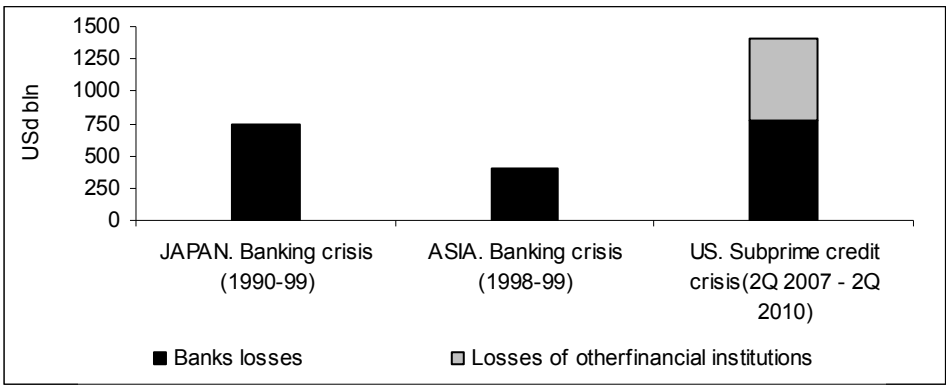


Fig. 1.2. Losses caused by financial crises (USD bln)

* All the data are in real prices of 2007. The losses incurred by non-financial institutions are given using IMF data published in October 2008; for banks, using data published in October 2010.
Sources: IMF, 2008, 2010.

The events characterized by FRS Chairman Alan Greenspan as a "once-in-a century credit tsunami" are a unique example, observed in the newest history, which demonstrated a whole series of factors that have become possible in the context of globalization and deregulation.

About the Background to the Crisis

Like any complicated and large-scale phenomenon, this crisis is multidimensional. And there were concrete circumstances that provoked its development exactly at the time when it happened. However, its acuteness and scope were determining by much deeper causes.

Brief Summary

An important yet not decisive factor that promoted the development of the crisis and deepened the decline was the situation in the mortgage market, primarily in the United States, whose fast growth was supported by active government actions. In addition, this was happening with interest rates being kept at a low level during a long period, which stimulated market growth even more. Mortgage loan requirements sharply lowered, creating a great number of sub-prime loans of low quality and, therefore, heightening nonpayment risks. In addition, a rapid growth of derivative instruments was generally observed in the financial market. These instruments simultaneously included securities of different quality and were generally rated higher than the actual quality of

relevant components. It is important to note that this market actually was allowed to get out of required strict control. Moreover, efforts of interested lobbying and regulators were leading to a deregulation of important market segments, lowered requirements for participants and facilitated generation of profits. This resulted in an emergence of a whole system of institutions that used the indicated instruments (conventionally called a "shadow banking system"), with its scale being comparable with the banking system; in addition, the level of regulation of those institutions was considerably softer, while their market impact potential was extremely high. The resulting imbalances in those institutions caused an insufficiency of capital required to support relevant assets and created risks of recessionary liquidity compression, a kind of "credit deleverage", aggravating the threat of recessionary reduction in financial operations and the entire financial system, which eventually happened. Leverage in the financial system was accompanied by increasing debts owned by households and the public sectors in the leading countries, which made the general situation "fundamentally fragile." Finally, the most important factor that intensified the crisis and created a more favorable environment for its development was the globalization process, which promoted an intensive growth of cross-border operations and capital movements and increased interdependence of economies. In this connection, resources flowed from the countries having positive budget balances and balances of payments and high levels of savings to the countries having deficits and high levels of consumption. As a consequence, this put a downward pressure on the even so low level of interest rates and decreased profitability in the financial markets, making their participants look for more higher-yield and more risky instruments and stimulating financial institutions to enlarge balances, oftentimes having low-quality assets and unstable source of financing (liabilities). The resulting environment (in this entire range from the microlevel, balance condition, and business strategy to macro indicators—cross-border dependence and global imbalances) was a favorable ground that strengthened the overall negative effect and caused the gravest financial crisis in the post-war period.

In this connection, it is obvious that the main causes of the crisis were mostly created by accumulation of systemic imbalances in the global economy and a rapid growth of a qualitatively new segment of the financial market of derivative instruments with its inadequate regulation, rather than current (though considerable) mortgage problems.

With the system being so unstable, mortgage problems merely made all the accumulated imbalances come out and triggered-off the development of the crisis.

The main causes of the crisis included accumulating systemic imbalances in the global economy and a rapid growth of a qualitatively new segment of the financial market of derivative instruments with its inadequate regulation, rather than current (though considerable) mortgage problems.

In November 1999, the US President's Working Group on Financial Markets issued a report dedicated to the development of derivatives. In the preface of this document, Secretary of the Treasury of the United States Lawrence Summers, FRS Chairman Alan Greenspan, and heads of the Securities and Exchange Commission and the Commodity Futures Trading Commission pointed out the document's priorities aimed at supporting innovations in the derivatives market[5]. The same period saw the repeal of the Glass–Steagall Act (adopted in the Great Depression period), which had drawn a line between the activities by investment banks and commercial banks and regulated their operations in a more rigorous manner. This Act was succeeded by the Gramm–Leach–Bliley Act, which abolished many of the effective limitations and essentially liberalized activities in the financial market[6].

All this created an extremely favorable environment for a growth in derivative instruments. Before the crisis, this market became 10 times as large as the global GDP[7].

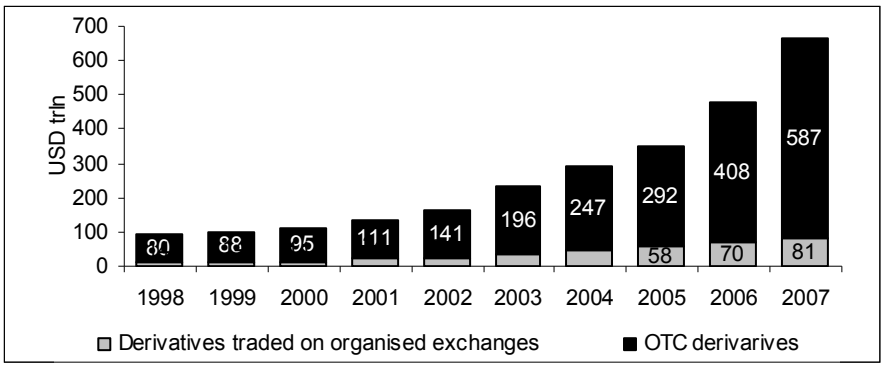


Fig. 1.3. Volume of the derivatives market* (USD trln)

* excl. commodity derivatives.

Source: BIS.

[5] Over-the-Counter Derivatives Markets and the Commodity Exchange Act. Report of the President's Working Group on Financial Markets. November 1999.

[6] Many of the regulators' attempts to bring the financial sector under stricter control were opposed by a powerful lobbying by banks that blocked such laws. For example, see: A Fistful of Dollars: Lobbying and the Financial Crisis. Igan D., Mishra P., Tressel T. 10Th Jacques Polak Annual Research Conference, November 5–6, 2009.

[7] The Financial Crisis and the Global Shadow Banking System. Farhi M., Cintra M.A.M. Revue de la régulation, No5, 2009.

As a rule, granted mortgage loans formed pools, which oftentimes did not remain on the balance sheets of the banks that granted them, but were transferred (sold) to special purpose vehicles (SPV). There, in their turn, they were grouped into new pools, which served as security for new issues already on the part of SPV. As a rule, they issued instruments conventionally called asset-backed securities (ABS). Subsequently, ABS could be regrouped and new securities were issued on their basis. Besides, to improve the quality of a new paper, low-rate instruments used as its security were often regrouped with papers of better levels and, on the basis of a new portfolio, new instruments were issued, which with a correct regrouping of assets usually enhanced the resulting rating of a derivative instrument, sometimes bringing it to the high quality level of AAA (Figure 1.4). Resulting new derivates could again be grouped into new blocks to issue new derivatives[8]. Operations like this could be reproduced many times.

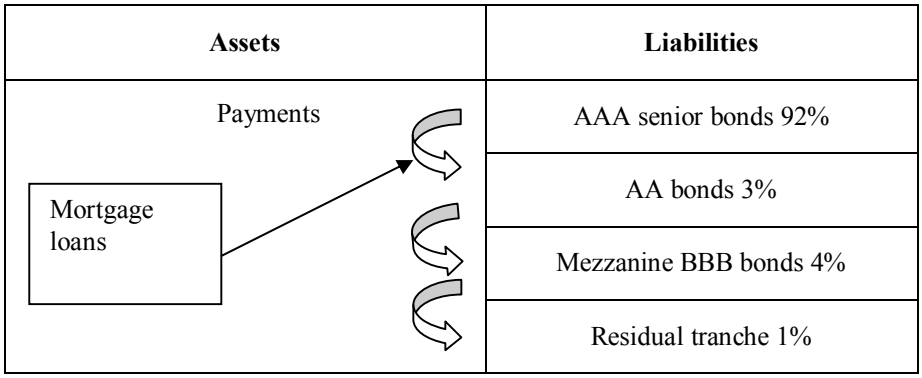


Fig. 1.4. Balance sheet of MBS

Source: FCIC, April 2010.

This was essentially done to bring more papers into circulation in order to disperse risks and increase trading volume. However, all this made its increasingly difficult to figure our actual security holders, risk concentration, and a number of securities. Moreover, the level of intertwining became exceedingly high, making security holders dependant on the status of issuers of all levels of involvement and at all stages of formation of specific derivative instruments. As a result, the use of derivatives eventually increased risks, rather than diminished them.

The use of derivatives eventually increased risks, rather than diminished them.

[8] In some cases, these papers (ABS, CDO, etc.) could again be entered into the balance sheet to be used again as security to raise funds.

In addition, the great number of intermediate link made it absolutely unclear what and who may produce a negative impact. These risks were acknowledged even by representatives of leading banks, which eventually suffered from those risks. "While many of these complex products were designed to spread out risk, they often had just the opposite effect—obscuring where that risk was concentrated and to what degree," emphasized, among other things, the head of the Morgan Stanley Bank at a hearing about the causes of the crisis.[9]

While a considerable part of derivatives fell on interest-based and exchange rate instruments that reduce financial market risks (these instruments were often associated with mortgage processes), the mid-2000s saw a steady growth of mortgage instruments proper, which were an important factor for the expansion of the housing market.

About Mortgages Prior to the Crisis

It would be incorrect to say that only the US mortgage market experienced at first an upsurge and then a decline and that this was the main cause of the crisis. This phenomenon was typical of many markets in the leading countries (Figure 1.5).

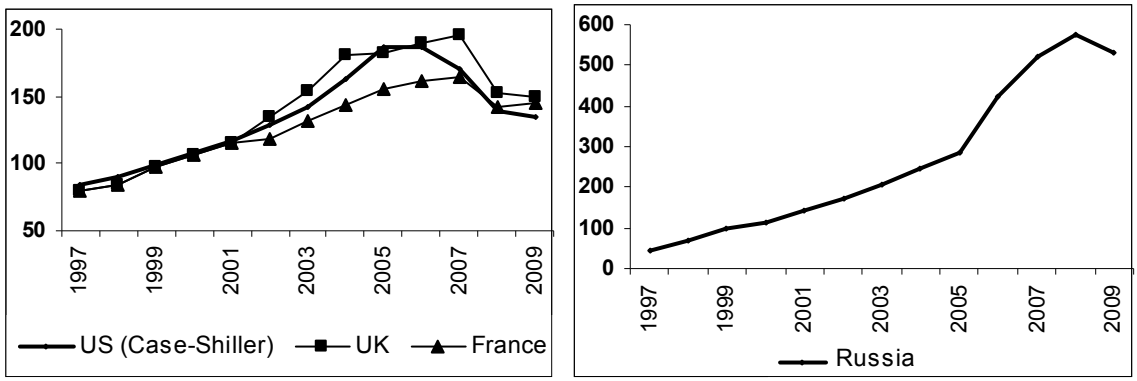


Fig. 1.5. Indexes of actual prices of housing in the United States, the United Kingdom, France, and Russia (1999=100)

Source: national statistics, S&P.

It is obvious that the indicated growth in asset value caused a growth in its servicing instruments, which in its turn accelerated changes in the mortgage market. In addition, this market saw an extensive use of both - mortgage papers and their derivative instruments. Along with mortgage loans, this cause a rapid increase in the US mortgage market itself (Fig. 1.6–1.7).

[9] Hearings in Financial Crisis Inquiry Commission. January 2010. Mack J.J. Written submission of Morgan Stanley to the FCIC. P. 15.

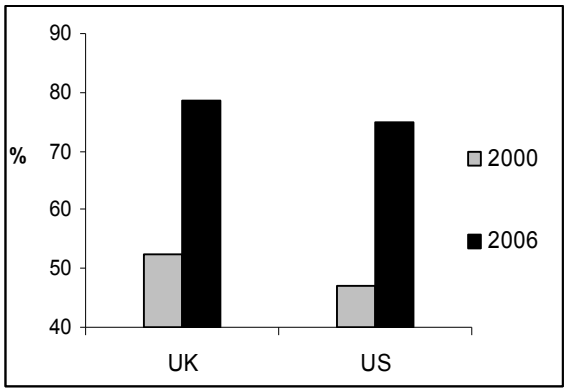


Fig. 1.6. Household mortgage debt (% of GDP)

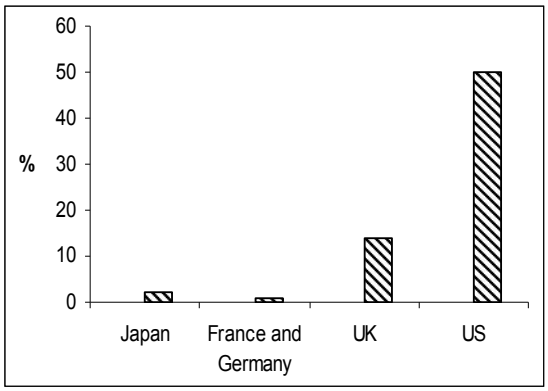
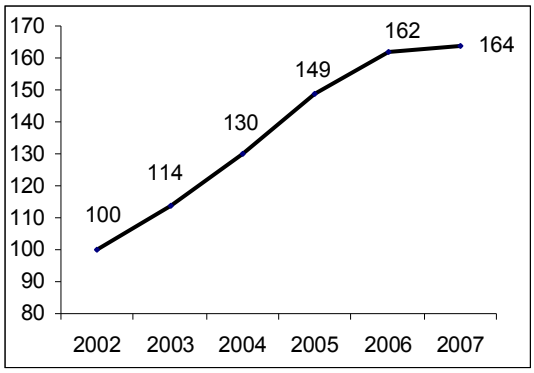


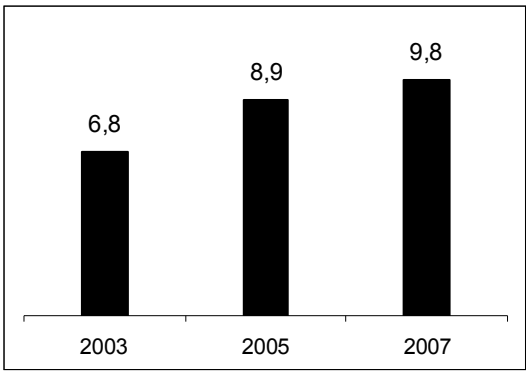
Fig. 1.7. Residential mortgage-backed securitization (2006, % of GDP)

Source: BIS, May 2009.

The indicated decrease in interest rate and easier credit conditions resulted in a rapid increase in mortgage debt of US households. Over 5 pre-crisis years, total mortgage arrears grew by more than 60% and reach nearly USD 10 trillion (75% of GDP) by April 2007.



a) Growth in mortgage debt owed by households (2002=100)



b) Scope of mortgage debt owed by households (USD in trillions)

Fig. 1.8. Changes in mortgage debt in the United States

Source: according to FRS data.

The main source of mortgage loans granted in the United States were specialized agencies (Fannie Mae, Freddie Mac), although nearly half of the total amount of loaned funds also fell on commercial banks and other participants of the financial market.

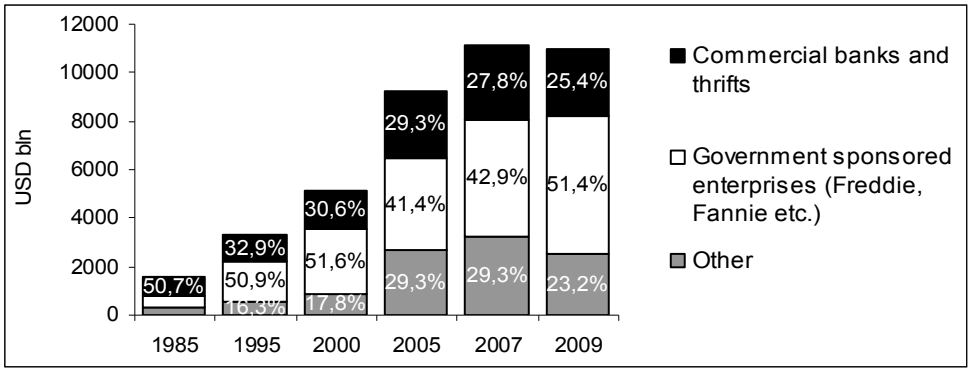


Fig. 1.9. Mortgage loans: breakdown by owners* (USD bln, %)

* Data as of the 4Q of each year, in 2009 – 3Q.

Source: Sheila C. Bair on the Causes and Current State of the Financial Crisis before the Financial Crisis Inquiry Commission, January 2010.

This was accompanied by a diversification of different instruments, with the scope of issues growing. These processes could be observed most extensively in one of the largest markets, the US market.

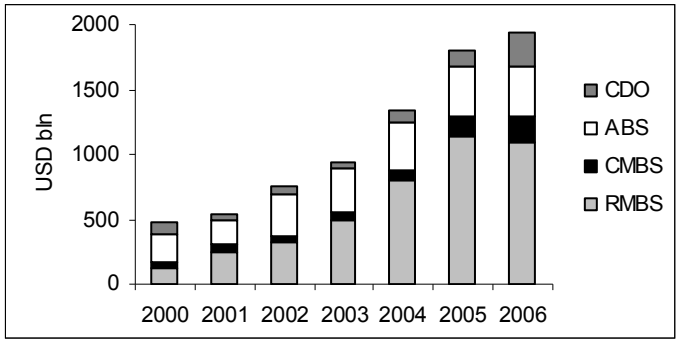


Fig. 1.10. US: issue of bonds (USD bln)

Source: Written testimony before the Financial Crisis Inquiry Commission, Jan. 13, 2010.

In this connection, instruments secured by "sub-prime debt" were growing at a faster rate (their share in the total scope of mortgage papers increased from 6% in 2001 to almost 15% in 2006, while the total amount in early 2007 exceeded USD 800 bln.

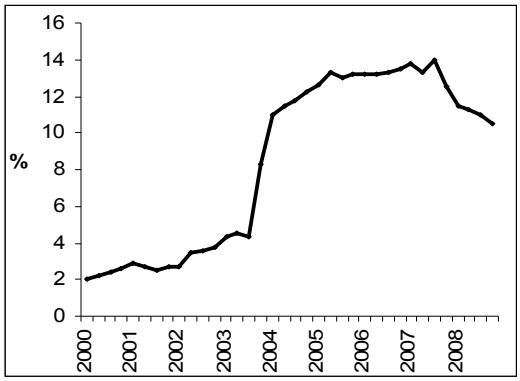


Figure 1.11. US: Share of subprime mortgage loans in the total scope of mortgage loans (%)

Source: Exhibits Hearing on WS and the Financial Crisis: the role of investment banks. April 2010.

Initially, low requirements for borrowers did not appear there to be a great problem, as a considerable part of loans were granted at the federal level, but later, from 2004, the extent of guarantees sharply decreased (Fig. 1.12).

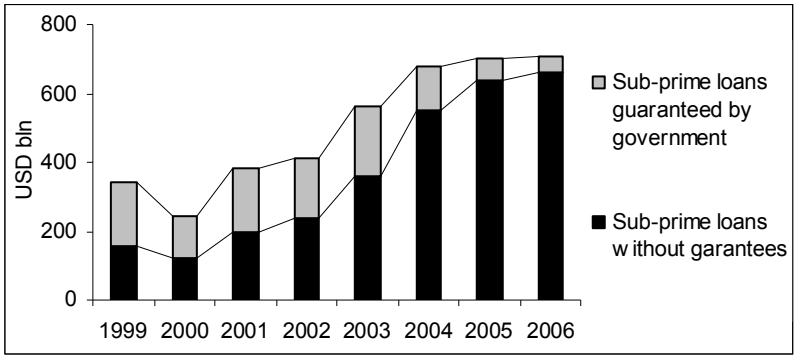


Fig. 1.12. US: market for subprime loans (USD bln)

Source: according to data from Mortgage Finance.

Mortgage loans themselves granted in the United States and some other countries had a high loan-to-value ratio (LTV), often reaching 75-80% (Fig. 1.13). One could naturally suppose that any decline in home prices would aggravate the problem of security for granted loans, making relevant conditions more rigorous. This could increase the possibility of a default—with all ensuing consequences—at the corporate and customer levels—in terms of new write-offs and a decrease in consumer demand. This eventually happened and created serious long-term problems in the mortgage market. Even when the acuteness of the crisis somewhat subsided, according to estimates by M. Feldstein (who, alongside with B. Bernanke, was a candidate for Chairman of the Federal Reserve System when decision about new Chairmen was considered), about one third of all the homes encumbered with mortgage incur debts exceeding the collateralized value (of a home). In addition, in half of the cases LTV exceeds 130%[10], which creates serious prerequisite for new recessionary upsurges in the future, especially if mortgage prices decline.

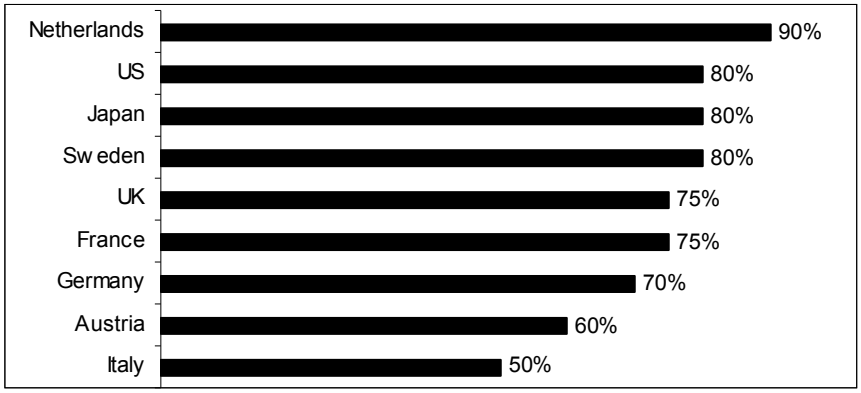


Fig. 1.13. Home loan- to-value ratio (LTV, %)

Source: IMF, April 2008.

[10] WSJ, August 7, 2009.

The situation was also aggravated by the fact that loans were oftentimes granted figuring on a growth in real estate prices in the future, therefore loans were granted "preemptively"(when scopes of granted loans were insufficiently secured by collaterals) and eventually scopes of loans started to break away from the actual collateral value. If the growth forecasts had come true and home prices had grown as was expected, then the scope of collaterals would have come to correspond with the scope of granted loans, which would have made it possible to refinance the debt, in certain cases even upgrading it to a higher category (prime) with cheaper refinancing. In expectation of a cheapening in resources, loans were also often received at floating rates.

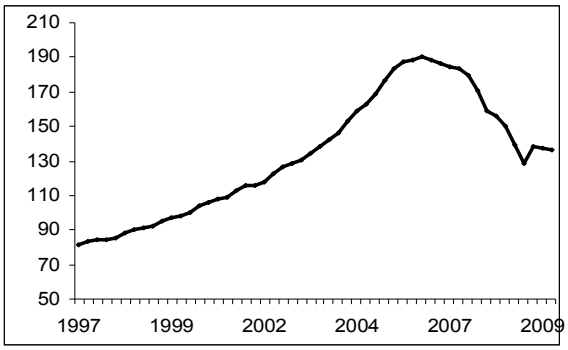


Fig. 1.14. US home price index
(S&P/Case-Shiller)

Source: S&P

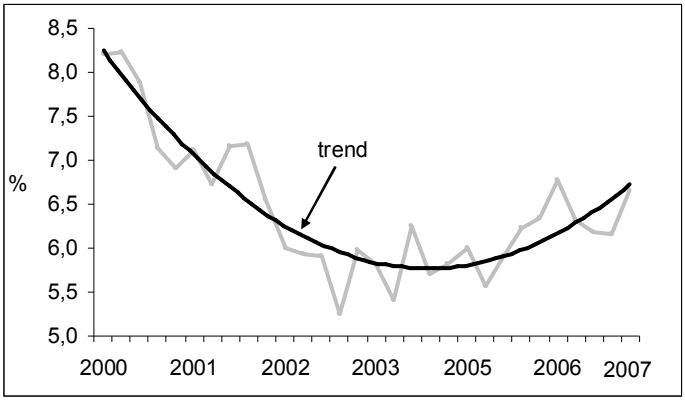


Fig. 1.15. US: long-term mortgage loan rates (30 years) in 2000–2007* (%)

* 2007 – 1H07
Source: according to mortgage-x.com

However, when interest rates started to grow, while home prices started to decrease, there arose a problem with loan repayment.

Only in 1 year—from 1Q2007 to 1Q2008—the S&P/Case Shiller index (characterizing the US housing market) showed the greatest decline in 20 years, reaching almost 15%, which naturally aggravated the problem of non-payments and bankruptcies.

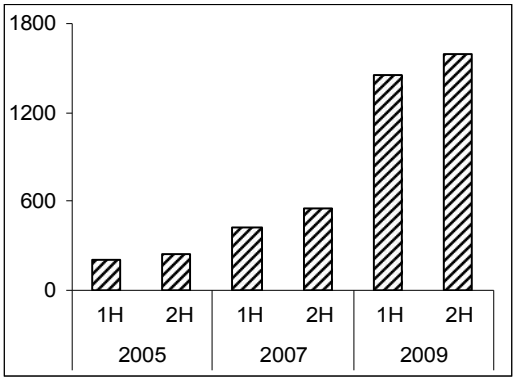


Fig. 1.16. US: number of overdue mortgage loans (arrears of 90 days and more, in thousands)

Source: Zandi M. Written testimony before the Financial Crisis Inquiry Commission, Jan. 13, 2010.

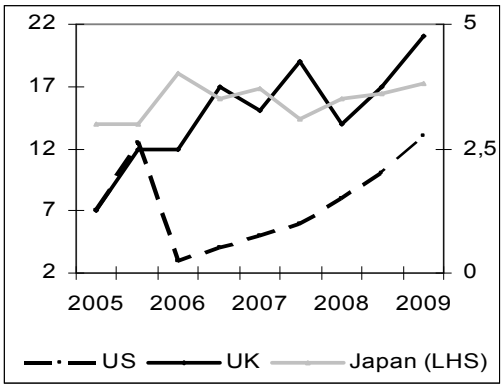


Fig. 1.17. Number of bankruptcies* (in thousands)

* According to different types of documents (procedures) justifying bankruptcy (the United States – business bankruptcy filings; the United Kingdom – bankruptcy orders; Japan – business failures).

Sources: BIS, 2009.

This resulted in a greater mutual distrust among market participants and a disruption of normal credit activities. When the economic environment was vulnerable to an expansion of the crisis, the mentioned trends in the mortgage market gave an impetus to further development of the crisis.

Let us return, however, to our overview of the general environment where the crisis was developing. The growth in derivate instruments was accompanied by a rapid growth in this market and a growth in companies that were engaged in these operations, while considerably outstripping the growth in assets of the traditional banking system and households (Fig. 1.18).

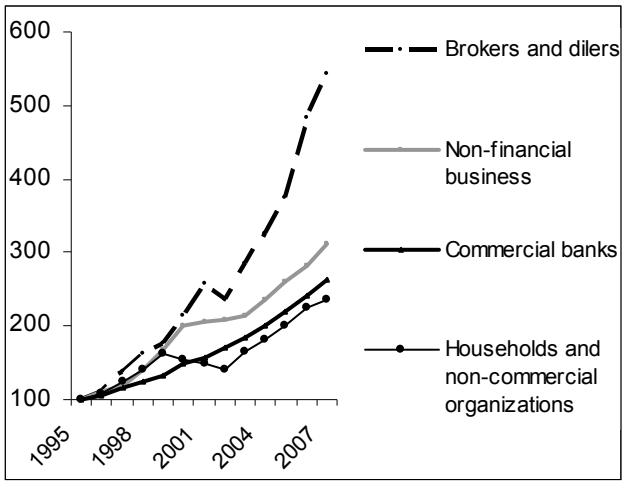


Fig. 1.18. Growth of financial assets in the US (1995=100)

Source: calculations based on data from US Fed, Flow of Funds for relevant years.

Softer regulation than that of traditional commercial banks enabled financial companies, investment banks, hedge funds, and money market funds perform financial intermediation activities at lower costs than those of the traditional commercial banking system. Transactions ensuring circulation of financial resources between households and businesses as sources of funds, on the one hand, and bringing these funds to their final recipients—borrowers and investors—on the other hand, started eventually to flow more and more into this "parallel" banking system that came to be called ‘shadow banking system’.

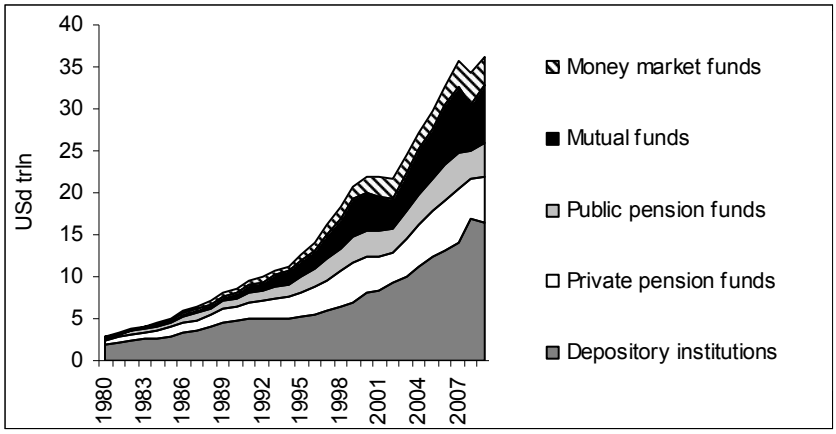


Fig. 1.19. US: Assets of some financial institutions (USD trln)

Source: FCIC, May, 2010.

In this connection, while as early as the 1980s the traditional banking system accounted for about 70% of the assets of the entire financial sector, by the 2000s its share went down to less than 50%, whereas the importance of other financial institutions grew considerably (Fig. 1.20).

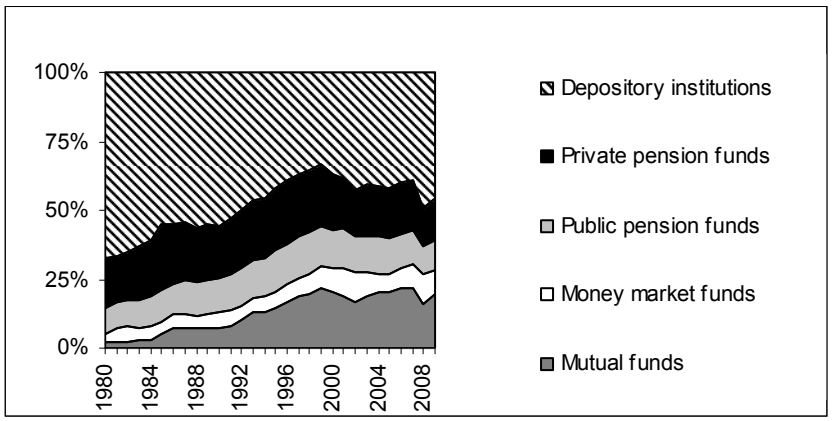


Fig. 1.20. US: assets of some financial institutions (%)

Source: US Fed, Flow of Funds for relevant years.

In addition, new market participants emerged and new instruments were intensively used in the market in a global economic environment with a substantial expansion of cross-country relations and interdependences, which had a strengthening transnational aspect.

About Internationalization

Prior to the crisis, the share of the global financial assets owned by foreigners was about USD 70 trillion (or more than 30% of the total assets).

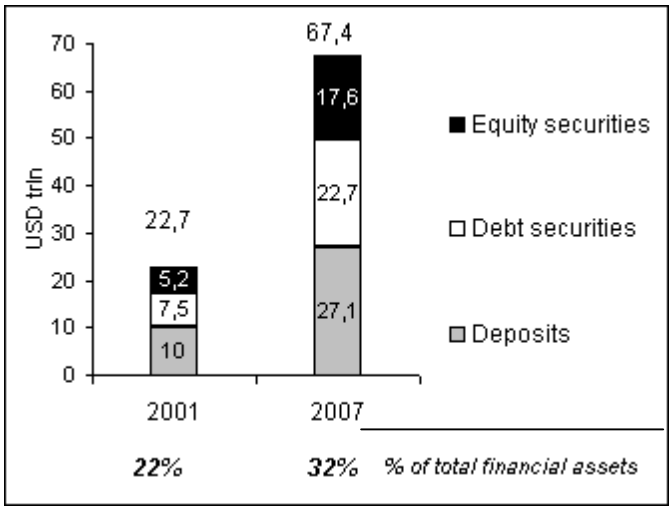


Fig. 1.21. Global structure of financial assets owned by foreigners (Estimate, USD trln)

Source: World Economic Forum, The Future of the Global Financial System. 2009.

This was accompanied by a steady growth in cross-border operations by global banks, which led to their setting higher requirements for foreign participants, with their interdependence becoming higher (Fig. 1.22).

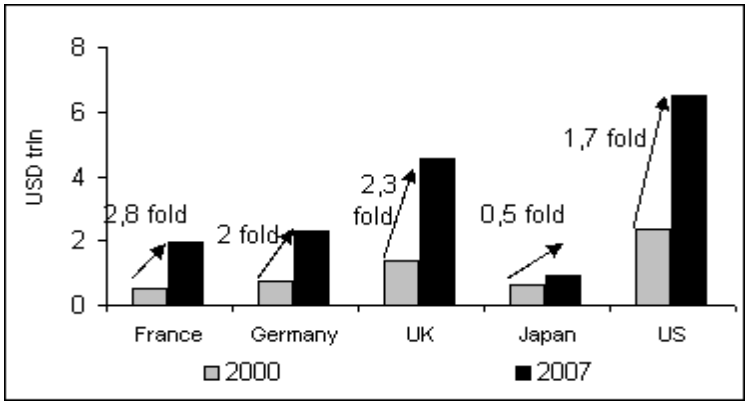


Fig. 1.22. Total foreign claims on the rest of the world (USD trln)

Source: calculations based on data from BIS.

Total claims to foreign participants grew from less than 60% of the global GDP in the early 2000s to more than 80% of the global GDP by 2008 (Fig. 1.23).

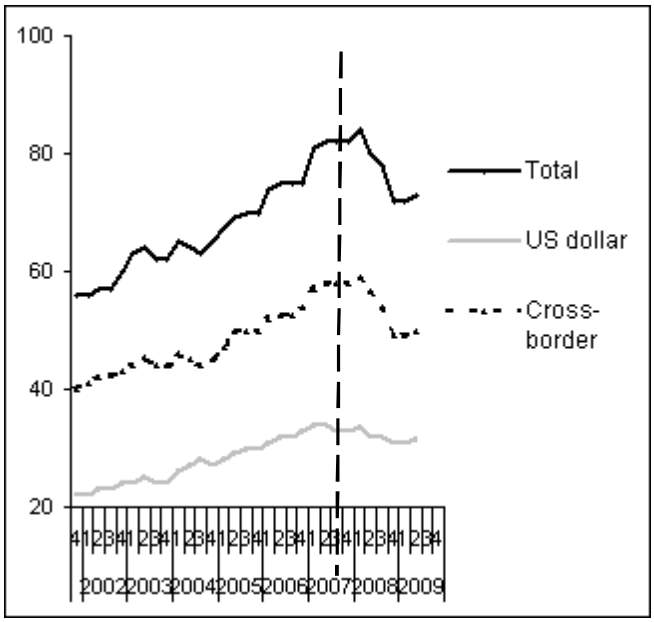


Fig. 1.23. Foreign claims as a share of world GDP (%)

Source: BIS, March 2010.

While analyzing the channels through which the crisis spread across the world, it is essential to take into account that the US economy was the epicenter of the crisis. As a consequence, one should take into consideration the level of other countries' dependence on the US financial market and financial instruments as a whole, as well as foreign participants' claims with respect to the US economy.

From the viewpoint of the obligation portfolio structure, foreign participants quite intensively bought corporate instruments and agency securities (their portfolios exceeded USD 4 trillions). US ABSs held by foreign holders exceeded USD 2.5 trillions (which according to estimates by the US FRS) accounted for about 60% of their total volume and more than 15% of all the foreign requirements to US[11].

[11] FRS, January 2010.

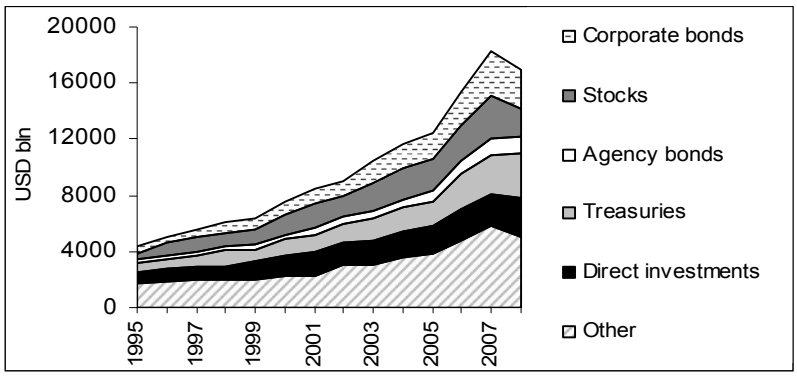


Fig. 1.24. Composition of US external liabilities (USD bln)

Source: US Fed, Jan. 2010.

It is obvious that this situation largely promoted a faster global spread of the crisis.

Amid the crisis, G-20 concluded that the costs of financial liberalization and global integration include a wider propagation of shocks and the effects could be more severe[12].

Global Imbalances

In addition, the pre-crisis developments were promoted by a situation that can be called "global imbalances", which have existed over an extended period of time. We well remember some elements of this situation in the United States as early as the 1980s—they were called "twin deficits" and were indicative of budget deficit and trade balance deficit (balance of payment deficit). In the recent decade, trends have developed quite predictably on the whole and some countries showed stable surplus, whereas the United States and, in some periods, Japan and Western Europe had current account deficits (Fig. 1.25).

[12] G-20 Study Group on Global credit Market Disruptions, Paper Prepared by Australia, 30 October 2008. P. 42.

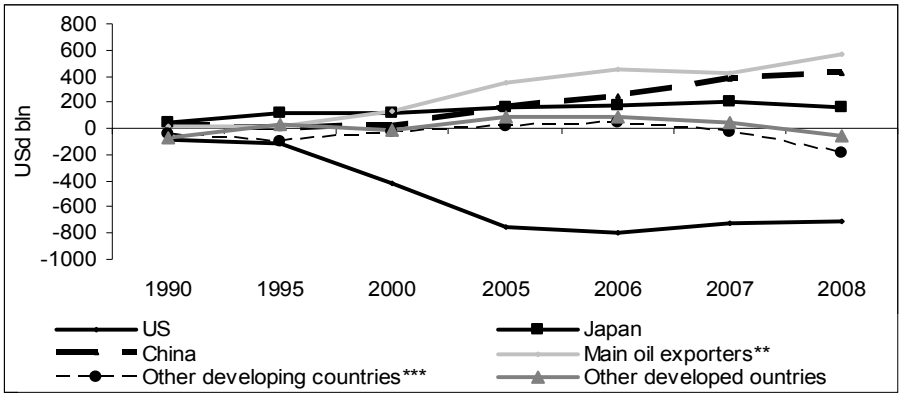


Fig. 1.25. Current account deficit (USD bln)

* Algeria, Iran, Kuwait, Mexico, Nigeria, Norway, Russia, Saudi Arabia, the United Arab Emirates, Venezuela.
** including NIC.
Source: IMF, Bank of England.

Concurrently with that, most developed countries had budget deficits, which even more aggravated the problem of financing of deficits.

Deficits in some countries and surpluses in other ones developed in interconnection with consumption exceeding savings or vice versa (Table 1.1).

	Savings		Investments	
	2001	2008	2001	2008
Developed countries	20.0	18.8	20.6	20.4
USA	16.4	11.9	19.1	17.5
UK	15.4	15.1	17.4	16.8
Japan	26.9	26.7	24.8	23.5
Germany	19.5	25.7	19.5	19.3
Developing countries	26.6	36.6	25.1	31.8
China	38.4	49.2	36.3	42.6
India	23.5	32.5	22.8	34.9
Russia	32.5	31.5	16.8	21.0

Table 1.1. Gross savings and investments (% of GDP)

Source: BIS, 2009.

As a consequence, some countries came to have surplus free financial resources, while other countries had to look for ways to attract funds required to finance their deficits (Fig. 1.26).

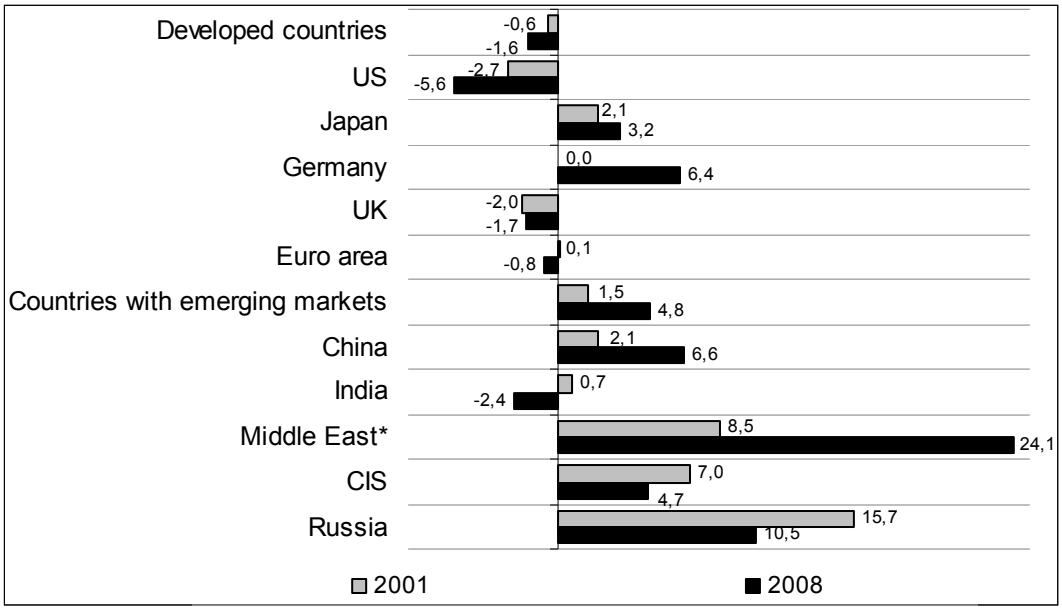
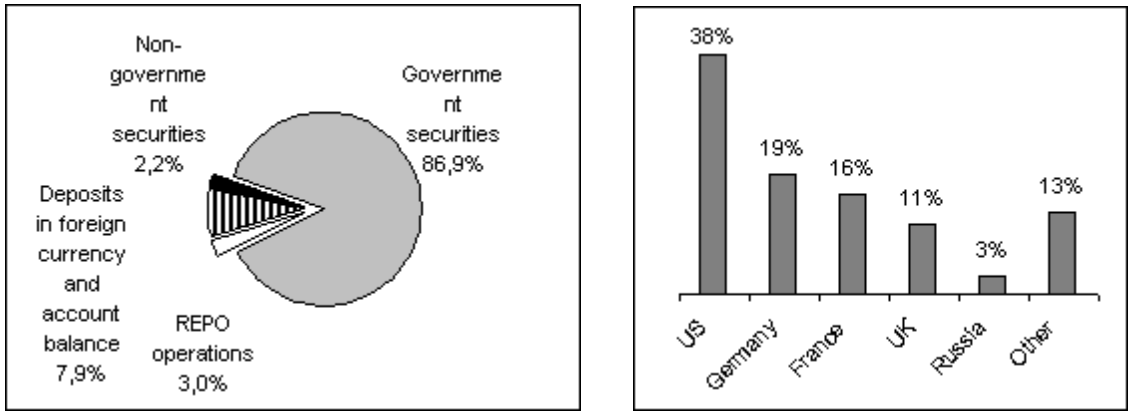


Fig. 1.26. Difference between savings and investments (% of GDP)

* Iran, Kuwait, Libya, Oman, Qatar, Saudi Arabia, Yemen.
Source: based on data from BIS, 2009.

Russia is among the countries where savings exceed investments, which potentially makes Russia a source of financial resources for deficit countries (we know that in practice some of our financial resources in both specialized funds—the Stabilization Fund and others ones—and international reserves were invested in US treasury bonds and instruments of other countries, which helped finance their deficits) (Fig. 1.27).



a) by instruments type **b) by countries**

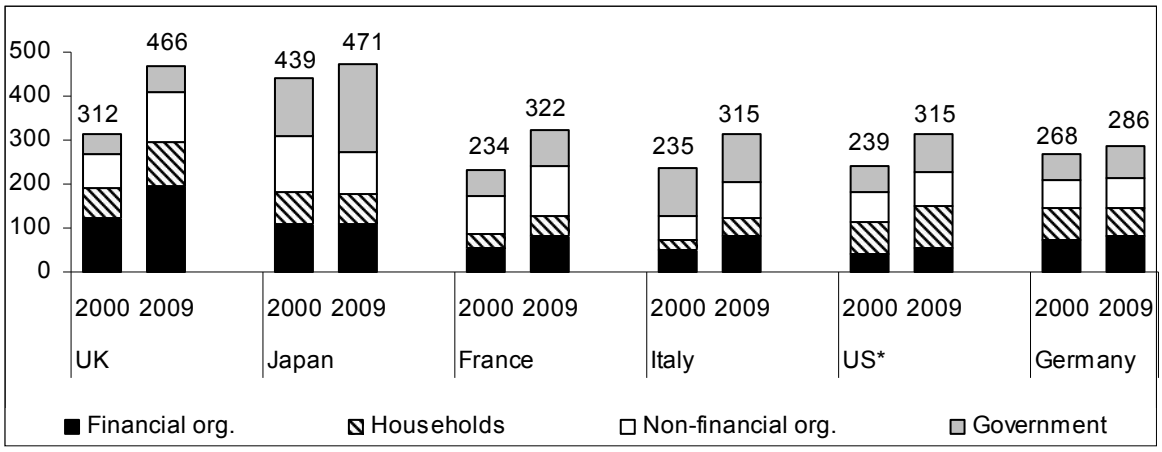
Fig. 1.27. Distribution of currency reserves of the Bank of Russia by instruments and countries (as of 31.03.2010, %)

Source: Bank of Russia, 2010.

As is known, the principal debtor is the United States, making the issue of financing extremely important for them. Resources inflowing in this connection from countries with

surplus savings put, inter alia, downward pressure on interest rates (which, as we remember, have generally remained at a quite low level in the United States over a period of years). This decreases transaction profitability for financial market participants, who have to, firstly, turn attention to more risky and, as a consequence, higher-yield instruments and, secondly, use tools that unreasonably expand their balance sheets, increase leverage, making them less stable and increasing compression risks on the whole.

It is also important to bear in mind that leverage of the financial sector can be observed alongside with a large-scale debt of the public and private sectors. The volume of debt substantially increased in the 2000s (Fig. 1.28).



* Net of ABSs. Factoring in ABSs, the ratio between the total debt and GDP in 2009 was 350–360%.

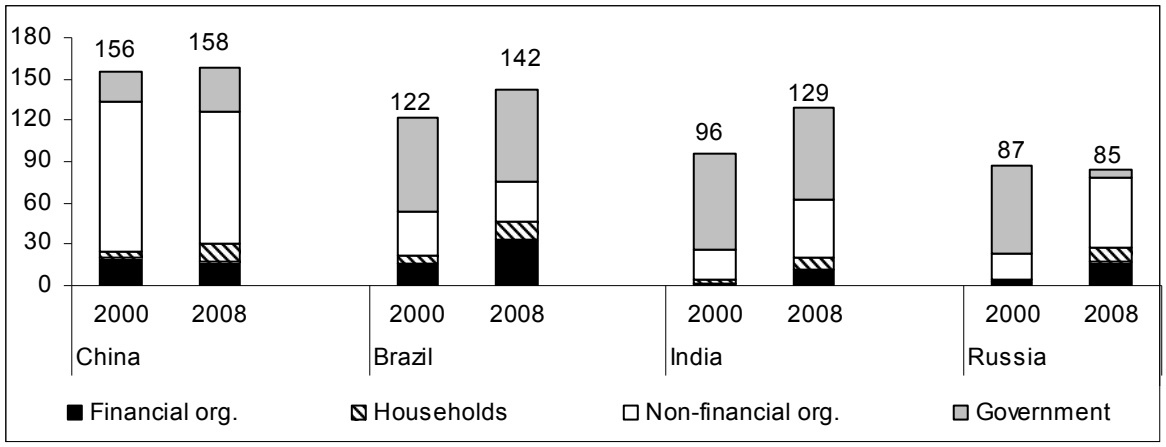


Fig. 1.28. Debt to GDP Ratio (%)

Source: calculated using data from the Bank of Russia, Ministry of Finance of the Russian Federation, Federal Treasury of Russia, Rosstat; Haver Analytics; McKinsey Global Institute.

It is noteworthy that that the problems of expanding of balance sheets and the conceptually incorrect behavior in the market were important factors that aggravated the crisis. According to official conclusions "subjective" factor played an important role in the crisis. By FCIC estimates “this financial crisis was avoidable. The crisis was the result of human action

and inaction"[13]. Subjective problems only enhanced the effect of objective factors, which not only remain unsolved, but the attempts made to alleviate the problems resulted in the emergence of new additional risks. This makes the situation extremely unstable both - in the long term and in the medium term, with the remaining risk of new aggravation in the future.

The decrease in leverage of financial institutions is fraught with the risks of their balance sheets collapsing and economic recession.

The decrease in leverage of financial institutions is fraught with the risks of their balance sheets collapsing and economic recession.

Given the extent of the problems, it is also very likely that the issue of decreasing the leverage of the private sector would inevitably be solved **by increasing the public sector leverage**. In other words, the private debt may transform into a public debt (which is extremely large as it is), and will retain the acuteness of debt problems for the global economy, turning these problems into a long-term source of crisis risks.

The private debt may transform into a public debt (which is extremely large as it is), which will retain the acuteness of debt problems for the global economy, turning these problems into a long-term source of crisis risks.

[13] Financial Crisis Inquiry Report. Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States. January 2011.

2

ABOUT THE THREATS IN BANKS' BALANCE SHEETS AND ABOUT THE CRISIS DEVELOPMENT AT THE MICROLEVEL

The first alarming signs indicating an accumulation of risks could be observed as early as the summer of 2007, when the large "sub-prime creditors" New Century and NovaStar announced their problems. Later, there arose some problems with the UK bank Northern Rock, which required taking measures to actually nationalize it. However, those were single cases.

A year later, crisis problems already became systemic. In the summer of 2008, shares of the US mortgage agencies Fannie Mae and Freddie Mac, which were the basis of the US mortgage market, demonstrated a decrease of more than 30% in a period of a few days. Given that these entities (supported by the government) accounted for about USD 5 trillion worth of mortgage credit, or almost 50% of the entire US mortgage market, there immediately arose the issue of providing emergency assistance to them. As the decline continued, in September the US Treasury Department and the FRS launched a program of measures to establish public control over these agencies. This caused their further downfall, by more than 80%.

The US investment bank Bear Stearns, who failed to overcome its critical situation, was bought by the large bank JPMorgan Chase with the assistance of the US FRS. Another large US bank, Lehman Brothers, started to experience major problems—its shares fell by nearly 50% in one day—and eventually it had to declare its bankruptcy. Also in September, one of the largest US investment banks Merrill Lynch announced that it was in a critical situation, which eventually resulted in its purchase by the Bank of America.

The problem spread to the insurance sector—one of the largest insurance companies, AIG, was faced with serious problems. The US FRS accommodated it with a loan of USD 85 billion, yet this stop the fall of AIG shares and on the following day they fell by nearly 70%. Taking into consideration that the loan was secured by about 80% of AIG shares, one may actually speak about the company's passing into public ownership.

Later in this stage of the crisis, the two remaining investment bank—Morgan Stanley and Goldman Sachs—came under control of the FRS as banking holding companies and actually lost their investment bank status (this was announced on September 22, 2008). This is expected to

increase their ability to attract additional resources, inter alia by gaining access to FRS liquidity instruments ("discount window", etc.), and will also enable them to expand operations in dealing with individuals' funds (although to some extent they dealt with deposit operations even before the above-mentioned measures were taken).

This meant that the US investment bank system terminated its existence in its previous form.

The US investment bank system terminated its existence in its previous form.

In this connection, however, one may not exclude the possibility of emerging of **new risks**, when the US financial system actually revives the pre-Great Depression architecture that allowed combination of investment and commercial banking activities by one company.[14]

However, it is possible that new sources of risks may form.

Serious problem emerged in the US and European interbank credit markets, when banks sharply reduced lending operations due to potential loan defaults. Similar trends could be observed in other countries (including Russia). As is always the case amid crises, many banks started to prefer cash resources to form a kind of "strength reserve," which even more aggravated the shortage of available funds in the market.

Following US commercial banks, European banks started to experience problems. Fortis, Hypo Real Estate, Bradford&Bingley and some other financial institutions in the UK, Benelux countries, and Germany were either partially nationalized or provided with large-scale state aid. To activate the inter-bank market, more than USD 1.8 trillion was allocated to some leading European countries.

In other words, evident is the strengthening of the trend (that became obvious in early 2008) leading to a **substantial rearrangement of the corporate structure** of, primarily, the US financial market and, as a consequence, the global financial market as a whole. In this connection, also obvious is a sharp increase of state participation in the modern economy at both the national level and the cross-border one (as is the case with sovereign funds' investments). The topical issue that has become part of the present-day agenda is efficient functioning of the

[14] As this combination created high risks, including ones for individuals, shortly after the 1929–1933 crisis they enacted the Glass–Steagall Act, which separated the activities by commercial and investment banks. Even though the situation stabilized later on, the restriction remained in force until the late 1990s, and only after some time, with certain exemptions (associated with the remaining force of other related legal acts), this act was replaced by the Gramm–Leach–Bliley Act, which provided for a wider combination of investment and commercial banking operations.

new version of the old formation - of state capitalism, which has developed in the post-crisis period.

> The topical issue that has become part of the present-day agenda is efficient functioning of the new version of the old formation - of state capitalism, which has developed in the post-crisis period**.**

The inevitability of property redistribution caused by the crisis became especially obvious when there had emerged more detailed data about the extent of downfall of some companies (Fig. 2.1). Firstly, it became clear that it was time for investors to buy, as assets had never been so cheap. Secondly, already at the systemic geoeconomic level, one could say with a great probability that a global redistribution of property was about to happen and that deeper interests and centers of force were behind the fall of share prices.

> At the systemic geoeconomic level, one could say with a great probability that a global redistribution of property was about to happen and that deeper interests and centers of force were behind the fall of share prices.

As a result of these changes, the "explicit" and "implicit" economic picture of the world may become quite different in the foreseeable future.

In this connection, one should bear in mind the possibility of a more systemic geopolitical agenda related to current developments. This agenda may imply geomechanisms of "comprehensive cleaning" of the global economic area; change the balance of forces of explicit and implicit centers of influence, and rearranging the economic (for a start) map of the world.

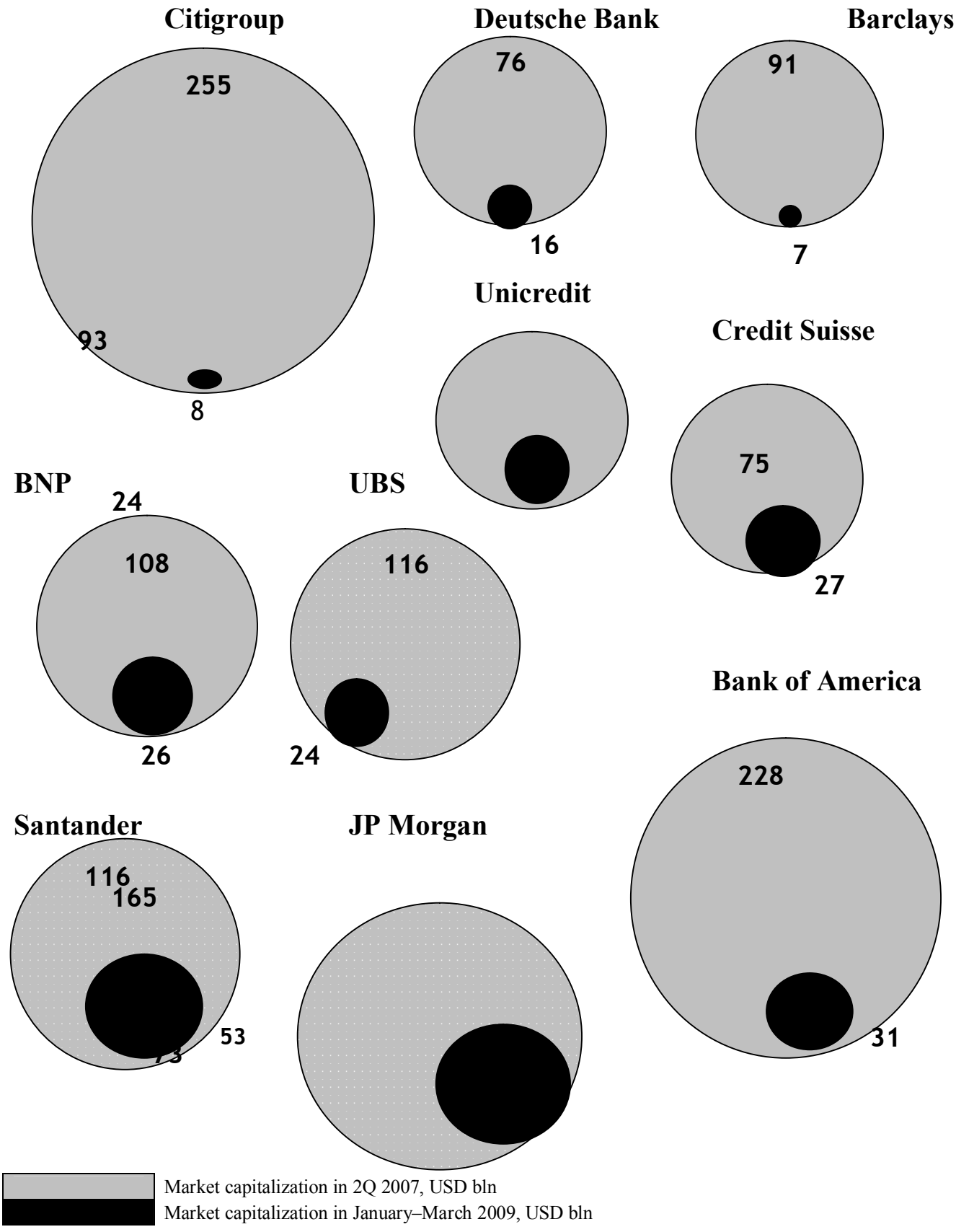


Fig. 2.1. Decrease of capitalization of the largest banks

Source: data from moneycentral.msn.com

And finally, one more aspect (of both technical and systemic nature) meant that large-scale bankruptcies and a paralysis of the entire financial system would be inevitable unless adequate financing was provided for balance sheets. The scope of compression of balance sheets and a potential decrease in leverage ("deleveraging"), with the multiplier ranging within 10 (for commercial banks) to 30 and higher (for former investment banks and hedge funds), made provision of liquidity a matter of survival for both specific companies and the economy as a whole.

About leverage

The pursuit of higher profitability from transactions caused many commercial and investment banks to intensively increase their investments on the basis of the same amount of own funds (equity capital). Additional funding required to buy new assets was, as a rule, gained using money market mechanisms, making it possible to attract necessary means funds. Considering that this process, firstly, was a large-scale one and, secondly, resulted in considerable and unreasonable imbalances in the balance sheets of relevant institutions, this phenomenon significantly aggravated the crisis development.

On the whole, for different groups of financial institutions, leverage showing the asset/equity ratio equaled on average 7–10, depending on types of transactions and types of activities (for hedge funds and investment banks, it was often about 20 and sometimes about 30)[15].

In this connection, taking into consideration off-balance-sheet transactions, leverage for most financial institutions was considerably higher, in some cases being 50–70 (Figure 2.2). In addition, off-balance-sheet transactions sometimes exceeded balance sheets themselves. So, according to estimates, in 2006 Citigroup's off-balance-sheet transactions reached about USD 2 trillion, whereas the balance sheet itself was only USD 1.8 trillion[16].

The aggregated leverage of the mortgage agencies Fannie Mae and Freddie Mac was about 75 (FCIC, Jan. 2011).

[15] This determination features, inter alia, in the materials of the hearings concerning the bankruptcy of Lehman Brothers at the US Bankruptcy Court, NY, March 11, 2010. Sometimes, leverage is defined in a different way, as the equity/assets ratio, making it similar to the N1 ratio used in the Russian banking practice and based on the Basel Principles (see inter alia the laws on the US fiscal reform HR 4173).
[16] IMF.

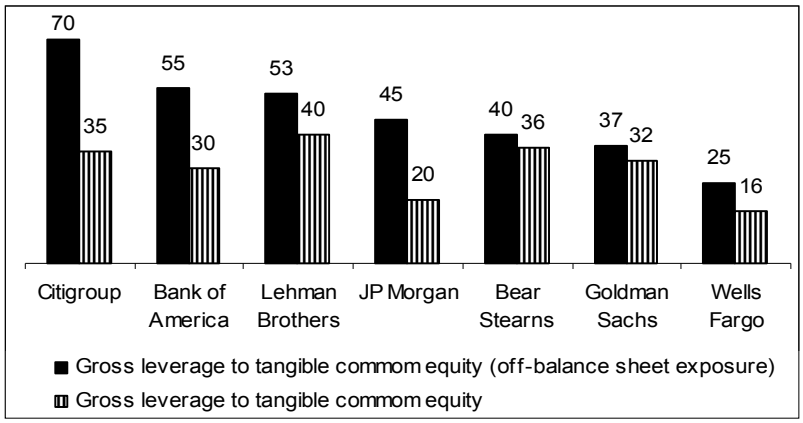


Fig. 2.2. Leverage of the leading US banks in late 2007

Source: FCIC, Jan. 2010.

On the whole, for different groups of financial institutions, the roles of off-balance-sheet transactions were different, while this role for institutions supporting the mortgage market was maximal (Figure 2.3).

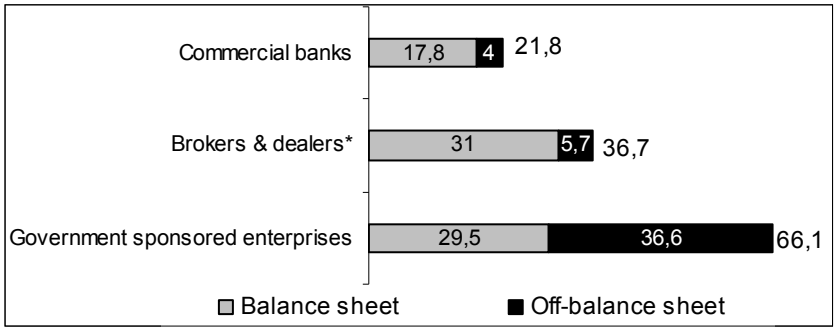


Fig. 2.3. Leverage of different financial intermediaries in US (2006)

** weighted average for the 5 largest broker dealers: Bear Stearns, Goldman Sachs, Lehman Brothers, Merill Lynch, and Morgan Stanley.

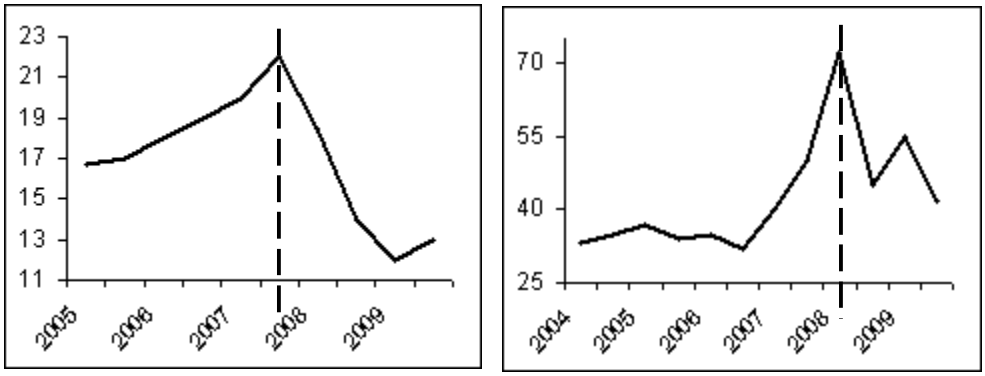
Source: FDIC; SEC; McKinsey.

At the US Financial Crisis Inquiry Commission's hearings dedicated to the causes of the crisis, the Bank of America President reasonably said that it was difficult to understand "how markets and regulators could tolerate leverage of 40-1 or even 60-1 in our largest investment banks"[17].

The fastest growth in leverage fell on the second half of the 2000s, when derivative instruments started to be traded extensively (Fig. 2.4).

It is noteworthy that this indicator grew very fast with foreign participants.

[17] B.T.Moynihan, Chief Executive Officer and President, Bank of America. Testimony to FCIC, Washington, D.C. January 13, 2010. P. 10.



a) Domestic dealers **b) Foreign dealers**

Fig. 2.4. Leverage of domestic and foreign dealers

Source: Federal Reserve Bank of New York, Staff Report, March 2010.

According to estimates by the FRS, "each of the peaks in leverage is associated with the onset of a financial crisis"[18].

> According to estimates by the FRS, "a marked increase in leverage usually precedes a financial crisis."

In addition, the risks and imbalances that arose as the market was growing were largely obvious to regulators. In one of her reports made back in 1998, US Commodity Futures Trading Commission Chairperson B. Born point at the risks that had emerged in that period in connection with the problems experienced by LTCM (Long-Term Capital Management), including those associated to operations involving derivative instruments. It was noted that the then - market regulation enabled the company to attract financing reaching USD 125 billion, which exceeded its capital 100-fold**!**

> The market regulation enabled the company to attract financing reaching USD 125 billion, which exceeded its capital 100-fold**!**

The proceeds then were used to open positions in derivatives for a par value of USD 1.25 trln or 1,000 (**!!!**) times the size of the capital[19].

A similar scenario was recorded in other areas. The capital of insurers dealing with certain risks inherent to certain operations (such as, insurance against default on specific stock)

[18] Federal Reserve Bank of New York, Staff Reports, Jan. 2009. P. 8.
[19] B.Born. "Regulatory Responses to risks in the OTC derivatives market", November 13, 1998, p. 3.

was estimated to be almost 100 times less than the amount of assets insured. It is obvious that such situation inherently carried the risk of default by the insurer itself in a crisis[20].

The use of the leverage has another instrumental aspect of not simply technical, but systemic nature, giving the whole issue a geoeconomic and even geopolitical turn. Namely, with such ratios between equity and borrowings, the major part of the market risked becoming controlled by a small group of persons operating relatively small assets. The hearings held by the Financial Crisis Inquiry Commission (FCIC) underlined that such approaches allowed a small group of investors to actually set prices for assets, making these investors capable of getting hold of enormous assets[21].

Such approaches allowed a small group of investors to actually set prices for assets making these investors capable of getting hold of enormous assets.

In the crisis environment, the multiplied asset expansion gives way to an opposite tendency - when liquidity shrinks at a "multiplier rate" of contraction thereby enhancing the overall deleverage effect.

While the deleverage ratio was 2x to 2.5x in average for bank holdings, it was around 4x for brokers and dealers.

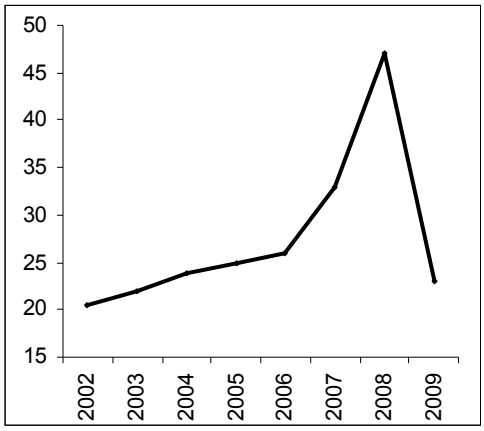


Fig. 2.5. Leverage of Top 10 US Bank Groups

Source: Federal Reserve Bank of Kansas City.

[20] IMF.
[21] FCIC hearings.

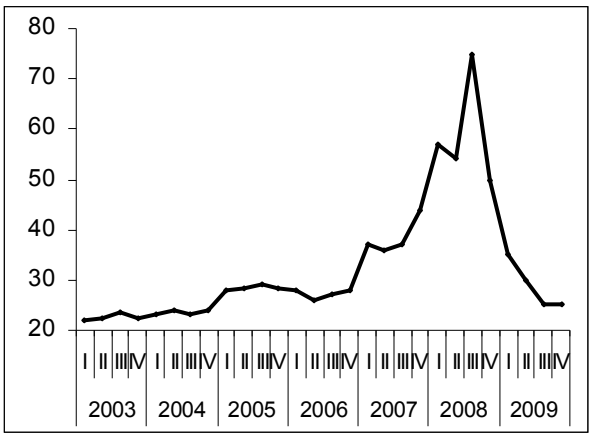


Fig. 2.6. Leverage of US Brokers and Dealers

Source: Federal Reserve Bank of Kansas City.

We would remind that the assets to capital ratio may, as mentioned before, be from 30x to 50 x (and higher); as a consequence, the liquidity will also be shrinking at a respective contraction rate just to enhance the overall liquidity shrinkage effect.

This effect may prove to be even more pronounced for the economy on the whole due to the multiplier effect from expansion of high-powered money turning into a respective monetary base. The multiplier differs by country; in particular, it currently reaches around 8x to 9x in the US. Reduction or withdrawal of money will result in a "demultiplier" effect enhancing the overall liquidity shrinkage in the economy.

The effect and respective neutralization measures vary for specific market players.

For investment banks, the practice of mark-to-market loss recognition will mean that they will need to be reflected in the balance sheet resulting in respective asset decrease. Meanwhile, the sale of assets required to adjust the balance sheet will bring about further decrease of prices for the assets and will increase the amount of losses and write-offs once more (i.e. resulting in a self-boosting tendency, snowball-effect of a kind). Drastic measures such as sale of the 'crisis bank' (as in the case of Bear Stearns) are oftentimes required to avoid such scenarios. The decision to give investment banks access to the FRS refinancing ('discount window') was also due to the need to ensure liquidity for them.

Commercial banks (whose average leverage is around 10x to 15x) have relatively much more time to strengthen their balance sheets and liquidity as they only write off in the event of default (e.g. on commercial loans) and before it happens they will be recognizing assets at their face value. Understanding that, at the end of the day, they will still have either to reduce their capital, or issue shares, or sell assets (not an easy task in a collapsing market), commercial banks are trying to expand the range of their debt sources to the maximum.

At the same time, they considerably alter the structure of loans and investments in third-world markets. "In the process of deleveraging, advanced country banks started drastically reducing their exposure to emerging markets, closing credit lines and repatriating funds."[22]

In their analysis of the issue, G20 experts concluded that the "significant foreign bank presence within many EMEs, particularly in Europe and Latin America, raises a further potential source of contagion during periods of financial stress. The parent bank may restrict lending in …international operations or repatriate capital"[23]. They conclude that "the need to restructure balance sheets in the home country may have some protracted effects on the availability of credit from foreign banks"[24].

Given that most CEE countries record a considerable share of liabilities to foreign banks (Fig. 2.7), the issue requires thorough monitoring.

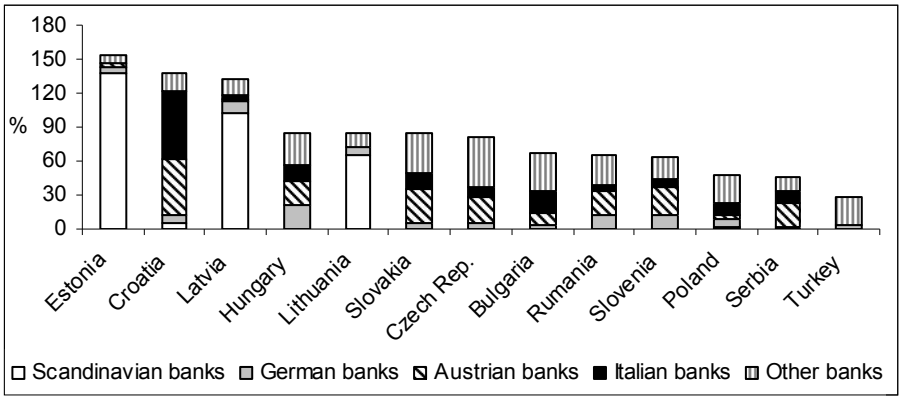


Fig. 2.7. Liabilities to Foreign Banks as of Q2 2007 (% of GDP)

Source: IMF, April 2008.

Note that expected losses of major banks were often undervalued, while experts estimate that actual losses might have been notably higher.

[22] IMF. O. Blanchard. The crisis: Basic Mechanisms, and Appropriate Policies. IMF. P.19.
[23] G-20 Study Group on Global credit Market Disruptions, Paper Prepared by Australia, 30 October 2008. P. 29.
[24] Idem.

	Reported loss expectation (total implied loss)	Estimated loan losses			
		SCAP prediction	Citigroup report	Citadel report	Goldman Sachs report
Bank of America	47.7	104.1	83.8	148.4 - 203.7	93.4
Citigroup	47.8	79.4	N/A	102.6 - 137.4	71.0
JP Morgan	44.8	79.3	111.9	113.6 - 154.4	73.6
Wells Fargo	35.1	74.3	51.5	124.9 - 173.4	77.3

Table 2.1. Loan loss estimates implied by reported fair values vs. external estimates (USD bln)

Source: NBER, Nov. 2009.

Accumulated losses of individual banks often reach significant levels (Fig. 2.8) and, unless their capital grows, balance sheets of such banks might considerably shrink.

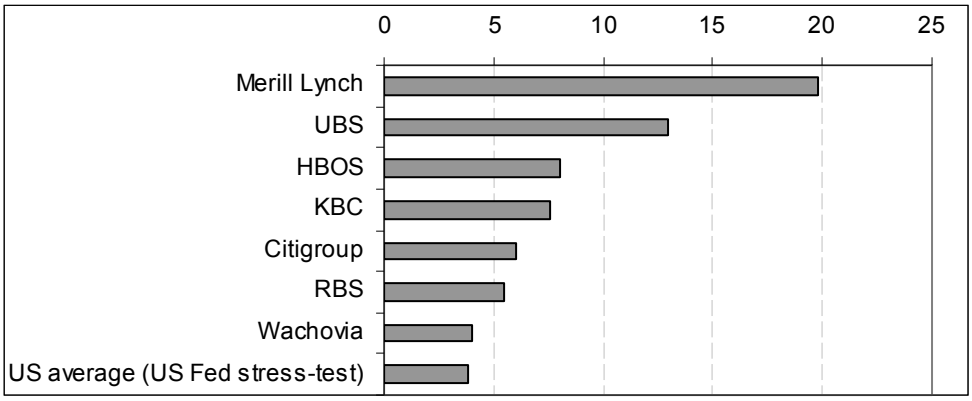


Fig. 2.8. Maximum accumulated bank losses (% of risk weighted assets, 2006 – early 2010)

Source: The Economist, Jan. 2010

In the line of forecasts, many attempts to assess outlooks of global financial market developments actually failed. When speaking at the hearings on the financial crisis in the US Congress, A. Greenspan admitted that the crisis made people take a different look at many things and reassess them. He also (as a sort of justification) noted that robust models were created to forecast similar events and some authors were even Noble Prizes. However, the models failed to foresee such course of events. "The whole intellectual edifice collapsed ... because the data inputted into the risk management models generally covered the past two decades, a period of euphoria."[25]

[25] A.Greenspan. Statement during Committee Hearings on the Financial Crisis and the Role of Federal Regulators, US House of Representatives. Oct. 23, 2008.

Let us ask a couple of questions in this regard. For instance, who needs models that fail to achieve the key objectives for which they were created? True, now they say that risk assessment models had poor rationale since such complex systems cannot be perceived in all details (as mentioned, in particular, by Noble Prize winner E. Phelps). Indeed, it is difficult to deal with so rapidly evolving mechanisms and tools. But constraining oneself to mere extrapolation of trends observed (even though having appearance of "scientific models" often hard to understand even for experts) is hardly what is needed by modern economic systems to assess development prospects. Furthermore, such approaches do not require in-depth perception of the fundamental essence of the course of events, and actual facts clearly prove this.

The very fact that the downside scenarios have not been considered as realistic alternative show that the economic science and business **are losing their ability to get a realistic grasp of what is really happening** and that global corporate interests (and ensuing profit-making objectives) are unready to adopt more balanced business strategies not so profitable in the shorter run.

If really so, then both issues are really deplorable since they assume a too 'short-sighted' approach by the respective participants (although multiple examples show that exactly this is often the case).

One more question, just as troublesome... What is the actual quality of highest economic awards which are given today? The reality is that the awards are given to authors of non-performing models, and the 'expert board' is unable to assess what these models are really worth, and it becomes apparent only when the real life "dots all the i's".

Why have models that fail to achieve the key objectives they were created to achieve?

What is the actual quality of highest economic awards which are given today? The reality is that the awards are given to authors of non-performing models, and the 'expert board' is unable to assess what these models are really worth, and it becomes apparent only when the real life "dots all the i's".

About Sovereign Funds

Immediately after the crisis, everybody focused on sovereign funds as liquidity sources. Investments from such sources acquired a notable share in the capital of major banks. (Fig. 2.9).

There were also talks about the outlooks of creating a sovereign fund during the visit of the US Finance Secretary Polson to Moscow (June 2008), which is an indirect proof that the 'domestic view' of the situation in the US market did not inspire confidence and drove the quest for new liquidity sources on and on.

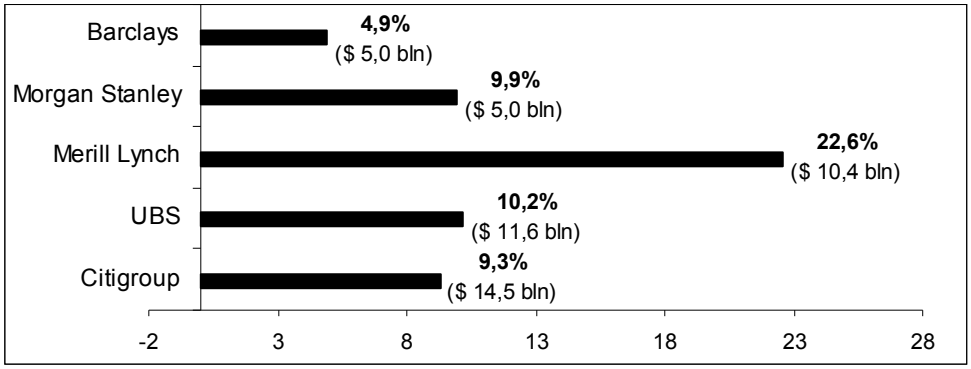


Fig. 2.9. Share of investments of sovereign funds in companies' stock in 2007 – Q12008 (%, USD bln)

Source: ECB, July 2008.

However, along with voices supporting the 'economic expediency' of such funding, concerns of political nature also became heard, since the financial industry has a strategic importance - a factor to be reckoned with.

Therefore, if the above trend continues developing, in the foreseeable future, this trend might bring about fundamental changes in geoeconomic and geopolitical line, shaping the new corporate and economic global landscape (by enhancing, at the micro level, already perceptible trends of newly emerging economic powerhouses, a higher role for BRIC countries, and so on).

We are already witnessing "sectoral" implications of the crisis when all investment banks of the US ceased to exist in their previous form.

The issues of seeking for new investors and funding sources will also have a geopolitical side. Many major financial companies and banks historically forming an instrumental element in the national economy and serving as the cornerstone of the economic and political system may already focus on other priorities reflecting the position of new foreign shareholders. Oftentimes, the investments may come from countries whose approaches to a broad range of geopolitical issues may considerably diverge from the approaches of the home country on the whole (or resources may even come from sources of 'unidentified origin'). As a consequence, operations of sovereign funds immediately sparked suspicions and draw high attention of regulators.

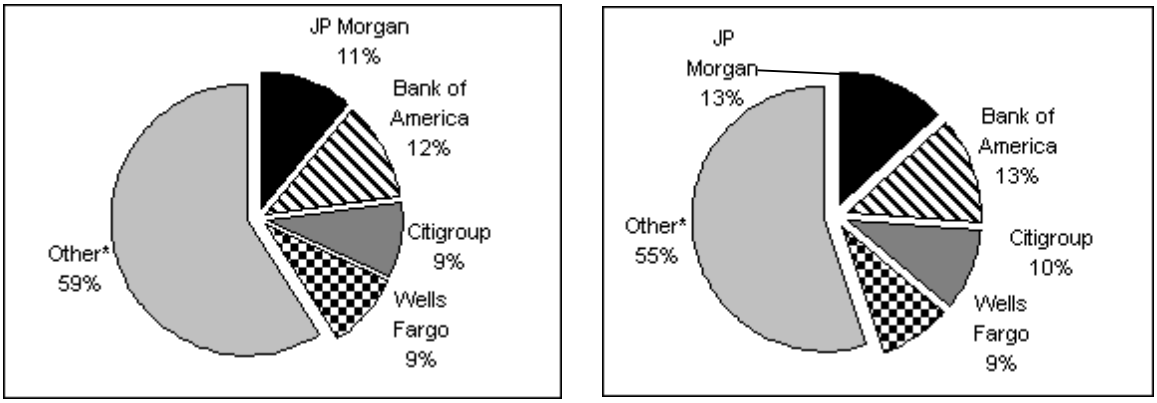
When analyzing the current crisis in 2008, we wrote:

"The gravity of the current crisis raises the issue of survival of the financial system as it is, with the maximum range of sources and tools available mobilized to support the system (despite the poorer quality of incoming capital, and with allowance for all its geoeconomic

encumbrances attached). At the same time, its control and consolidation in new circumstances will require considerable expansion and tightening of regulatory approaches. This measure is due to the need, first, to correct the faults and errors in the financial market; second, to follow up issues related to the stronger role of the cross-border factor (with all ensuing geopolitical risks); and, third, to build a more consistent system of uniform approaches on the bank of the growing segmentation of the financial market itself and diversification of its tools."[26]

Note that the high level of concentration (from both - asset and fund raising standpoints) observed in the US financial market **made the arising issues systemic.**

The high level of concentration (from both - asset standpoint and fund raising standpoint)
observed in the US financial market **made the arising issues systemic.**



a) Deposit Concentration **b) Asset Concentration**

Fig. 2.10. Concentration of deposits and assets in the US (%)

* 8,095 banks.

Source: FCIC, Jan. 2010.

Most major banks actively used derivatives that served as one of the 'catalysts' for the crisis (Fig. 2.11). It is clear that the large-scale use of derivatives by major players dominating in the market made the issues arising with such instruments systemic only to increase the overall crisis effect.

[26] M. Ershov. Crisis of 2008: The 'Moment of Truth' for the Global Economy and New Opportunities for Russia //Voprosy ekonomiki [Economic Issues]. No.12, 2008. Pp. 12-13.

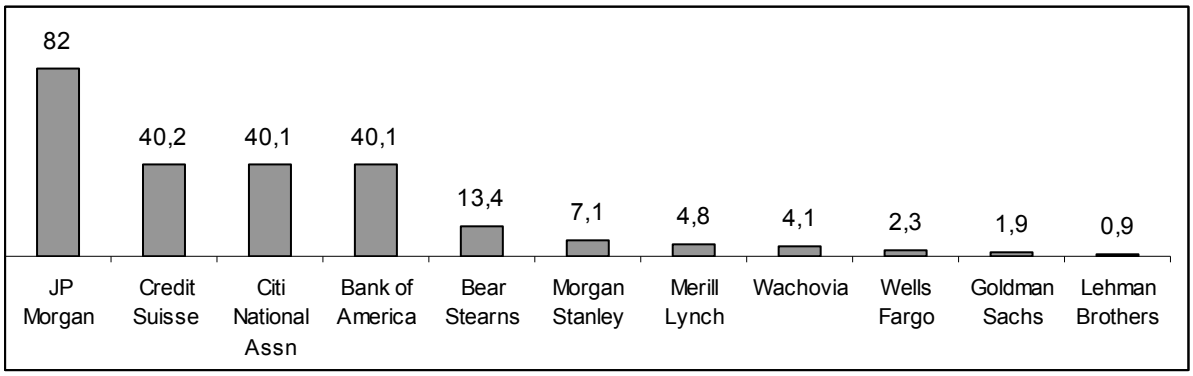


Fig. 2.11. OTC Derivatives of some banks (Late March 2008, USD trln)

Source: IMF, March 2008.

In this case, the banks aggravated the issue by placing assets on a long term basis and then funding them on a short-term, often intraday, basis. This situation actually meant that any risks emerging in the market would immediately affect the balance sheets of the banks and aggravate the funding issue for them.

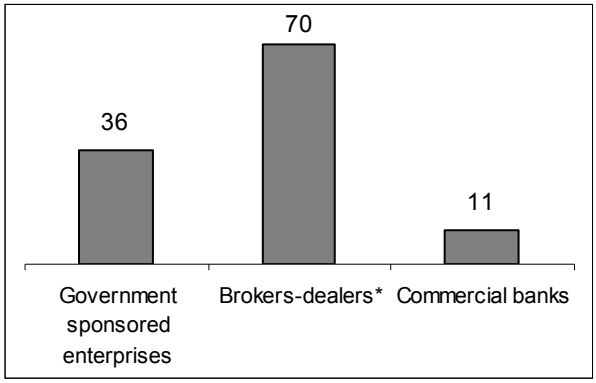


Fig. 2.12. US: The Short-Term Financing Share[27] in Assets of Financial Intermediaries (2006, %)

* av. weighted for 5 major broker dealers: Bear Stearns, Goldman Sachs, Lehman Brothers, Merill Lynch, Morgan Stanley.

Source: FDIC; SEC; McKinsey.

Meanwhile, US financial majors also actively used repo instruments to raise necessary funding. The Figure below shows how important the share of repo transactions (as a source of short-term funding) was in the banks' liabilities.

[27] including repo, funds raised in the money market, other short-term borrowings, and the current position in terms of long-term liabilities.

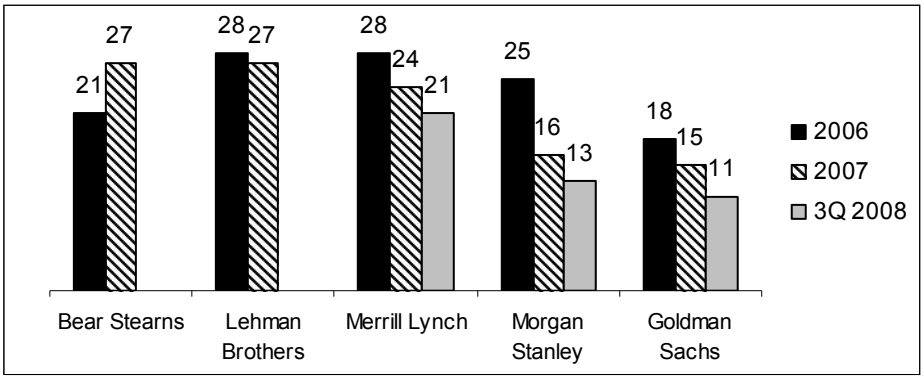


Fig. 2.13. Share of repo transactions in banks' liabilities (%)

Source: World Economic Forum, 2009.

In addition to mismatching maturities of assets and liabilities and strong exposure to short-term funding, another drawback of the situation was that **repo transactions were often secured with other trading assets.**

This situation implied, however, that if the market lost confidence in such assets, the financing was stopped, pledges were to be replaced with more secure ones, and the assets themselves (that did not inspire confidence any longer) were to be sold (at a significant discount implying higher losses). Issues with margin calls emerged as a result. All this became even more perceptible when the market in many instruments used either stopped, or dwindled to the minimum.

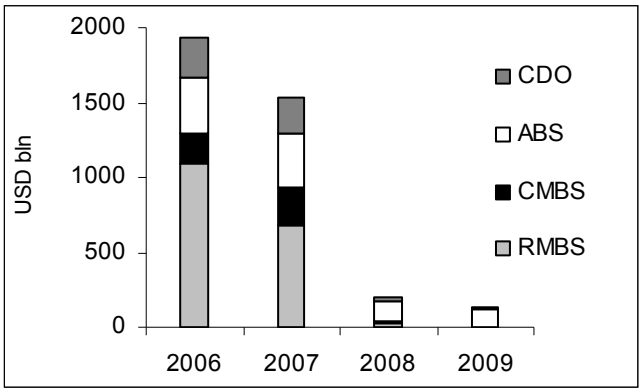


Fig. 2.14. US: bonds issuance (USD bln)

Source: FCIC, Jan. 2010.

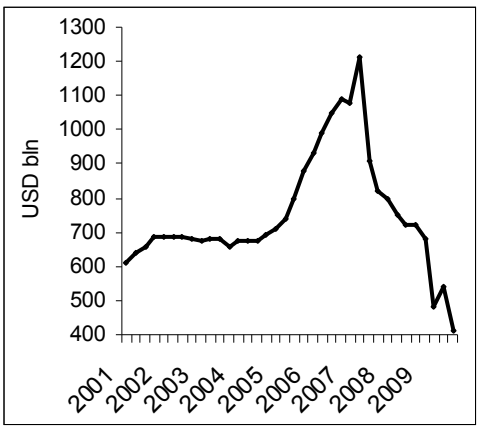


Fig. 2.15. Asset Backed Securities (USD bln)

Source: Fed of New York, April 2010.

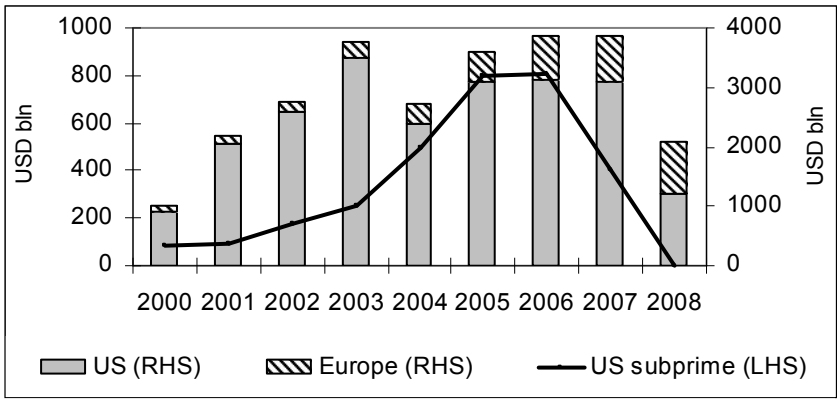


Fig. 2.16. Size of asset backed securities issues (USD bln)

Source: BIS, 2009.

Note that many of the instruments mentioned above are classified in the balance sheet as 'traded assets' and as 'other securities'. These categories account for a considerable share of assets of both investment banks and commercial banks (Table 2.2).

Consolidated examples of balance sheet structures of investment banks and bank groups shed some light on the nature of operations and specific parameters of their market strategies.

Large bank holdings companies		Large investment banks	
Trading assets	12.2	Trading assets	33.3
Other securities	14.7	Collateralized agreements	39.5
Loans and leases	47.3	Receivables	12.2
Repo agreements	10.4	Securities received as collateral	2.8
Other financial instruments	3.2	Other financial instruments	9.9
Other instruments	12.2	Other instruments	2.3
Total Assets	100	Total Assets	100

Table 2.2. Key assets on US banks' balance sheets* (%)

* averages (weighted) over the year-end amounts from 2004 to 2006 for various bank assets. Large bank holding companies include banks with total assets greater than USD 100 bln (27 banks). Large investment banks include Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, Bear Stearns.

Source: NBER, Nov. 2009

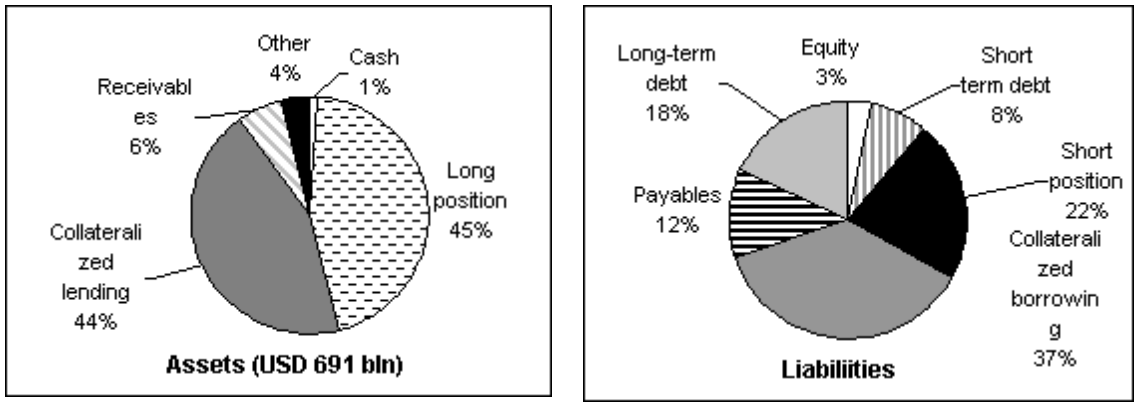
It is also rewarding to examine the situation with the balance sheets of the two 'most crisis-affected' banks, Bear Stearns and Lehman Brothers, in more detail. Even in the most general form their balance sheets showed some details which worth attention.

In particular, we would point out the considerable share of 'accounts payable' in the liabilities, with deposits by customers of hedge funds accounting for a significant part thereof. Such deposits are demand deposits as a rule, and, therefore, represent the unstable part of liabilities and may be exposed to 'bank runs' and rapid withdrawal. Moreover, 'collateralized loans' that include money raised through 'repo' facilities that are very short (often 'overnight') to a large extent take a substantial share in liabilities. Thus, subject to 'short-term debt'[28], a significant part of liabilities in the balance sheet are short-term liabilities that increase its sensibility to market fluctuations. We would also note minor cash resources (in particular, in the case of Lehman Brothers) in the assets which complicated the maintenance of the overall liquidity level.

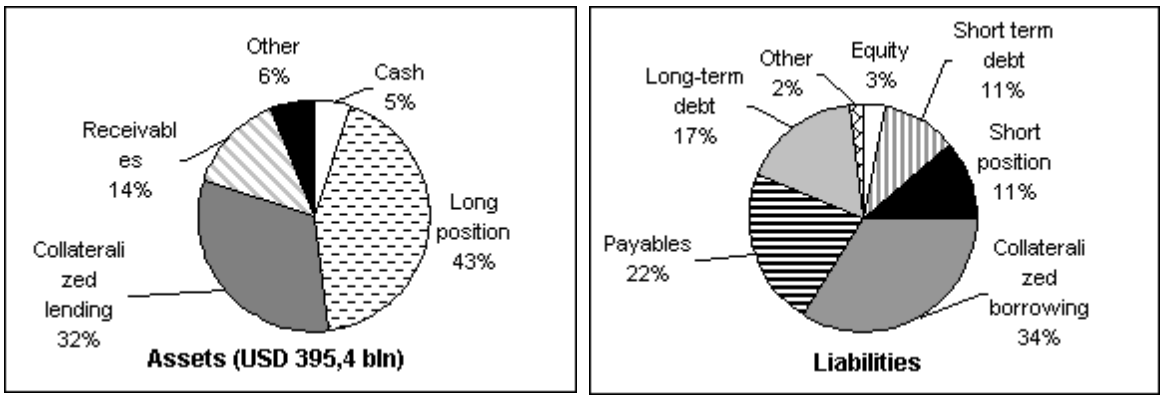
The necessary cash could partially be raised by selling liquid instruments from the assets; but we should bear in mind that such deals are complicated and often imply extra discounts in a collapsed market. Special schemes such as 'repo 105' and 'repo 108' were used to prevent losses from sale and avoid negative impact on the leverage. Such schemes allowed interpreting fund

[28] This category may include short-term funding sources of SPE related to the bank whose operations are to be recognized in the overall balance sheet on a consolidated basis

raising transactions as sale of assets and withdrawing them from the balance sheet for as long as was needed.[29]



Lehman Brothers



Bear Stearns

Fig. 2.17. Assets and liabilities of Bear Stearns and Lehman Brothers (end 2007, structure, %)

Source: Federal Reserve Bank of New York, 2008.

When the crisis pressure increased, many banks were prompted to significantly grow the share of cash in their assets that substantially exceeded average levels for a long period (Fig. 2.18-2.19).

[29] Report of A.R. Valukas, examiner. March 11, 2010. In re Lehman Brothers Holdings Inc., et al. US Bankruptcy Court Southern District of new York.

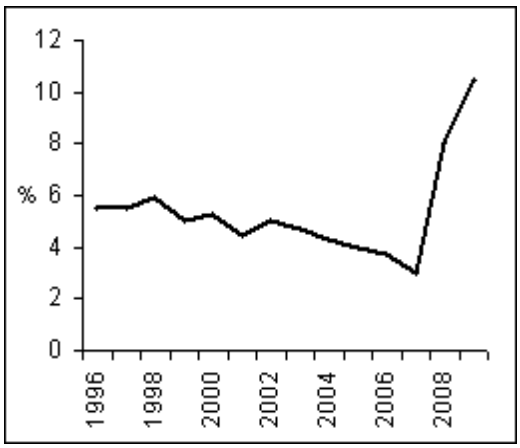


Fig. 2.18. Share of cash in assets of commercial banks (%)

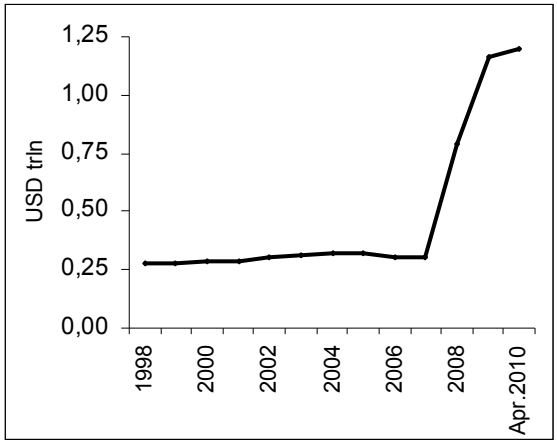


Fig. 2.19. Cash of banks (USD trln)

Source: US Fed.

At the macro-level, such step resulted in a notable growth of liquid instruments in the money market (Fig. 2.20).

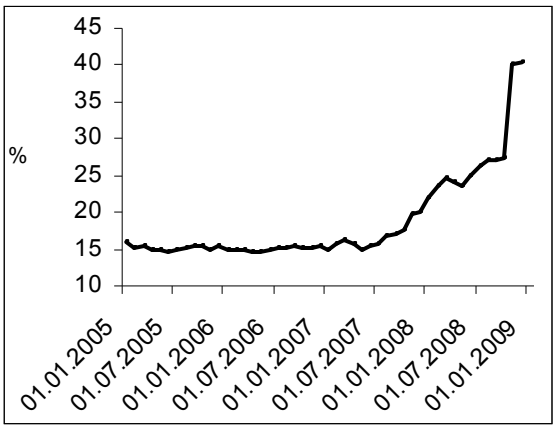


Fig. 2.20. Ratio of money market assets to stock market capitalization (2005-2008, %)

Source: Fidelity Investments, 2009.

The large-scale downfall or even shutdown of markets (as mentioned before) resulted in higher bank losses and had a negative impact on their performance on the whole. The size of provisions materially grew, while earnings, ROE and ROA went down.

	Profit before tax		Provisions	
	2006	2008	2006	2008
France (5)*	0.73	0.05	0.05	0.21
Germany (6)*	0.43	-0.41	0.05	0.19
Italy (5)*	1.05	0.29	0.25	0.42
Japan (13)*	0.46	0.12	0.04	0.19
Switzerland (6)*	0.8	-1.94	0	0.07
UK (9)*	0.9	-0.1	0.25	0.4
US (9)*	1.71	0.36	0.19	1.11

Table 2.3. Performance of major banks of some countries (% of total average assets)

* number of banks.

Source: BIS, 2009.

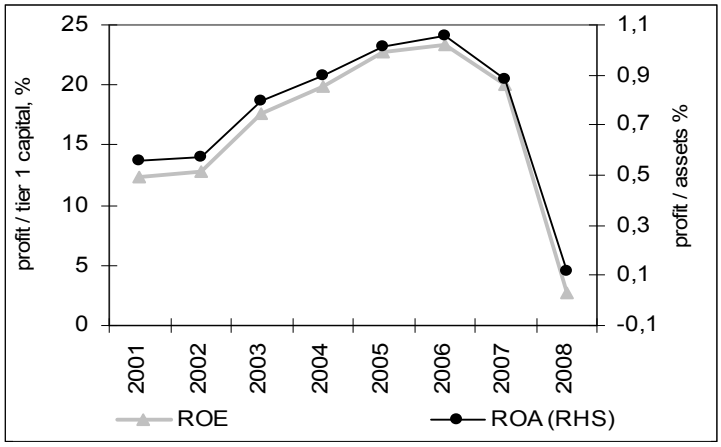


Fig. 2.21. ROE and ROA for all banks (%)

Source: The Banker, 2010.

As a result, even despite shrinking balance sheets of multiple banks (Fig. 2.22), their stock performance decreased so much (as we have already observed as of certain dates, see above) that their market capitalization went considerably below the book value of their equity.[30]

[30] book value of common shareholders equity.
Given that nominal losses of banks could often be restructured and diluted in the balance sheet appearing to be materially lower than actual losses included in the balance sheet, the ultimate ratios between market and book values may eventually be slightly adjusted towards increasing the market/book ratios.

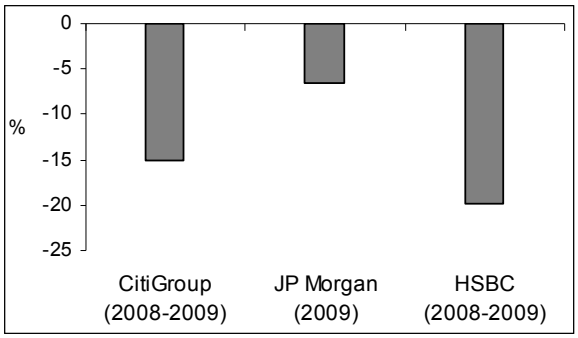


Fig. 2.22. Reduction of banks' balance sheets (%)

Source: US Fed National Information Center.

	Major Investment Banks	Major Bank Groups
2007	2.24	2.08
2008	1.53	1.42
2009	0.86	0.45

Table 2.4. Market-to-Book Ratio (Q1)

Source: NBER, Nov. 2009.

Subject to apparent and hidden 'menaces' contained in balance sheets of major financial institutions, the scale of losses already recorded in some countries has not attained even half of the potentially expected level yet (Fig. 2.23).

The scale of losses already recorded in some countries has not attained even half of the potentially expected level yet.

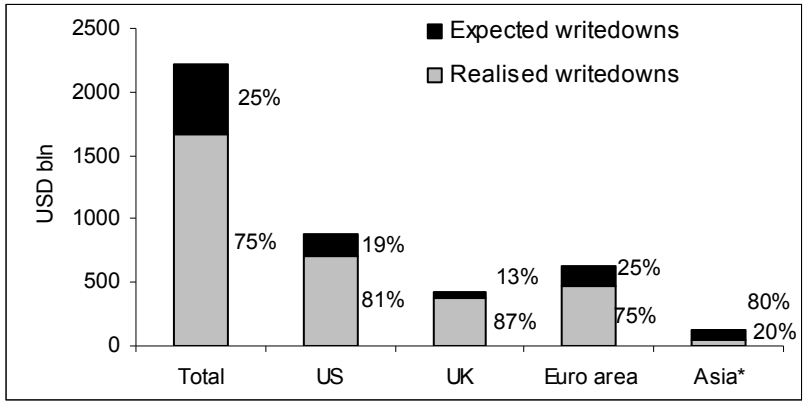


Fig. 2.23. Realized and Expected Writedowns of Banks (June 2009, USD bln)

* including Australia, Hong Kong, Japan, New Zealand, and Singapore.

Source: IMF, Oct. 2010.

This means that even if the overall situation does not worsen, problems of financial sector will still remain complicated due to growth of losses.

Even if the overall situation does not worsen, problems of financial sector will still remain complicated due to growth of losses.

If there are any ‘global deteriorations’ (various ‘second wave’ scenarios, new risk sources emerging, etc.), than the situation might look even more unstable.

Given the role played by financial structures in Western economies and their large scale losses, regulators focused all their attention in terms of providing aid to this sector.

3

SOME ANTI-CRISIS MEASURES

The scale and gravity of the recession forced the use of a broad range of anti-crisis measures. They varied from purely market instruments (such as interest rates) to tougher administrative tools such as direct budget support and even actual nationalization.

It is clear that international regulators and regulators of major countries, facing such large-scale challenges, adopted purely pragmatic approaches in handling the crisis, putting aside such ideological slogans as 'non-intervention of a state', 'vices of printing money', 'virtues of cutting budgetary expenses' and many others. What had previously been viewed as undisputable dogmas was replaced with common-sense rationale and practicality. Since then, all action was driven by the actual situation.

The scale of aid allocated by now has considerably surpassed the amount of support to national economies during previous recessions (Fig. 3.1).

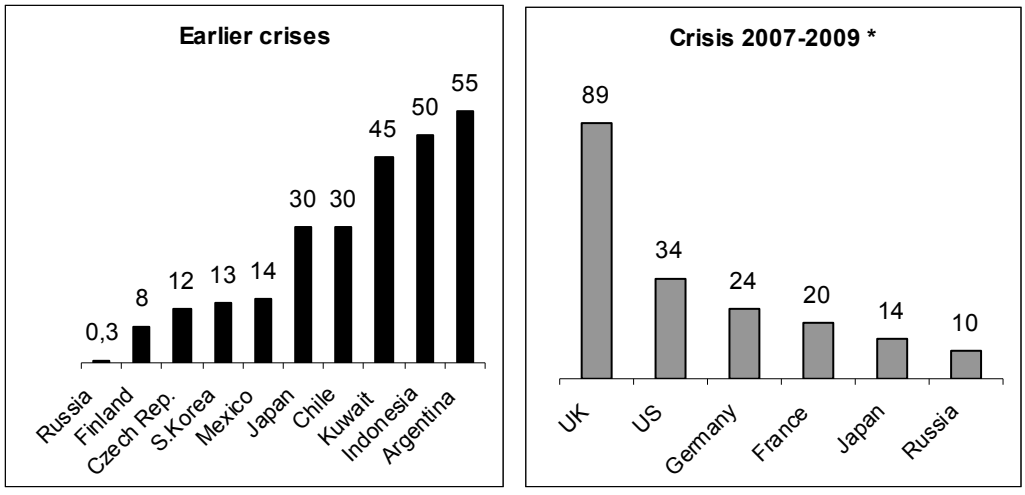


Fig. 3.1. Expenses incurred by monetary authorities to overcome banking system crises (% of GDP)

* Purchase (or exchange) of assets, guarantees, direct financing, capital injections.

Source: IMF, Oct. 2008, June 2010.

It is interesting to note that the actual format of support was closely related to the specifics of financial sectors in respective countries. Aid instruments in the financial sector were primarily aimed at banks in countries where commercial banks (and, as a consequence, loans, deposits, and so on) outperform stock and debt market tools as liquidity sources (in particular, in the Euro area), unlike the US who focus on using stock market instruments (Fig. 3.2).

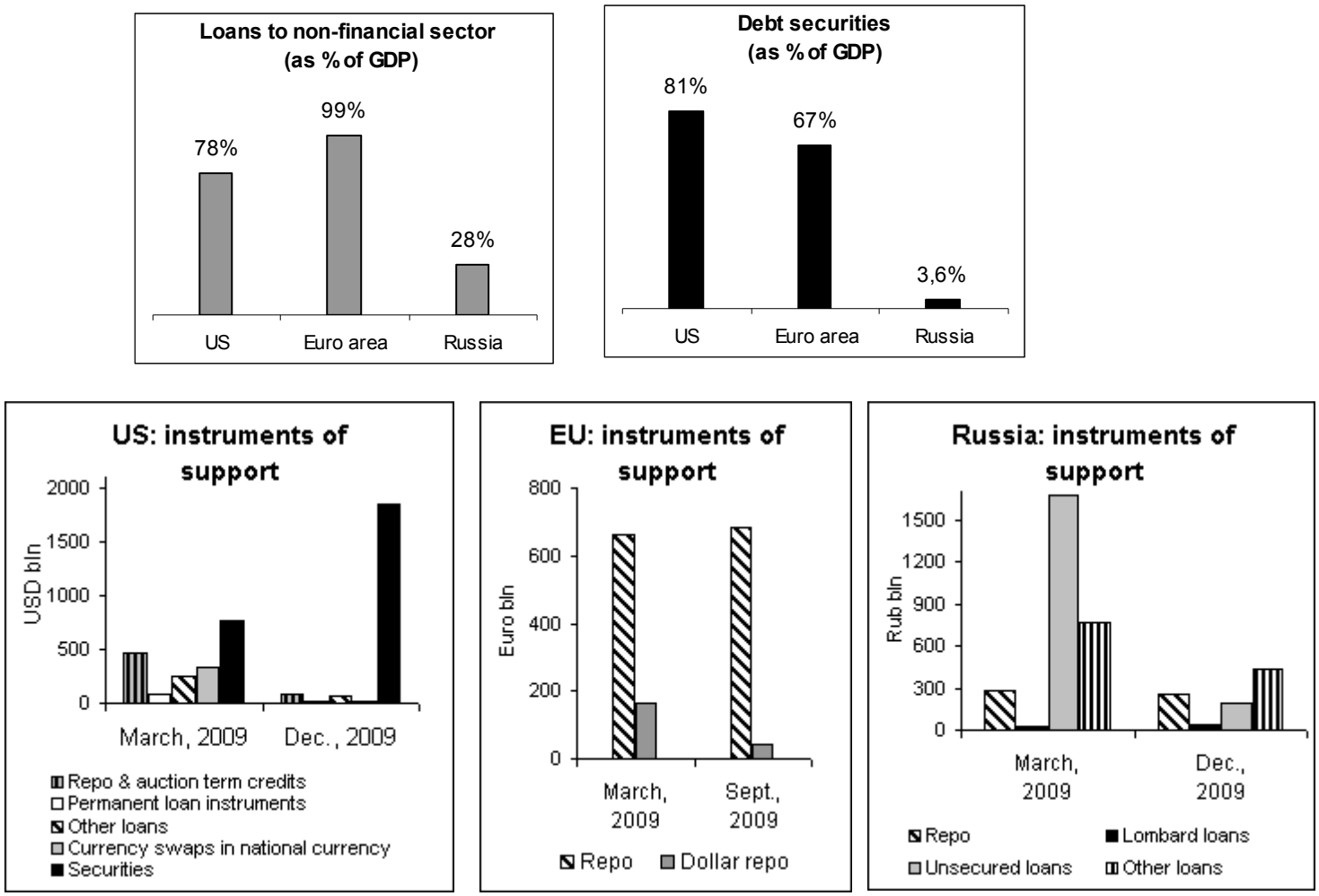


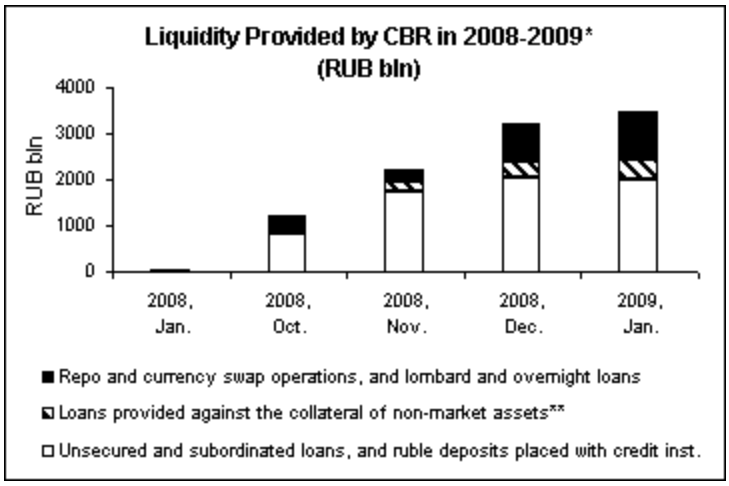
Fig. 3.2. Specific markets require appropriate support measures

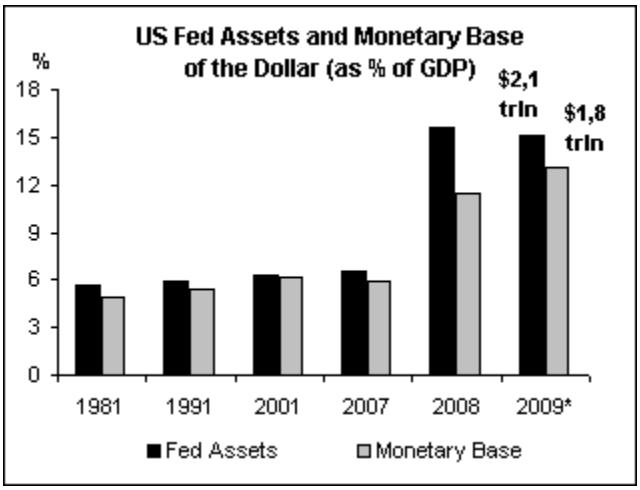
Source: US Fed, ECB, Bank of Russia, Federal Service of Financial Markets.

New Approaches

The exposure was so great that a number of leading countries had to alter substantially the framework and structure of their monetary approaches (Fig. 3.3). At earlier stages, they recurred to both interest rate reduction and additional liquidity injection in the economy through all monetary channels. Still, the scope of measures taken was by far more considerable than over many previous observed years.

In particular, what deserves to be mentioned is the urgency and decisiveness with which many countries almost instantly changed their long-held approaches and recommendations which were previously declared.





* excl. subordinated loans to Sberbank of Russia.
** incl. promissory notes and claims under credit agreements.
Source: Bank of Russia.

* as of early Oct.2009.
Source: US Fed; calc. based on US Fed and Bureau of Economic Analysis data.

Fig. 3.3. Certain approaches by central banks to liquidity forming

Source: Bank of Russia; US Fed; based on data by US Fed and the Bureau of Economic Analysis.

At later stages of anti-recessionary measures when interest rates in major economies (first of all, in the US) started going so low that, in their anti-recessionary efforts, regulators focussed on the policy of 'quantitative easing' that actually meant massive injection of financial resources in the economies and keeping them there further on.

> There are examples when in a 'liquidity trap' situation further liquidity build-up on the back of low interest rates results in negative interest rates (as was the case, for example, in Sweden whose Central Bank set negative rates for deposits of commercial banks with the Central Bank).

Such measures materially increased balance sheets of central banks in major countries (Fig. 3.4).

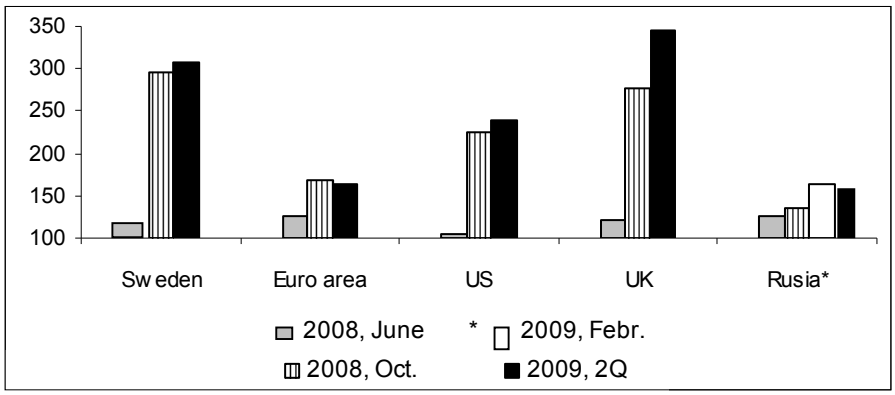


Fig. 3.4. Balance sheets of central banks (2007 = 100)

Source: IMF; based on data of the Bank of Russia.

We would also point out the emerging new dimensions of the monetary policy itself. Bailing out specific companies and banks – as we saw happen on a massive scale during the recession – is actually an element of the industrial policy. In this connection, the application of monetary policies in correlation with anti-recessionary measures by developed economies fully raised the issue of a peculiar kind of **'monetary and industrial'** policy that implies implementation of monetary approaches in correlation with industrial priorities: its industry-specific and corporate elements.

The recession made many original champions of the 'free market' such as Levitt (former Chairman of the US Securities and Exchange Commission, SEC) to change their minds and start talking of the want of industrial policy. According to M. Boskin, Chairman of the Council of Economic Advisers to the US President (he occupied that position when George Bush senior was the incumbent President) 'Ronald Reagan and George Bush senior tried to eliminate industrial policy wherever they found it... While there has always been some level of industrial policy it has waxed and waned at a low level in previous administrations... The Obama administration has greatly expanded its size and scope.'[31]

On Industrial Policy

It is clear that anti-crisis measures in the Russian economy and national modernisation objectives are also directly related to the industrial policy.

Nevertheless, we need to remember that the state of the manufacturing industry greatly affects the country's position overall. Russia needs to integrate into the rapidly developing global economic and industrial environment. To this end, Russia must focus on building an innovative economy and energy- and material-efficient manufacturing that requires highly skilled labour. Undoubtedly, its competitiveness is a must, as well. The structure of the Russian economy should become more 'progressive' through the enhanced role of knowledge-intensive and high-tech segments and the manufacturing industry on the whole.

Approaches to building an advanced industrial policy cannot be reduced to a certain pool of highly efficient projects (as the Russian Ministry of Economy attempted to do in the mid-1990s). The system of national industrial policy priorities is by definition different from priorities of commercial or investment banks that focus on maximising their profits.

[31] Economist, Aug. 7-13. 2010. P. 55.

The national industrial policy targets objectives are of a much more fundamental nature. Such policy must provide the reasonable balance between highly efficient industries, drivers of economic growth on the one hand, as well as less efficient sectors (that are nonetheless important for advanced industries) on the other hand.

Moreover, we need to build 'carrying structures' in the scope of such approaches that are necessary for normal operation of any economic system. Only a national industrial policy makes possible implementation of long-term large-scale programmes that require important investments and that would pay back in ten or twenty years (such as space exploration or development of new sophisticated technologies). Geo-economic and strategic aspects are important as well from the standpoint of national economic security and national economic sovereignty.

The private sector should clearly also be interested in such development. The scale and timelines of tasks we face today often go beyond the capabilities of even major companies. Nobody, however, doubts that robust infrastructure support, advanced research capabilities, and availability of knowledge-intensive developments reinforce both - domestic and international positions of a nation and national business, - while helping implement their competitive advantages based on cutting-edge technologies and a 'knowledge economy'.

Market forces have in general a much shorter term time horisont. As a result, many important economic sectors are left beyond the current needs of the business. Therefore, there should be a system of direct and indirect government regulation measures that would channel the industrial development in the right direction and enhance the domestic and international economic status of the country. Such a system must be founded on criteria that will help focussing all efforts on specific economic sectors or entire industries. Such criteria may include, *inter alia*, economic growth indicators that capture not only the input by the specific industry, but also the multiplier effect when the growth of an industry prompts helps related industries grow. Higher employment is also of great importance.

Apart from purely economic criteria, much attention should be also paid to 'social importance' factors, systemically important, strategic and other parameters. We would place specific emphasis on the territorial aspect of industrial development. A wide set of instruments represented by different areas of economic policy are needed to enhance its geographical homogeneity.

For instance, the US actively applies the 'Community Reinvestment Act' (CRA) that encourages community investments and development of low efficiency investment programmes. The implementation of the law is followed up by the Federal Reserve System, U.S. Department of the Treasury and other governmental agencies. Although, technically, the parameters based on the Act are not binding, market players try to follow them closely since their behaviour will be

taken into account by the Fed in making its respective decisions. Besides, other acts will also be applicable to them depending on their compliance with the CRA. For instance, the Glass-Steagal Act adopted in the aftermath of the Great Depression imposed considerable restrictions on market players. As the current situation in the US did not require such strict regulation, the GSA was repealed to be replaced by a more liberal Graham-Leech-Bliley Act. A number of newly introduced provisions were not extended to those who breach the Community Reinvestment Act.

For a long time the US restricted interpenetration of banks between states in order to balance financial capabilities of different US communities. Only in the 1980s, they adopted the principle of mutuality in the access to other domestic markets and it was not before the early 1990s that similar practices became widely spread and summarised in the Wrigley-Neal Act.

Until recently, the country used ratios that affected interest rates (Regulation Q and others) which among other things, capped the interest rate for a number of transactions to cheapen the access to resources.

Japan has also been running its economic policy in a very consistent and strong way. This attitude helped the country substantially reinforce its economy and gain leading global positions, the phenomenon known as the 'Japanese economic miracle'. As a result, from a ruined economy, with no natural resources compared to those available to many leading countries, Japan became the number two among developed countries that successfully competes with any other developed nation.

As a result, from a ruined economy, with no natural resources compared to those available to many leading countries, Japan became the number two among developed countries that successfully competes with any other developed nation.

Let us take a closer look at a number of parameters in approaches used by Japan.

Some Information on the Japanese Experience

The Bank of Japan estimated that 'instead of relying on purely market forces, the government ran an active policy by complementing their effect with regulation and clear benchmarks'[32]. A system was built to ensure capital inflow into strategic industries at interest rates acceptable to market players (including by restricting unjustified competition in the scope of the interest rate policy).

[32] BoJ, Dec 2003, p. 2

The banks themselves were grouped by various criteria to carry out primarily those operations that were considered as priority targets of each group.

For example, 'urban banks' provided short-term financing to strategically important industries. Banks specialized in long-term financing served as the source of long resources to mitigate the need to issue bonds for these purposes. Regional and credit unions focussed on small- and medium-size enterprises. The result was a sufficiently controllable financial system, with the major role played by commercial banks, which supported economic growth by funnelling capital flows (via loans and investments) into strategically important top priority industries.

Japan applied its "5-3-3-2 investment regulation" to regulate financial flows until the mid-1990s. The regulation imposed a certain investment portfolio structure on market players, including pension funds and other large investors. The country actively runs a cheap debt policy. In the late 1990s, the interest rates of the Central Bank were close to zero. Japan also applies various economic ratios to redirect resources of Japanese banks from abroad to domestic operations.

Naturally, the market and regulators should thoroughly examine the Japanese experience, their economic approaches, mechanisms and instruments that were emphasised to overcome economic challenges and that made possible such a break-through[33].

The industrial policy with an emphasis on structural transformations and creation of conditions for capital accumulation and investments occupied a pivotal place in Japanese economic approaches. Japan also widely used international technological practices.

Japan did care about defining industrial priorities as their development was vital for the Japanese economy to strengthen and move forward. The applicable criteria included, among others, such factors as the cumulative effect on related industries, high performance rates, higher employment rates, high income elasticity of demand for their products (i.e. relation between the growth of, say, consumer income and demand for certain products).

They also considered import substitution, export growth, competitiveness increase and some other factors.

The overall logic of the approaches used was founded on the understanding that successful stimulation of a certain industry (or sector) requires its linkages with an industry (sector) that is closely interrelated with the former in the inter-industry balance. As a result, such coupled stimulation could help the industries push each other forward.

In general, the Japanese preferred encouraging specific sectors or sub-industries rather than entire industries. Such approach implied designation of individual critical sectors.

[33] This issue requires a specific study; therefore, we will only touch upon some of its important aspects.

As a result, certain criteria for selecting priority areas were worked out. Under such criteria, the 'designated' sectors included:

1. sectors related to fundamental industries and acting as bottlenecks in the respective industry's structure;

2. sectors that played a key role from the standpoint of exports and carrying out the import substitution function. Additionally, such sectors were to provide great input to the growth of other industries;

3. sectors that, once streamlined, were able of considerably expanding their operations or cutting down operating costs;

4. high-yield sectors with high exports quotas that were able to substantially enhance the international competitiveness of their products by installing new equipment;

5. sectors that were to be streamlined and upgraded as soon as possible to give a boost to the industry on the whole;

6. sectors where the bulk of equipment needed to be urgently upgraded;

7. sectors with strong potential to upgrade their equipment.

The above criteria were used to select 32 types of sectors and sub-industries[34].

Companies targeted by the policy underwent a thorough selection procedure based on consistent approaches that assumed concentration of means and resources (not only in the companies of priority business areas, but also in related sectors), simultaneous involvement of multiple political tools and setup of an ongoing monitoring mechanism to ensure timely adjustments to such policy.

The White Paper on the Industry Streamlining Policy (1957), a special edition by the Ministry of Foreign Trade and Industry most completely defines such policy. Its contents may be summarized in four key areas:

1. business streamlining, i.e. adapting new operating equipment, investing in new equipment and operating capacities, following up quality, cutting back costs, introducing new management methods and enhancing administrative control;

2. business environment streamlining, including installation of industrial operations, development of land, installation of water, gas and power supply systems, and utility and transport infrastructure;

3. streamlining of industries, i.e. creation of conditions for all businesses in an industry that will ensure fair competition or cooperation in the framework of cartel-like arrangements;

[34] Japan External Trade Organization, 2007; Japan Policy Research Institute, Japan Economic Research Institute. Tokyo, 1995.

4. streamlining of the overall industrial structure to achieve international competitiveness standards.

Japan widely used various support and encouragement means and mechanisms to see government objectives implemented.

Thus, the government introduced a system of price subsidies that were primarily applied to priority sectors. Apart from direct governmental subsidies, Japan also used preferential loans issued by government-owned banks. In their turn, commercial banks were also actually obliged to issue loans to priority sectors.

The Central Bank, however, provided commercial banks with guarantees to minimise the risks of such lending, and accepted promissory notes for rediscounting. Furthermore, the Bank of Japan directly lent to Japanese commercial banks (with the amount of loans approaching Yen 270 billion in 1950 alone) and reduced the borrowing costs by cutting down interest rates. These approaches are still widely applied by leading countries such as the US and Japan.

At the same time, commercial banks were to comply with ratios and limits applicable to the amounts and use of such borrowings (there even was a list of areas of 'preferred lending', again linked to the priorities set by the government).

In the event of breaches, banks lost the opportunity to obtain such resources from the Central Bank on the same terms in future.

We would remind that the US still (!) applies similar logic to some business areas, which may be subject to regulation of the Community Reinvestment Act that we discussed before.

Priority sector companies were authorised to issue promissory notes that could be discounted or rediscounted by the Central Bank.

Such papers could also be used to borrow on relatively more preferential terms.

Companies operating in such sectors were subject to special taxation, lending, foreign exchange distribution, imports quota, tariffs, etc. On the other hand, the reverse side of it was that the government quite roughly interfered with their operating and commercial activities. Companies that were eligible for such privileges became subject to rigorous monitoring and control by relevant agencies. They were to take commitments to achieve certain performance within a certain period of time in terms of either their product output or a certain level of return (or both). The government was vested with broad control over the priority businesses, including the right to control their investment and capex programmes.

At the same time, the government exercised strict control over the capital flow, foreign exchange operations and foreign trade. A report by the Japan Policy Research Institute and Japan Economic Research Institute underlined that 'economic liberalisation could not be successful

unless strict administrative control is introduced at its initial stage'[35]. Later on, Japanese regulators, however, were forced to meet the requirements of international players who wished to see Japanese markets more open and less regulated. To ensure its necessary presence in external markets, Japan had to capture requirements by other countries and liberalise its foreign trade operations and capital markets in exchange for the access to their markets. However, such liberalisation was carried out in an extremely cautious, slow and sure way. For instance, liberalisation of interest rates took 15 years, while foreign exchange and capital flow operations had been liberalising for more than 30 years.

Japanese experts estimate that 'Japan was able to postpone the launch of markets and sectors that were unready to compete against external rivals to avoid thereby numerous adverse implications'[36].

Opportunities for Using the Japanese Experience of Post-War Reforms

The domestic market opening policy began when the economy was on the rise, that is when domestic macroeconomic stability was achieved. On the whole, the country followed the general order of liberalisation: from commodity deals to capital transactions. In other words, foreign trade was liberalised first, followed by the foreign exchange market and capital flow[37].

1964	Apr.	Japan accepts IMF Article VIII obligations. Japan becomes an OECD member.
1968	Feb.	Yen conversion controls introduced to restrict conversion of foreign currencies into yen and domestic investment in yen.
1971	July	Upper limit on foreign securities purchased by investment trusts and insurance companies abolished.
	Aug.	US suspends dollar conversion to gold (the so-called "Nixon Shock").
	Dec.	IMF parity changed to ¥308US$ (Smithsonian rate) and band widened by +/-2,5%.
1972	Feb.	Purchase of foreign securities by trust banks liberalized.
	Mar.	Purchase of foreign securities by commercial banks liberalized.
	June	Outward foreign direct investment liberalized.
1973	Feb.	Floating exchange rate regime introduced.
	May	Inward direct investment liberalized with exception of five categories of business.

[35] Japan Policy Research Institute, Japan Economic Research Institute. Tokyo, 1995. P. 37.
[36] Japan Policy Research Institute, Japan Economic Research Institute. Tokyo, 1995. P. 169.
[37] It is also important that liberalisation was thoroughly planned: the programmes that provided for opening individual sectors and segments of the domestic market to international competition with specific timelines had been developed, agreed and communicated to respective affiliated participants in advance (several years before the policy in question was actually launched). These measures provided them with time and ability to work out their own plans for necessary preparatory actions.

	Dec.	Yen conversion controls on banks partially eased (non-residents permitted to hold yen accounts <except inter-office accounts>.
1974	Jan.	"Voluntary restraint", to balance net foreign securities investments by banks, securities companies, investment trusts, and insurance companies introduced.
1976	Nov.	Conditions attaching to outward long-term bank loans are eased.
1977	Mar.	"Voluntary restraint" on foreign securities investments by banks abolished.
	June	Acquisition of foreign equities and bonds by residents belonging to foreign companies permitted.
		Regulations on net open positions of residents abolished.
1979	Jan.	Regulations on acquisition of yen-denominated bonds excluding those with remaining maturity of more than one year by non-residents relaxed.
	May	Repo transactions by non-residents liberalized (*gensaki* market).
		CD issuance commenced.
	June	Short-term impact loans introduced and regulations on long-term impact loans lifted.
1980	Dec.	New Foreign Exchange and Foreign Trade Control Law implemented; in-and-out transactions free in principle.
1984	Apr.	Regulations based on the principle of real demand related to forward foreign exchange transactions abolished.
	June	Regulations regarding the conversion of foreign currency-denominated funds into yen abolished. Yen-denominated loans to residents contracted in overseas markets liberalized.
1985	Oct.	Interest rates on large time deposits liberalized.
1986	Dec.	Japan Offshore Market (JOM) established.
1993	June	Interest rates on time deposit fully liberalized.
1994	Oct.	Interest rates on demand deposits (excluding current accounts) liberalized.
1995	June	Restriction on number of new branches a bank can establish removed.
	Aug.	Recycling restrictions on yen-denominated bonds issued by non-residents in overseas markets abolished.
1996	Nov.	"Big-Bang" reform of capital market announced.
1997	Dec.	Ban on financial holding companies lifted.
1998	Apr.	Revised Foreign Exchange and Foreign Trade Law enforced. Cross-border capital transaction liberalized.
	Sept.	Securitization of loan assets permitted.
	Dec.	Securities derivatives fully liberalized.
		Sale of investment trusts by banks permitted.
		Definition of "securities" expanded and enhanced.
2001	Apr.	Over-the-counter sale of insurance products by banks partly permitted.

Table 3.1. Liberalisation of the Japanese Capital Account

Source: Bank of Japan, Dec. 2003.

Approaches to implementation of the industrial policy need to be adequate to the existing economic challenges. **It is extremely important that current anti-crisis measures do not obstruct our long-term vision of the post-crisis Russia.**

It is extremely important that current anti-crisis measures do not obstruct our long-term vision of the post-crisis Russia.

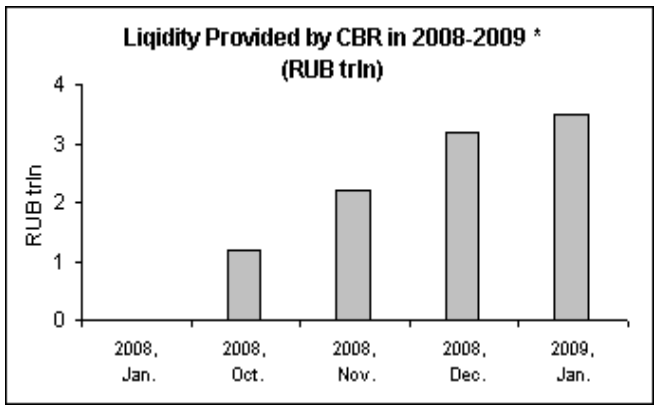
Otherwise, just like in the 1990s, we risk ending up with talks of 'limited opportunities' of the economy, about oil prices, about the need to further depreciate national currency and about the search of a certain number of highly efficient and projects with rapid returns that will represent the 'industrial policy'. As such, the current efforts to build new approaches to the 'knowledge economy' (Skolkovo and the like) inspire optimism making us believe that, with an efficient and balanced approach, the national industrial policy will be able to become the real backbone in working out critical national long-term development strategies.

Some Peculiarities of Providing Anti-Crisis Measures

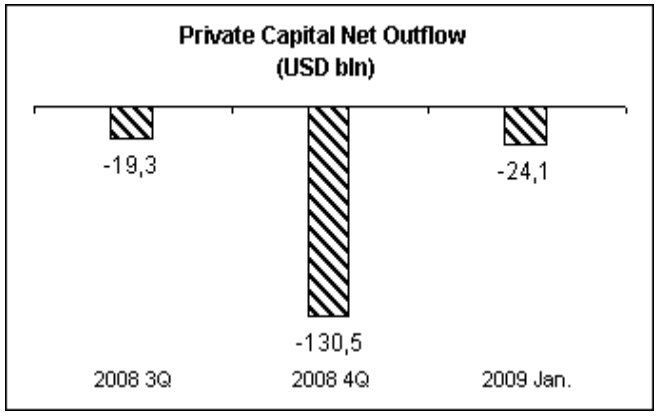
The developments highlighted another important issue: **how to monetize the economy and increase the supply of financial resources in the environment of openness and liberalization of capital flows?**

The developments highlighted another important issue: **how to monetize the economy and increase liquidity in the environment of openness and liberalization of capital flows?**

In the circumstances where the national currency is freely convertible and transferable across borders, the issue of maintaining national liquidity at a level appropriate for necessary economic activities becomes vital.



* excl. subordinated loans to the Savings Bank of Russia.



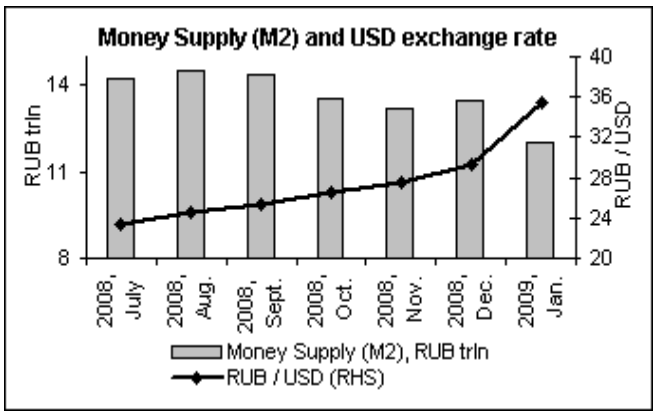


Fig. 3.5. Monetization of liberalized Russian economy
Source: Bank of Russia.

The liquidity growth trends in Russia in later 2008 – early 2009 were accompanied by a decrease in gold and foreign exchange reserves and a stronger capital outflow, which led to the rouble depreciation and, ultimately, a reduction in the money stock (Fig. 3.5).

To slow down the rouble inflow to the foreign exchange market, the Bank of Russia advised market players to maintain a certain amount of their foreign exchange reserves at a flat level, without decreasing them, and promised to take into account compliance with its recommendations when making decisions on issuing unsecured loans to banks.

Similar (at least in their philosophy) approaches had already been used before in a more rigorous way after the 1998 crisis when the Russian market was extremely turbulent and nervous, and its players could affect even more negatively the foreign exchange segment (with the rouble deeply depreciated as it was). At the time the regulators introduced so called 'zero currency position in conversion transactions'[38] to prevent any pressure on exchange rates and currency outflow. The measure substantially constrained non-transaction demand (demand unrelated to

[38] Instruction by the Bank of Russia №367-U of 23.09.98.

the need to support foreign trade activities of customers or ongoing operation of exchange offices and operations with bank cards) of banks for currency. Actually, at the close of a banking day, foreign exchange market players could not have had more currency than at the beginning of the day (with regard to currency that was unrelated to the servicing of foreign trade contracts, but was acquired purely as a hedging asset or for speculative purposes). Though very rigorous, this measure allowed preventing the market from further downfall and was cancelled later when the situation stabilized.

On a wider scale, many countries face the issue of regulating financial flows at both international and domestic levels.

Also in this connection, at the international level, regulators consider the importance of national priorities in spending taxpayers' money. "Financial institutions have been increasingly asked to serve for the domestic 'interests' and sort of '**financial nationalism' seems to have** emerged", underlined the Chairman of the Bank of Japan at the Fed Reserve Symposium in August 2009[39].

As the crisis broke out, even such partisans of 'financial neutrality' as Switzerland recurred to a set of measures encouraging more intensive lending by their banks to domestic projects as opposed to international ones.

About Protectionism

Countries are increasingly concerned with the risk of protectionism that becomes more and more likely with the financial turmoil. While international 'rules of the game' require certain guarantees to prevent such approaches, the estimates at a more down-to-earth progmatic level are more ambiguous. Touching upon international regulation, US Secretary of the Treasury Timothy Geithner stated that regulation is a sovereign prerogative: "We are not going to give anyone else the responsibility for deciding what balance between stability and efficiency is right for our markets"40. Following the Pittsburgh statements by G20 that stressed the importance of resistance to protectionism, the United States took steps to restrict trade with China in the automobile tire supply market, which may clearly provoke response and result in a new cycle of trade conflicts. In general, as rightfully put by Alan Greenspan, "you cannot have free global trade with highly restrictive, regulated domestic markets"41. Given the increasing role of regulation

[39] M. Shirakawa. International Policy Response to Financial Crises. Remarks at the Symposium Sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming. Aug. 22, 2009. P. 5.
[40] Financial Times, 30.03.2009.
[41] BBC, 08.09.2009.

and the government on the whole in developed and developing economies during the crisis, the risk of protectionist decisions becomes higher.

While, before the 'globalization era', governments focussed on foreign trade, financial flows and investments become a priority in the new circumstances. For this reason, so much attention is paid to ensure free capital flow and 'institutional support' to these processes (presence of foreign banks in economies).

Although all forms of global integration and liberalization should technically meet the interests of the entire international community, as a matter of fact they are created and initiated by developed countries to enhance their global presence.

Eventually (if we discard ideological components and arguments about equality of resulting advantages, etc.), all these mechanisms and institutions are obviously aimed at ensuring external expansion of their countries of origin and mainly meet the interests of the latter. Being historically stronger, they were initially interested in an unhindered entry to the markets of weaker countries. So called 'equal competitive terms' promoted by developed countries actually builds up advantages for stronger countries that as a matter of fact have a head start even in technically equal conditions[42]. Furthermore, in situations when their own markets need to be protected, developed countries are often ready to do so, although they advise the rest of the world to do the opposite.

And it's due to such reasons that these countries exert continues pressure to impose global liberalization.

The statement by G20 discusses resistance to protectionism, specifically underlining the need to resist financial protectionism and in particular measures that constrain worldwide capital flows, especially to developing countries[43].

Newly created financial resources will obviously seek for investment opportunities in new conditions and their holders will clearly wish that such opportunities were unlimited. Emerging markets offer a considerable potential for such investments. They already see the risks of global liquidity flows and are introducing capital flow restrictions.

Emerging markets already see the risks of global liquidity flows and are introducing capital flow restrictions.

It is clear that such circumstances might result in a liquidity inflow to the stock market and a subsequent growth (although potentially short-term) of stock market performance, and an inflow of longer-term investments.

[42] For more details see: M. V. Ershov. Economic Sovereignty of Russia in Global Economy. M.: Ekonomika, 2005.
[43] G-20, "The Global Plan for Recovery and Reform", 2 April 2009.

At the same time, it is more important for potential recipients to assess incoming resources on a more informed basis, not on a formal basis such as 'any resources are good' and 'the more the better'. They need to have a clear view of the nature of their use, period of stay in the country and the repatriation conditions[44].

In major countries, inflow and stay of foreign resources in the country are subject to rigorous control. E.g. the Committee on Foreign Investment created in the US in 2007 to regulate the inflow of investments to the country in addition to 4 economy related secretaries it initially included as its members the heads of: Department of Defence, Department of Homeland Security, Department of Justice, Department of State[45], which only proves that, in the context of new risks, the issue acquires geo-economic and strategic nature.

The Committee on Foreign Investments in the US regulates the inflow of investments to the country. In addition to 4 economy related secretaries it initially included as its members the heads of: Department of Defence, Department of Homeland Security, Department of Justice, Department of State, which only proves that, in the context of new risks, the issue acquires geo-economic and strategic nature.

It is also obvious that, in general, support provided by the US regulators primarily to the financial sector might imply that problems are being pushed out of the financial sector and can eventually transform into general economic complications for the entire economy. The next stage of further development of this situation with high probability could see these US domestic economic problems transform into systemic currency issues, this time at the international level.

It is hard to speak so far about all the intricacies and in-depth links of the events underway in full, but in any event the problem requires thorough monitoring.

It is clear that inter-governmental coordination extremely important and desirable for enhancing the ultimate impact by joint anti-recessionary efforts will be impeded by unilateral measures taken by major countries (mainly by those with freely convertible currencies).

Moreover, in general, from the standpoint of opportunities for access to financial services market, even in developed economies the access to their markets was liberalized only when such countries reached a high and stable level of economic development. As we know, Japan started actually liberalizing its financial sector only in the second half of the 1990s. By that time, Japanese economy consistently ranked second in the group of industrially developed countries (and even after such liberalization the share of foreign banks in the Japanese banking system did not exceed 5-6%). Still in the mid-2000s, foreign participation in other segments of the Japanese financial market stayed low. The share of all foreign direct investments in Japanese GDP did not

[44] For example, during the crisis China extended the period after which foreign investors may sell shares of Chinese banks to 5 years.

[45] Later on, the Committee's structure changed, but retained the military and intelligence component on the whole.

surpass 2% by 2004, while the share of foreign presence in the Japanese stock market amounted to around 2% by 2004.[46] Later on, these levels considerably grew, but after the crisis Japanese banks felt quite comfortable as a result of their conservative exposure to 'global innovations'. They were affected by general economic downturn due to the exposure of the economy to external markets. In general, the OECD estimated that 'Japanese banks largely avoided the direct impact from the global financial crisis thanks to their limited exposure to foreign toxic assets, the regulatory framework in Japan and the small role of securitisation.'[47]

Similarly, **domestic** market players prevail among investors in Japanese private and public debt instruments (Fig. 3.6).

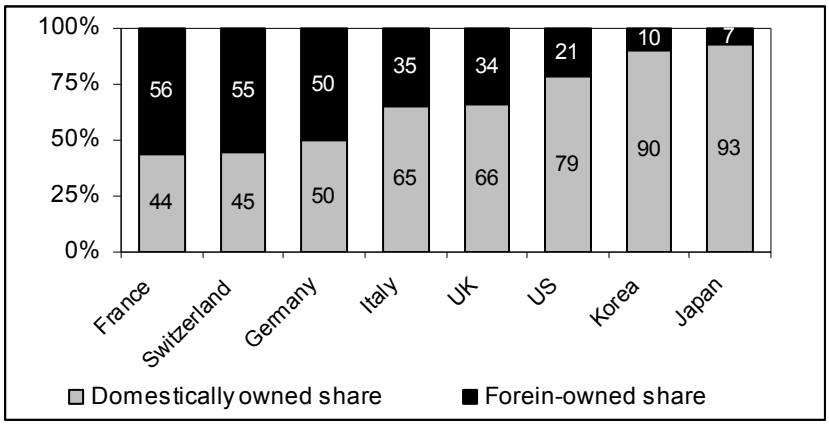


Fig. 3.6. Private and public debt: breakdown by holder (%)

Source: Haver Analytics; McKinsey, Jan. 2010.

In view of The Economist, Japan 'mastered the art of opening up on its own terms',[48] while the policy of relying on its own resources, rather than on foreign investments, and protection of national companies and banks allowed Japan to achieve one of its key objectives – financial independence[49].

> Japan mastered the art of opening up on its own terms, which allowed it to achieve one of its key objectives – financial independence.

Despite all the differences in domestic economic particularities of different countries, they still recorded similar processes of actual segmentation of financial flows when such resources were constrained within a narrow framework, while the cash flow transmission mechanism did not actually work. It is well known that the interbank market (UK, US, Russia, etc.) did not work during the crisis, with intervention and support by central banks required to

[46] Ministry of Finance, Japan, December 2004.
[47] OECD, Economic Survey of Japan, December 2009.
[48] The Economist, 2003, July 12th, p. 20–22.
[49] Idem.

resume its operation. Financial resources often did not reach the real economy, and if they did, they could be used by recipients for financial rather than production purposes (e.g. to buy currency).

> We would remind that at earlier stages the Russian and Soviet economies faced the segmentation of cash flows due to either regulatory reasons (including separation of cashless and cash money turnover with restrictions to the transfer from one form to another, as was the case in the USSR, for example), or market situation. The latter was seen during the pre-crisis period of the second half of the 1990s when financial resources were directed to the GKO-OFZ market rather than to the real sector in the context of a low monetization level in the economy, thereby aggravating the problems of money transmission and cash flows even more. In such case, the money stock could include conventional money elements and its surrogates, barter, and non-payments making up for actual compression of liquidity.

In these conditions, efforts to create efficient mechanisms ensuring appropriate transmission of cash flows need to be continued. They need to include both 'targeted' refinancing facilities (secured with promissory notes of sufficiently rated companies) and other instruments such as regional securities that would facilitate intra-industry and territorial cash flows. Additional resources may be allocated, with subsequent 'strings' attached determining the nature of resource use.

We would remind in this connection the experience of Japanese regulators who introduced the so called '5-3-3-2' rule for their financial market players (including pension funds and other major investors), which actually imposed the breakdown of their investment portfolio by investment instrument.

The use of corporate securities, corporate promissory notes and other instruments (whose quality needs to meet certain criteria) may become instrumental in targeted allocation of resources when central bank's refinancing is done. Such mechanisms must, first, ensure inflow of financial resources to respective industries and, second, will facilitate transmission of resources to different regions (if such companies are located in such regions), and, third, diversify respective instruments of the financial market and enlarge its depth.

Refinancing facilities are a crucial mechanism for supplying liquidity to an economy. Back before the crisis we repeatedly indicated the need to improve such mechanisms. But only the crisis forced regulators to use approaches whose necessity was quite obvious even in a normal situation.

On Refinancing and Economic Development Tasks

(For the meeting of the Banking Committee of the Russian Union of Industrialists and Entrepreneurs (Unites Big Business)), March 2007[50]

Monetary policy mechanisms should be focused to the maximum extent on solving tasks that the Russian economy faces in the context of tough international competition and the need for progressive structural reforms.

At present when the favourable juncture ensures sufficient liquidity in the market, banks do find it easier to obtain necessary resources in the interbank market without recurring to refinancing capabilities.

At the same time, given the volatility of the situation, and considering the systemic nature of the issues that the economy is facing and emerging external risks, we need to take maximum advantage of the current 'leeway' to set up mechanisms that will ensure uninterrupted operation of the economy in less favourable conditions in the future.

Refinancing and money supply creation mechanisms are of paramount importance in these efforts.

We deem it reasonable to focus on the following issues:

1. It's nessecery to take larger advantage of refinancing capabilities, trigger liquidity supply mechanisms by expanding capabilities and objectives of such application and bringing them closer to the need to meet structural and regional priorities.

2. In general the objective must include:

1) prompt supply of current liquidity, including emergency events (crisis) in the market;

2) expanding capabilities for creating long-term resources;

3) ensuring targeted injection of liquidity in priority areas.

3. Refinancing mechanisms must play an important role in regulating the current level of liquidity in the banking system. It is of particular importance when the market is tense (as in May-June 2004) and potential access to financial resources must be rapidly expanded to reduce tension and prevent a full-blown crisis.

[50] M.V. Ershov. On Refinancing and Economic Development Tasks (For the meeting of the Banking Committee of the Russian Union of Industrialists and Entrepreneurs), March 2007.

Exactly such mechanisms were used, in particular, by the US Fed when the next day after 9/11 events the amount of financial resources received by US banks through the 'discount window' facilities grew by more 200 (!) times as compared to a normal situation.

We have to bear in mind the large degree of openness of Russian economy and the issuing transboarder risks that emerge, we need to provide for emergency mechanisms ensuring quick liquidity at acceptable prices with simplified procedures.

4. While the volume of refinancing substantially grew during the crisis, its scale is still lower than in developed economies, and not only in absolute terms (which would be understandable given the difference in the scale of banks), but in relative terms as well.

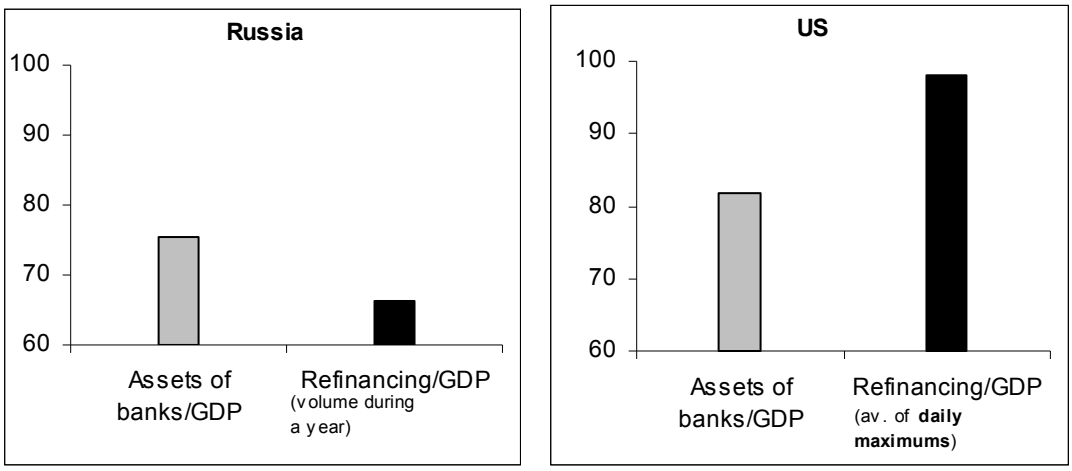


Fig. 3.7. Refinancing in 2009 (% to GDP)

Source: based on date of the Bank of Russia, US Fed, BEA.

Furthermore, maximum **average daily** refinancing figures in the US were the same in relative terms as respective figures for the Russian financial system **for a year**.

Maximum **average daily** refinancing figures in the US were the same in relative terms as respective figures for the Russian financial system **for a year**.

Rapid decision making might require, at earlier stages, quick access to liquidity provided by 25 to 30 backbone banks whose solvency secures the 'anti-recessionary' nature of the whole system and that will be used to ensure the necessary level of liquidity in the interbank market, with such approaches to be later expanded to other players.

On the whole, on-line liquidity supply mechanisms need to be refined by cutting down unjustified administrative and other obstacles.

5. Further expansion of the pledgeable securities list of the Bank of Russia would need to be revised. In particular, the list must include corporate bonds and promissory notes of major companies with high ratings assigned by international rating agencies, and regional securities. This step will help to make liquidity creation more even, attracting more liquidity to non-exporting industries and to issuing regions, and will facilitate the territorial and inter-industry cash flows on the whole. It will also raise the liquidity level of the financial market and will enhance its stability.

6. Considering that the Russian economy needs to undergo progressive structural reforms, refinancing capabilities must be oriented toward implementation of the above task by broadening the list of collateral which may include banks' loan requirements in priority growth areas (mortgage, small-size enterprises, etc.) in the Lombard List.

7. It's necessary to examine potential extension of duration of loans provided for securities placed with the Bank of Russia during refinancing and it's also important to reduce the number of restrictions to obtain such loans.

At the time being, the bulk of refinancing funds is allocated in form of overnight or intraday loans. Technically available longer refinancing loans are not used in actual life, being too expensive and too complicated to obtain.

Simplifying the process of issuing long money (in terms of its legal and other issues) will enable creating resources on a more systemic and stable basis to promote thereby longer maturities.

8. Expansion of 'long' lending capabilities and minimization of related risks will also require providing for potential inclusion of banks' requirements to long loans in the Lombard List. Proper preparation of the regulatory framework for derivatives enabling the use of optimal forms and methods to secure such transactions (e.g. in form of notes that allow splitting the total loan amount into parts) will considerably increase lenders' capabilities for refinancing individual parts of a loan in the market by selling such papers (notes) to obtain thereby the liquidity they need.

9. The role of interest rates in the monetary policy needs to be enhanced to make refinancing rates a really effective instrument, which implies modifying a number of approaches and mechanisms, first of all, money supply.

10. About Money Supply

Money supply mechanisms represent broader approaches to the creation of money resources in the economy.

At present, the rouble's monetary base (money supply) is largely formed based on the inflow of foreign exchange (primarily export) resources, which conserves the commodity-based structure of the Russian economy (discussed in more detail below).

This approach is exposed to important risks:

- first, the Russian economy remains exposed to the global economic and political juncture;

- second, the commodity orientation of the economy is conserved, with raw-material industries supplying the currency being the key growth and demand drivers;

- third, **refinancing rates** which determine the price of financial resources stop working, thus limiting the ability of monetary authorities to run active financial and monetary policies affecting the nature of economic development and the economy's structure.

To transform the refinancing rate into an actually effective mechanism which determines the price parameters of the financial market, the authorities will need to increase the share of the 'internal' component in expanding the monetary base implying that the money supply will primarily be generated based on internal mechanisms and instruments that better reflect the domestic demand for money.

Moreover, the above approaches will theoretically allow, first, ensuring the formation of money resources in conjunction with the structural policy objectives, and, second, expand the basis for longer resources (as it happens in developed countries).

Notes

For example, in the US and in Japan only 5% monetary base of the dollar and yen is supported by the gold and foreign exchange component, with government securities accounting for 70-90% of the money stock sources (i.e. budget priorities are financed). Up to 50% of them are represented by long instruments, which actually means that the Fed and the Bank of Japan issue long debt to the economy (we will discussed these approaches below. – M. E.).

Private sector instruments are also used in generating the monetary base, which allows using a portion of resources to finance priority programmes involving the business community (e.g. in Japan more than 20% of money supply is created based on private sector pledges).

As a result, primary monetization, first, ensures the funding of priority tasks; second, creates the basis for long resources in the economy, and, third, signals to the market about economic policy priorities (we will discuss this below).

In this connection, we will need to consider potential application of approaches used by developed countries linking the liquidity creation to the targeted nature of money allocation in the context of the Russian economy, capturing the systemic and long-term nature of issues facing the economy of the country.

11. We believe that coordination of approaches to the creation of money resources in conjunction with achieving economic policy objectives will increase the efficiency of current reforms and will contribute to the development of the economy in the post-crisis world by reinforcing its positions in the context of global competition.

As subsequent developments showed, a number of approaches proposed were used by regulators. Moreover, systemic proposals to more closely attach monetary approaches to economic policy objectives became a priority in all major global economies.

Crisis aggravations turned this instrument into an important anti-recessionary stabilizer, with its momentary and large-scale introduction calming down markets to a great extent.

We would remind that their use helped calm panic not once. We shall again mention that, after the 11 September 2001 in the US, the amount of refinancing was raised by 200 times (in one day) as compared to normal days to restore the tranquillity in the market. Along with cheaper resources that were used by the Fed (and other leading central banks) for emergency purposes to support their financial systems in 2011, this step allowed stabilizing the situation.

Now we enter the post-crisis world featuring a great number of risks and unsolved problems, each capable of provoking new crises. Given that all this happens in the context of the remaining global openness, it is important to have a clear understanding whether the Russian financial system and banks may rely on such instantaneous and large-scale response by its monetary authorities to handle a financial crisis, had such occurred in the future? The examples of the summer and autumn 2007 and anti-recessionary measures of the late 2000s witnessed that regulators are quick in their response, but it is important that market players are confident that such steps are a guaranteed response to new risks and new challenges.

May the Russian financial system and banks rely on such instantaneous and large-scale response by its monetary authorities to handle a financial crisis, had such occurred in the future?

The examples of the summer and autumn 2007 and anti-recessionary measures of the late 2000s showed that regulators were quick in their response, but it is important that market players are confident that such steps are a guaranteed response to new risks and new challenges.

Similar questions arise in connection with the **refinancing rate**. Let alone that in Russia the refinancing rate still has purely fiscal functions following rather than shaping up the market. (While short repo rates are more likely to be a more accurate indicator of the demand for money). In examining this issue, we will limit ourselves to stating that the rate cannot be used as a powerful economic policy instrument so far (although it would be vital for the economy), unlike, say, the US where the refinancing rate was lowered 13 times in the early 2000s to encourage the economy and reached 1%. As a result, both - the economy and **stock markets** resumed their growth (though the surplus of inexpensive liquidity eventually was one of the factors that gave rise to the recession). We will hope that the Russian economy will sooner or later also enhance the role of rates as a consequence of changes to the economic situation and modification of monetary regulation.

Let us discuss some fundamental issues of conceptual nature. In the above example, the refinancing rate stayed at a level below inflation rates, and resources were available to the market at such price for a certain time. Approaches similar in their ideological component have been long applied by US regulators. Since the 1960s to the early 2000, the US set the rates at a below-market level in providing the adjustment credit, one of their refinancing instruments. Such rates allowed market players, when necessary, to obtain resources at a price below market provided that they meet certain criteria (note that this happened both - in successful years, and during considerable inflation). In 2002, the application of such approaches changed due to some reasons. However it's important to note that **the world's strongest banking and financial system had an opportunity to use such robust support instruments for almost 40 years!**

During the recession of the late 2000s, both the US and Japan maintained their interest rates at low levels.

The Bank of Russia also took the path of gradual rate reduction.

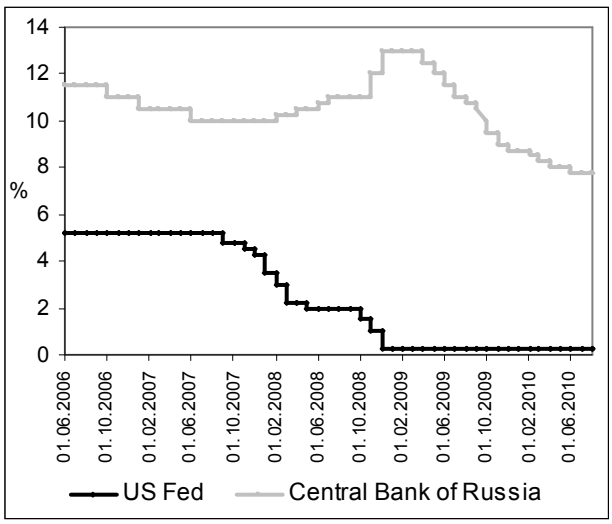


Fig. 3.8. Refinancing rates in the US and in Russia (%)

Source: Fed of New York, Bank of Russia.

Practice shows that such quite specific application instruments are of particular importance in the context of economic openness. To achieve actual success in an economy operating in the context of global competition, all correct ideas on enhancing work quality, competition, discipline, etc. must be backed by actual methods and economic instruments similar to those available to stronger competitors.

If refinancing is quick, and resources become cheaper as needed (e.g. to overcome negative trends in the economy), the opportunities of interaction between the financial market and the real sector will substantially expand.

We estimate that the amount of refinancing in the US and in Japan exceed respective Russian figures by 40 to 50 times in average. Even if adjusted for the scale of the banking systems and GDP, the amount of refinancing in these countries is still 3 to 5 times higher than in Russia. Does this mean that US and Japanese banks are less efficient in managing liquidity? More likely, the highly developed refinancing system allows US and Japanese banks to take more active part in economic processes, while retaining quick access to liquidity from their central banks (for information: the loans to GDP ratio is around 30% in Russia and 48% and 65% in the US and in Japan, respectively).

The refinancing capabilities should be oriented at achieving general economic objectives and securing structural and regional priorities. The list of eligible securities must be expanded to this end by including papers issued by respective industries and territories in such list. This will ensure targeted liquidity inflow in the economy, subject to industry- and territory-specific tasks, and will increase diversification and capacity of the financial market itself, making it more liquid and stable on the whole.

We wrote about the need to expand refinancing in the context of global risks well before the subprime crisis broke out and underlined the need to refinance as an important instrument in both anti-recessionary and structural policies and its great role in supporting ongoing operation of the banking system.

At the earlier stages of the crisis, Russian regulators had to adopt a number of measures to expand liquidity in the market (reduction of Reserve requirement ratios, ability to use public funds to buy some stocks, reduction of oil export duties, etc.). The government also announced that a part of the National Welfare Fund and pension funds could potentially be invested in Russian stocks to support the market.

Bank of Russia	**Ministry of Finance**
• A subordinate loan issued to Sberbank (Rub 500 bln) • A deposit placed with VEB to issue corporate loans USD 50 bln) • Losses incurred in the IBL market due to the withdrawal of a license from a counteragent bank partially reimbursed • The range of tools expanded • Mandatory reserve ratio reduced (to 0.5) • Unsecured loans issued • Interest rates on deposits with the Bank of Russia increased • Participation in the stock market trading	• Collateral-free loans placed out of temporarily free funds of the federal budget • The limit of deposit loans to non-government bank increased • AHML's mortgage deposits refinanced • A deposit placed with VEB using the money from the National Welfare Fund to issue subordinate loans (Rub 625 bln) • The real sector supported via the stock market (Rub 175 bln) • Financial aid provided to the Deposit Insurance Agency to support banks' capitalisation (Rub 200 bln) • Retail deposit guarantees enhanced (up to Rub 700 thousand)

Table 3.2. Some Measures Taken to Support the Russian Financial System in 2007-2009

The list of above measures was later extended.

It is also interesting that many countries used substantially similar approaches to normalize the situation in the financial market.

	Government support to the financial sector	Increase of deposit insurance amounts	Nationalization of bank assets	Plans for acquisition of 'toxic assets'	Prohibition or restriction of short selling
France	X				X
Italy	X	X			X
Germany	X	X		X	X
UK	X	X		X	X
Japan	X				X
US	X	X	X	X	X
Austria	X	X			X
Switzerland	X	X		X	
South Korea	X			X	
Poland	X	X			
Hungary	X	X			
RUSSIA	X	X			X

Table 3.3. Key financial support measures in different countries

Source: OECD.

Despite all potential differences in the approaches in the future, it is obvious that the control over and consolidation of the financial system in the new conditions will require considerable expansion and reinforcement of regulatory approaches to set the required direction for policies run by financial institutions of the new type.

Regulatory approaches, as we see it, will be reinforced, first, due to the need to rectify existing flaws and distortions in financial markets, second, from the standpoint of control over the cross-border aspect of the issue (with all ensuing geo-political risks), and, third, from the standpoint of forming a more consistent and coherent system to implement uniform approaches on the back of the increasing segmentation of the financial market and diversification of its instruments.

We would underline that the actual logic of the financial system evolution at the current stage makes many of the above measures obvious. Back in 2007 (and before) we proposed many of the approaches that were suggested by the US regulators during the 2008-2010 crisis.

For example, the proposed programme of measures for reforming the US financial regulation system prepared by the US Treasury **in March 2008** underlined, *inter alia*:

1. The need for coordinated regulation of different financial market segments because of "the current system of functional regulation, which maintains separate regulatory agencies across segregated functional lines of financial services"[51], which prevents from coordinating regulation at an appropriate level.

2. In addition to classic functions of the Fed (central bank) that, as you know, include, among other things, maintaining the employment level and economic growth, it is suggested that its functions be further expanded from the standpoint of ensuring stability of the entire financial market and the whole financial system[52].

3. In his statement to the Congress of **10 July 2008**, Henry Paulson, US Secretary of the Treasury, spoke of the need to "give regulators additional emergency authority to limit temporary disruptions"[53].

4. The need of 'strengthening the capitalization of financial institutions of every size'.[54]

We suggested the use of roughly similar approaches before.

M. Ershov **(2007)**: 1. "The financial system cannot be viewed any longer as a set of independent sectors, with each sector having its 'local' growth targets and independent regulation principles. We need uniform principles and approaches to reinforce the foundation of the financial system... This implies multi-dimensional and coordinated work by all regulators and market players"[55].

[51] US Treasury, Henry M. Paulson, "Blueprint for a modernized financial regulatory structure", March 2008, p.4.
[52] Idem, p. 15.
[53] US Treasury, Opening Statement by Henry M. Paulson, July 10, 2008, p. 30.
[54] US Treasury, Statement by Secretary Henry M. Paulson, Jr. on Financial Markets Update, October 8, 2008, p. 2.
[55] M. V. Ershov. How To Ensure Stable Development In The Context of Financial Instability?// Voprosy ekonomiki, No. 12, 2007, p. 26.

2. "The Central Bank must become a real lender-of-last-resort, whose well-timed and appropriate measures will be crucial to the stability of **the financial sector** and the economic growth on the whole"[56].
"We need to consider expansion of the Central Bank's functions …"[57]
"Monetary policy instruments must be also used to stabilize the situation in the **stock market**"[58].

3. We need to develop "emergency mechanisms and facilities that can be rapidly triggered in the event of a crisis"[59].

4. **(2006):** It is important to ensure "reinforcement of the banking sector as the cornerstone of the financial system, and to ensure its capitalization growth"[60].

In general, the IMF estimates that, despite some successes in recapitalization of banks, markets will remain fragile, concerns regarding losses and economic slowdown will persist, while lending terms in developed countries will remain rigorous.[61]

The most important issue is the issue of bank capitalization both - from the standpoint of their higher stability required to ensure stability of the economy on the whole, - and from the standpoint of more active involvement of banks in lending and investments. Technically, this issue is also of importance given the leverage problem, with the solution largely depending on the level of banks' capital.

[56] Idem, p. 26.
[57] Idem, p. 26.
[58] Idem, p. 26.
[59] Idem, p. 25.
[60] M. V. Ershov. Economic Growth: New Issues and New Risks. // Voprosy ekonomiki, No. 12, 2006, p. 35.
[61] World Economic Outlook [update], IMF, July 2008.

Monetization of the Economy and Capitalization of Russian Banks

The capitalization rate of Russian banks is many times smaller than that of leading financial institutions of developed countries. The capital of any large Western bank is comparable with the capital of the entire Russian banking system (and often exceeds it). Although the capital rate is gradually growing, the gap persists and is still significant (Fig. 3.9).

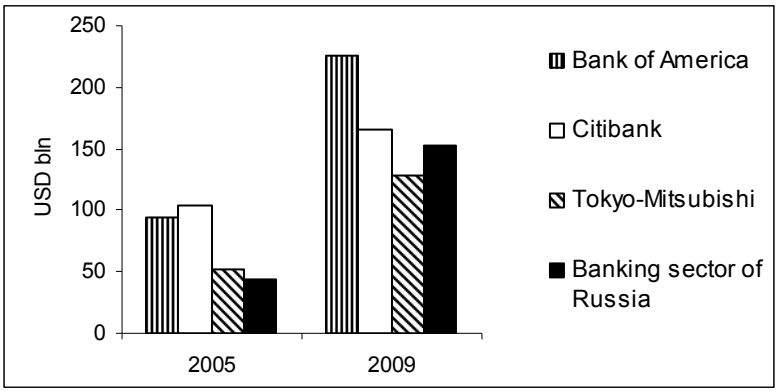


Fig. 3.9. Capital of Large Banks and Russian Banking System (USD bln)

Source: built using data from the Central Bank of the Russian Federation, US Fed, Bank of Tokyo-Mitsubishi.

Low capitalization rate of Russia's banking system is an issue inherent in the so called market reforms of the 1990s.

Drop in industrial output in that period, low GDP growth rates, a decline in investments, high inflation, a decrease in direct government participation in the capital of the banking system and a number of other factors were to a large extent behind low capitalization rate.

From a more fundamental standpoint, it appears that certain monetary and financial factors played their crucial role. These factors not only hampered capitalization (and related processes such as investment, lending, etc) but also created favorable preconditions for the crisis of 1998. Moreover, these deformations shaped the environment which much later, in the late 2000s, aggravated the "mortgage crisis" effects on the Russian economy.

Money Supply Contraction: Old Risks in the New Environment

As a result of drastic contraction of the real money supply in the first half of the 1990s caused by price liberalization, growth of money supply was significantly lagging behind the growth of prices.

In the early '90s, prices (both consumer prices and the GDP-deflator index) grew by a few **thousand-times**; money supply – grew by a few **hundred-times,** showing real, almost **ten-fold, money supply contraction** (table 3.4, Fig. 3.10).

> Prices grew by a few **thousand-times**; money supply – grew by a few **hundred-times,** showing real, almost **ten-fold, money supply contraction.**

	1991	1992	1993	1994	1995	1998 *
M2, Rub trln	1.32	8.55	38.26	103.83	220.8	452.5
Annual increment in nominal M2, **%**	214.3	547.7	347.5	171.4	112.7	21.0
M2, Rub trln in the 1991 prices	1.32	0.53	0.24	0.16	0.12	0.13
GDP deflator index, times (1991 = 1)	1	16	157	645	1,808	4,281

Table 3.4. Money Supply Indicators in 1991–1998, Russia

*Net of denomination.

Source: calculated using data from the Central Bank of the Russian Federation and the Federal State Statistics Service.

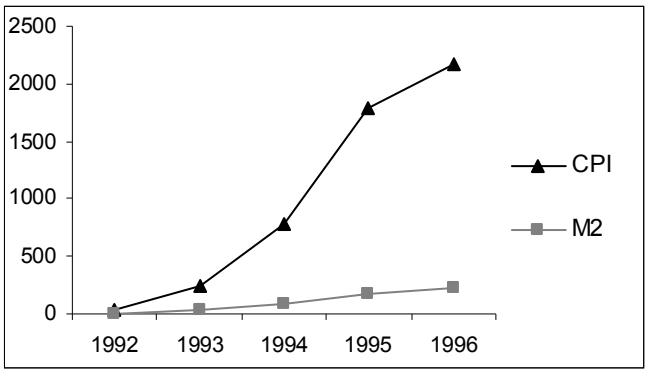


Fig. 3.10. Consumer Price Indexes and M2 in 1992-1996, Russia (1992=1)

Source: calculated using data from the Central Bank of the Russian Federation and the Federal State Statistics Service.

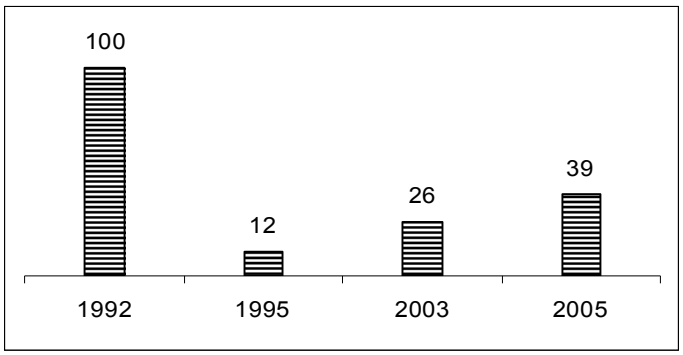


Fig. 3.11. Real Money Supply Contraction (M2) in 1992-2005, Russia (1992=100, %)

Source: calculated using data from the Central Bank of the Russian Federation.

The situation was further aggravated by the fact that, as a result of privatization policies, money supply, which had traditionally serviced the needs of current operations (settlements among entities, consumer market transactions, etc), became exposed to an additional burden associated with servicing and maintaining liquidity in a fundamentally new market segment of shares, bonds, etc, which previously had never been transacted and, therefore, didn't need money supply to rely on.

Since the inflow of additional assets to the market was not accompanied by an adequate increment in money supply, it is obvious that the emergence of new assets for purchase and sale, first, increased the burden on money supply and, second, gave rise to an undervaluation of the assets sold as well as undervaluation and low liquidity of the stock market in general.

Since the inflow of additional assets to the market was not accompanied by an adequate increment in money supply, it is obvious that the emergence of new assets for purchase and sale, first, increased the burden on money supply and, second, gave rise to an undervaluation of the assets sold as well as undervaluation and low liquidity of the stock market in general.

The monetization of economy (M2/GDP) dropped as a result of the above-mentioned trends. Even currently, despite an increase in this indicator, the average rate is about 35-40%, which is lower than in many developed and even transition economies, in which its values vary between 60% and 100% (in some countries it is significantly higher).[62]

	1991	1992	1997	2000	2009
Russia	94	45	15	16	40
United Kingdom	88	86	92	85	133
US	57	55	50	50	60
France	42	40	45	47	96
Italy	57	54	41	55	86
Germany	35	36	35	63	86
Japan	106	105	110	116	158
China	92	105	236	152	181

Table 3.5. Money Supply (Aggregate M2) as a Percentage of GDP in a Number of Countries

Source: IMF, national statistics.

[62] M.V. Ershov. Economic Sovereignty of Russia in Global Economy. M.: Ekonomika, 2005. pp. 134-161, 191-205.

1991	1992	1995	1997	2000	2009
21	31	16	17	20	50

Table 3.6. Money Supply (Aggregate M2X) as a Percentage of GDP, Russia

Source: IMF, national statistics.

It should also be noted that the very ability of national economy to withstand such domestic shock is a very meaningful fact by itself, demostrating its strong anti-crisis margin of safety.

The very ability of national economy to withstand such domestic shock is a very meaningful fact by itself, demostrating its strong anti-crisis margin of safety.

Obviously, such significant money supply contraction and its concentration in the sole narrow segment of economic operations (Government Short-Term Bonds and Federal Loan Bonds) were among the most important factors causing the reduction of domestic supply, which aggravated economic recession at the time.

The contraction of money supply, in its turn, derived from the fact that lacking supply began to be replenished locally. Virtually, appearing means of settlement (notes, etc.) and arrears, which, in fact, were an involuntary commercial loan extended on the part of the seller to the insolvent buyer, were in a way a spontaneous emission (money creation) avoiding the channels of the Central Bank.

At the same time, rapid growth of arrears was seen during the most intense money supply contraction since in this manner the economy attempted to neutralize the lack of money using available methods (table 3.7).

	1993	1994	1995	1996	1997
Overdue payables aggregate	17.4	96	250	538	782
Namely:					
Overdue bank loans and advances payable	1.0	5.6	10.6	23.5	26
Overdue accounts payable of enterprises and organizations	16.4	90.4	239	514	756

Table 3.7. Arrears in the Russian Federation in 1993–1997 (Rub trln)

Source: caculated using data from the Federal State Statistics Service of Russiafor respective years.

The lack of money strengthened the naturalization of exchange, i.e. barter operations (exchanges-in-kind).

Although barter had existed before, in this period it became widespread. Entities often had to use it as an involuntary measure. The emerging deformations created a number of "inconveniences" as well as vast opportunities for abuses. The use of barter necessitated appraising goods at higher prices, thus increasing the tax base and causing arrears. Likewise, the use of securities for turnover needs lead to losses and more expensive money resources for sellers, which in most cases would have preferred "real" money as a means of payment for their goods.

Furthermore, when later in the 2000s, the economy gradually started to be filled by "real" money, it immediately lead to the reduction of defaults and barter and the growth of cash settlements. If it had been the case of deliberate system deformations, the scope of barter and defaults would have remained the same, whereas as a result of emergence of "real" money they decreased drastically (table 3.8).

	1999	2000	2004	2009
Cash	46.6	72.1	88.9	97.8
Notes	19.7	7.7	3.3	0.3
Offsets	21.4	14.0	5.2	1.7
Barter	4.9	2.8	0.4	0
Other	7.4	3.4	2.6	0.2

Table 3.8. Structure of Settlements for Dispatched Products in 1999-2009, Russia (%)

Source: Bank of Russia Bulletin, the Federal State Statistics Service for respective periods.

In general, it is safe to say that defaults and the use of "quasi-money" (barter, surrogates), as undesirable as they had been, played their positive role. In essence, they protected the economy against complete collapse and ensured the execution of economic operations, though using such “uncivilized” methods, actually performing "quasi-emission" beyond the Central Bank and thus replenishing lacking financial resources in the economy.

Defaults and the use of "quasi-money", in essence, protected the economy against complete collapse and ensured the execution of economic operations, though using such “uncivilized” methods, actually performing "quasi-emission" beyond the Central Bank and thus replenishing lacking financial resources in the economy.

However, low monetization and weak connection between the real economy and the financial sector, despite numerous adverse effects of this phenomenon, had their positive side as well, making the financial shock of 1998 and recession less dramatic for the economy, thus allowing it to restore quickly (Fig. 3.12).

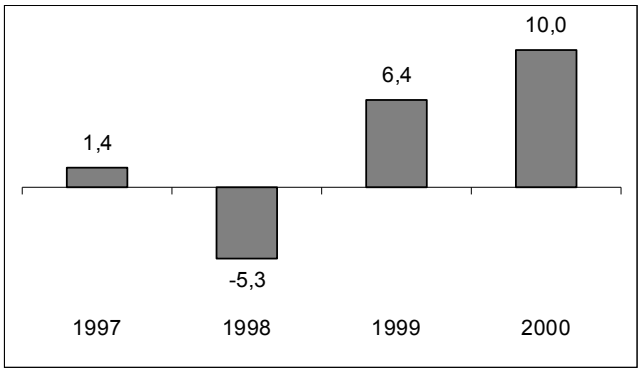


Fig. 3.12. Real GDP Growth in Russia in 1997-2000 (%)

Source: the Federal State Statistics Service.

The unavailability of domestic sources of financing to economic players, virtually, pushed them into the external market, where resources were more abundant, lower-priced and more readily-available (wih the exception of crisis tension periods).

In the crisis of 1998, the principal risk generator was the budget segment dependence on external financing[63], whereas in the crisis of the late 2000s external factor became the main risk channel for private sector, whose dependence on the external segment grew abruptly.

We would remind that in the pre-crisis years the financing of economy switched focus from domestic sources to external ones. For example, in 1994, more than 90% of budget expenses were financed using domestic sources and only 8%, came from international sources; in 1998, the ratio was 42% and 58% respectively.

In the threshold of "mortgage crisis," due to the unavailability of necessary resources in the domestic market, companies and banks had to raise funds from external markets, causing sustainable growth of corporate external debt.

[63] M.V. Ershov. Economic Sovereignty of Russia in Global Economy. M.: Ekonomika, 2005. P. 149.

2003	2004	2005	2006	2007	July 1, 2008
80	**108**	**175**	**265**	**425**	**497**

Table 3.9. Corporate External Debt in the Russian Economy in 2003-2008 (USD bln)
Source: the Central Bank of the Russian Federation, November 2010; the Bureau of Economic Analysis

Rapid growth was demonstrated by net external debt of non-financial sector (table 3.10).

2003	2004	2005	2006	2007
-56	**-117**	**-202**	**-307**	**-513**

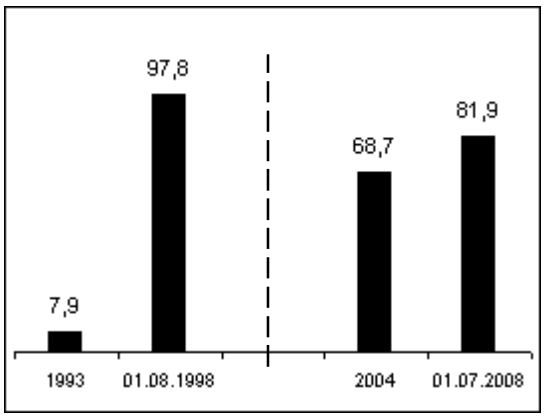
Table 3.10. Net International Investment Position of Non-financial Entities of the Russian Federation in 2003-2007 (as of Period End, USD bln)
Source: Dengi i Kredit No. 9, 2006; calculated using data from the Central Bank of the Russian Federation.

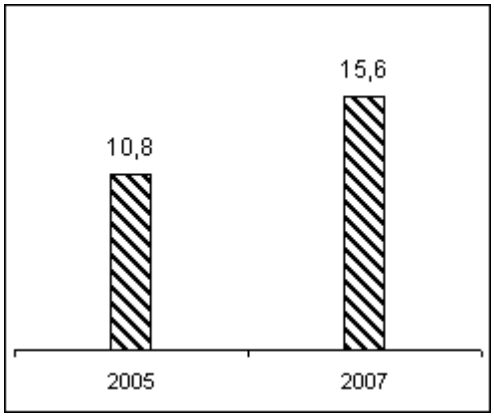
This resulted in lower values of net international investment position of the Russian Federation, in fact, reflecting "net external debt" of the entire economy (table 3.11).

2004	2005	2006	2007
-10	**-31**	**-39**	**-150**

Table 3.11. Net international Investment Position of the Russian Federation in 2004-2007 (as of Period End, USD bln)
Source: the Central Bank of the Russian Federation, November 2010

In other words, large-scale inflow of external financial resources took place. At the same time, their share in money supply grew (Fig. 3.13-a), thus creating destabilizing potential (a common situation in the pre-crisis periods in many countries). A gradual increase in the share of short-term corporate debt was ever more disquieting (Fig. 3.13-b).





a) corporate external debt **b) short-term corporate external debt**

Fig. 3.13. Corporate External Debt to M2 (%)

Source: calculated using data from the Central Bank of the Russian Federation.

As early as 2005, we highlighted a disquieting trend toward rapid growth of external debts owed by Russian companies and banks. It was emphasized that, as a result, the "Russian financial sector, primarily banks, not only faces aggravating global economic risks but also, in general, finds itself in an extremely challenging situation due to the unavailability of adequate domestic mechanisms capable to offset such deformations."[64]

"Although the inflow of external liquidity is one of possible ways of meeting domestic demand for resources, it generates a set of debt issues: debt administration, possible changes in price conditions, risks associated with the rapid outflow of funds (if short resources are implied), etc."[65]

Furthermore, later, we underlined another obvious trend: "growing economy needs additional financial resources; if the latter are not available from the domestic market and are not created domestically, they need to be raised from abroad."[66]

While it was possible to raise resources, liquidity issues, in general, never arose. Yet as soon as this channel narrowed (by the summer and autumn of 2007), the Russian financial system came under considerable pressure. This created preconditions generally capable of hampering economic growth.

The risks of excessive focus on external financing was also emphasized by us earlier (2006). It was said that, in particular, "consideration should be given to the possibility of

[64] M. Ershov, V. Zubov. Possibilities and Risks of Financial Integration, Voprosy ekonomiki [Economic Issues]. No.12, 2005, pp.5-6.
[65] M.V. Ershov. How Stable Development Can Be Ensured in the Environment of Financial Instability?// Voprosy ekonomiki [Economic Issues]. No. 12, 2007.
[66] M.V. Ershov. Economic Growth: New Issues and New Risks.// Voprosy ekonomiki [Economic Issues]. No.12, 2006, pp. 25.

changes in global financial environment, which can make financial resources more expensive"[67]. "The terms of loans obtained may drastically differ from the current ones, which, if the situation worsens, will place borrowers in a difficult situation"[68].

> Even before the crisis, in 2006, we said that "consideration should be given to the possibility of changes in global financial environment, which can make financial resources more expensive". "The terms of loans obtained may drastically differ from the current ones, which, if the situation worsens, will place borrowers in a difficult situation".

Practical experience showed that mortgage crisis in the USA, indeed, aggravated the issue of global liquidity and led to the tightening of conditions for loan extension and the growth of their cost.

A number of fundamental questions arise in a more systemic context. Why does the economy have to go for external resources? Indeed, they are more abundant, extended for long terms and often low-priced. But perhaps it's worth creating the same conditions in the domestic market? Which is particularly relevant if the economy needs financial resources. Besides, the withdrawal of resources from the economy (even for sterilization purposes) is not the most feasible measure in a situation like this – all the more so as later the economy will have to raise them at a higher price from the outside? It should be noted that money raised from abroad is no less inflationary than the money raised from domestic markets. However so far the potential of economy allows absorbing it with almost minimal inflation implications (we will address this question below).

Let us note that both the crisis of 1998 and the current crisis were preceded by considerable cancellation of almost all restrictions on capital flow.

Note

The market for Government Short-Term Bonds (GKO) imposed restrictions on the withdrawal of foreign currency resources by non-residents from the country. In withdrawing GKO, a foreign investor had to stick to ruble positions for three months and then could convert them into foreign currency and transfer the obtained currency abroad. Later, this period was reduced at first to two months and then to one month. This was followed by the introduction of the so-called "T+1" regime, which allowed repatriating currency on the third business day. Given considerable currency resources raised to the GKO market, such measure raised the vulnerability of the Russian economy to subjective or situational moods of foreign market

[67] M.V. Ershov. Economic Growth: New Issues and New Risks.// Voprosy ekonomiki [Economic Issues]. No.12, 2006, p. 30.
[68] Idem.

participants. Everyone remembers the arguments of advocates of the 1998 liberalization who said that the more liberal a regime is, the more investors can be attracted and the longer they will stay in the market, knowing there are no obstacles for them to withdraw. **However, as a result it was a rapid withdrawal of funds abroad that provoked the collapse of foreign exchange and stock markets[69].**

When international investors search for the opportunities of minimizing risks in placing funds and start showing greater interest in developing markets, which are relatively more stable and have bigger growth potential, the inflow of foreign financial resources to the Russian market should be monitored effectively[70].

By July 2008, accumulated foreign capital accounted for a considerable share of both money supply and the economy in general (Fig. 3.14).

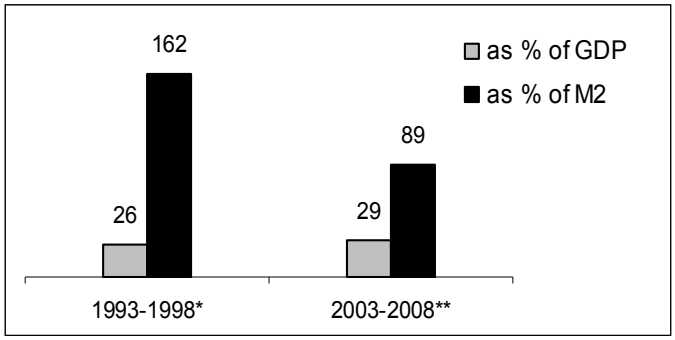


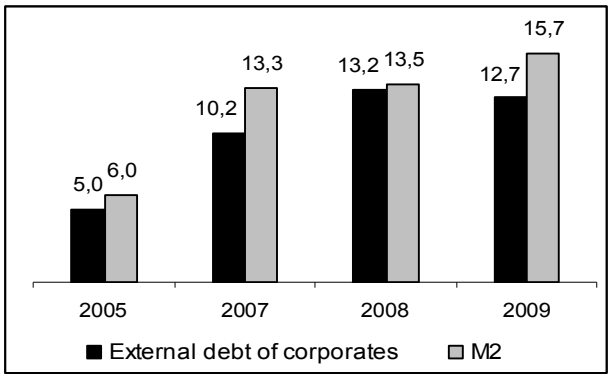
Fig. 3.14. Capital Inflow as % of GDP and as % of Money Supply (M2), Russia

* as of July 1, 1998
** as of July 1, 2008

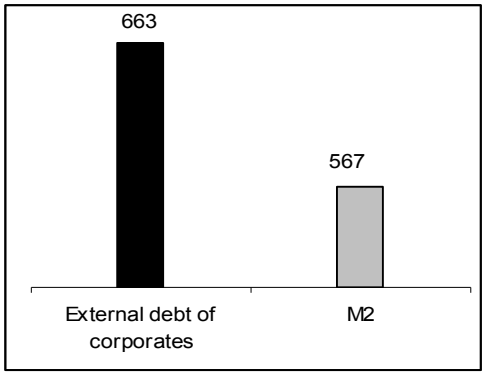
Source: calculated using data from the Central Bank of the Russian Federation and the Federal State Statistics Service.

In this context, it is even more important for domestic monetary mechanisms to be able to neutralize effectively any risks associated with the rapid termination of cash inflow and outflow and shape the necessary financial resources primarily at the domestic level, which is less dependent on external conditions. However, in fact, before and even after the crisis, money supply is still created using external sources (Fig. 3.15).

[69] Likewise, so far it is only partly safe to say that the reduction of money circulation velocity had a systemic role to play (as a factor which could explain the gap between the growth of prices and money supply). Furthermore, we remember how "artificial" this indicator was in the 1990s, when the velocity was also assessed (by mechanically dividing GDP by M2) while defaults and barter existed in the economy.
[70] M.V. Ershov. Economic Growth: New Issues and New Risks.// Voprosy ekonomiki [Economic Issues]. No.12, 2006, p.29.



a) 2005 - 2009 (Rub trln)



b) growth since 2003 - 2Q 2008 (%)

Fig. 3.15. Corporate External Debt and Money Supply (M2), Russia

Source: calculated using data from the Central Bank of the Russian Federation.

It creates the instability potential since in the crisis environment access to external financing will be complicated or financial resources will be accumulated by foreign investors in their head-banks and withdrawn from the Russian market (as was noted during the current mortgage crisis in the US).

Furthermore, before both crises (in 1997 and 1998), the economy was characterized by high fixed asset depreciation rate and low diversification (Fig. 3.16). At the same time, in the case of export, its structure considerably deteriorated by the recent crisis even compared with 1998 (Fig. 3.17).

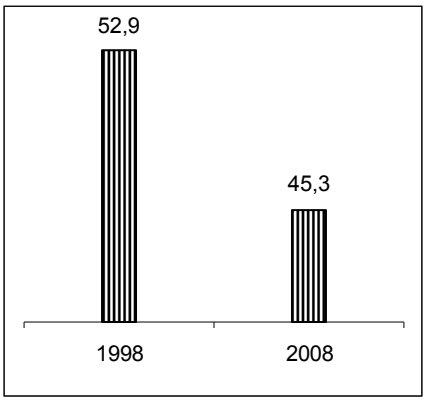


Fig. 3.16. Fixed assets depreciation rate, Russia (%)

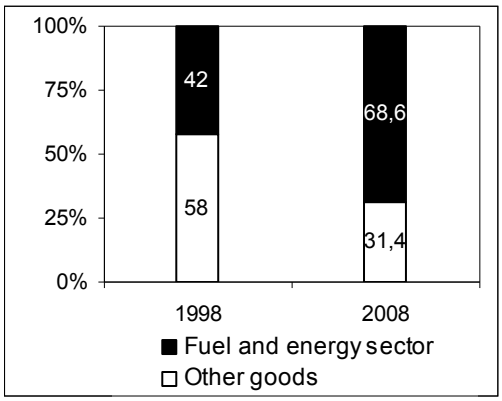


Fig. 3.17. Structure of export of goods, Russia (%)

Source: the Federal State Statistics Service, Mayor of the Russian Federation, the Ministry of Finance of the Russian Federation.

Let us also point out that, in the late 1990s, the primary question was government debt, whereas now it is corporate debt owed by companies and banks, which, theoretically, will have to solve all of its problems on their own. **However,** given that a considerable portion of funds were raised by companies co-owned by the government, in case of their insolvency the

government will have to help them. Moreover, both - government-owned and private companies, - typically, are crucial and systemic economic players, whose troubles can infect other companies and provoke a large-scale crisis. As early as 2006, we emphasized in this regard that many companies, in fact, were of strategic importance and allowing them to default would be hardly feasible, "which would also imply the need for government interference and the use of currency resources of the economy to prevent the crisis."[71]

In particular, this was the case in the autumn of 2008 due to the complication of refinancing of external corporate loans, when in late September it was decided to use the possibilities of VEB to extend the loans of at least USD 50 bln to commercial banks for the repayment of their external loans. VEB, in its turn, will be refinanced by the Bank of Russia, which, obviously, can cause the reduction of the government's currency resources.

All of these risks become even more intense in the situation when the degree of openness of Russian economy became high in the environment of growing external instability (Fig. 3.18).

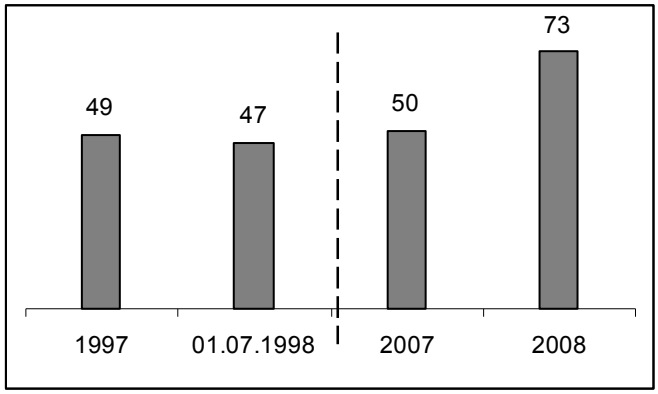


Fig. 3.18. Foreign Trade Turnover (% of GDP)

Source: calculated using data from the Central Bank of the Russian Federation and the Federal State Statistics Service.

Since external vulnerability grew during the significant growth of external global risks and taking into account the liberalization of foreign economic ties in the Russian economy, questions associated with ensuring the stability of domestic market in the environment of global crises become highly critical.

Obviously, low monetization rate was a significant factor constraining the development of banking system. The issue is further aggravated by the withdrawal of a considerable portion of funds from circulation (domestic debt instruments, pension fund, household deposits with government banks, etc.).

[71] M.V. Ershov. Economic Growth: New Issues and New Risks.// Voprosy ekonomiki [Economic Issues]. No.12, 2006, p.30.

In general, the process of gradual filling of economy with financial resources, which is underway, highlighted a whole range of interesting trends whose possibility (or impossibility) had been repeatedly discussed by the advocates and opponents of monetization.

Back in 2000, we emphasized, in particular, the possibility of monetization without strengthening inflation.

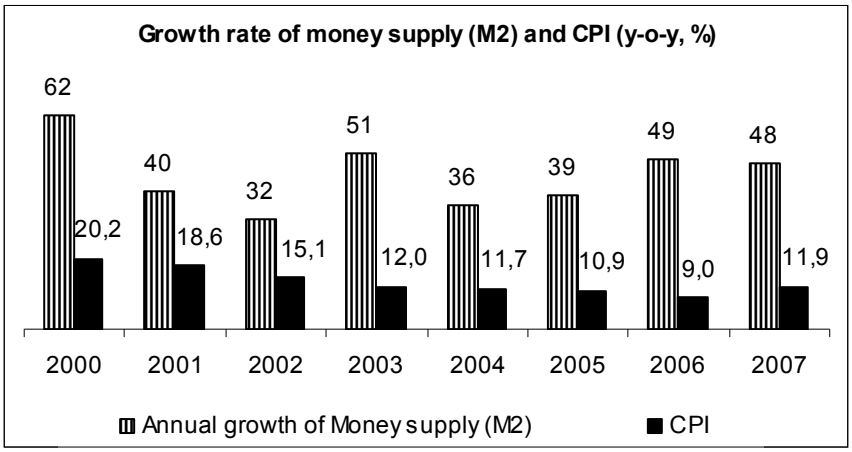
> **M. Ershov (2000)**: Non-monetized operations executed in the economy can contribute, to a considerable extent, to the efficient expansion of capital base of the economy. It should also be considered that in the absence of currency panic, the Russian economy has already demonstrated its ability to accept additional ruble-denominated resources on an inflation-free basis...
>
> In general, the replenishment of liquidity, obviously, has to be combined with the normalization of the structure of money supply by means of gradual replacement of those components which emerged spontaneously avoiding the channels of the Central Bank and are, therefore, less prone to centralized regulation, thus decreasing the effectiveness of monetary policy[72].

Further evolution of the situation, to a great extent, proved the above-mentioned assumption. Both nominal and real growth of money supply, which has been observed since 2001, was accompanied by the reduction of defaults and at the same time did not cause any comparable price growth. The structure of settlements and money supply-at-large generally stabilized, as well.

For example, between 2001 and 2007, the money supply (M2) growth rate exceeded 1,000%, whereas prices during the same period grew by slightly more than 130%. Furthermore, the gap became visible well before the use of strong "sterilizers" (the Stabilization Fund, etc), whose existence could explain such deviations between the issue and the prices. These tools have played a critical role since the above-mentioned price deviations became a persistent phenomenon (Fig. 3.19). In particular, between 2000 and 2004, the M2 money supply grew by 350%; consumer price index, by 190%. In general, in the early 2000s, money supply grew by 50-60% per year; prices, by 15-20%. In other words, the annual growth of money supply outpaced price growth by two-fold and sometimes by three-fold. It appears that the reasons

[72] M.Ershov. Financial and Monetary Mechanisms in the Modern World (Crisis Experience of the Late 90s). – M.: Ekonomika, 2000. – Pp. 317-319.

behind this were monetization of barter and surrogates, substitution of arrears. All these - finally allowed the economy to absorb liquidity, almost, on an inflation-free basis.



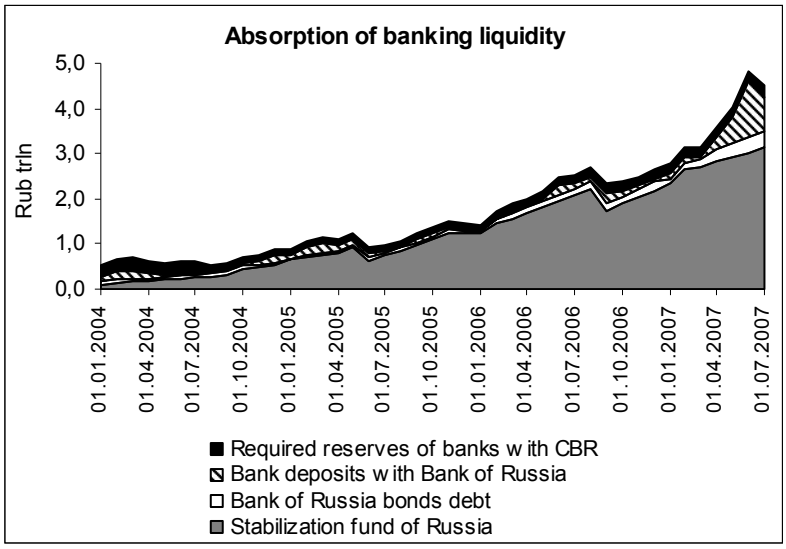


Fig. 3.19. Russia: M2, Prices and Liquidity

Source: built using data from the Federal State Statistics Service and the Central Bank of the Russian Federation.

The issues of creating necessary resources and making them available to the economy had a central role to play in the package of crisis management policies in leading economies.

Money Supply Creation

Back in March 2009, US Fed adopted a decision on the additional repurchase of a large amount of securities from the market. This implied an almost 50% increase in US Fed balance

and monetary base (Fig. 3.20) to more than USD 2 trln. Let us remind once again how rapidly both indicators grew.[73]

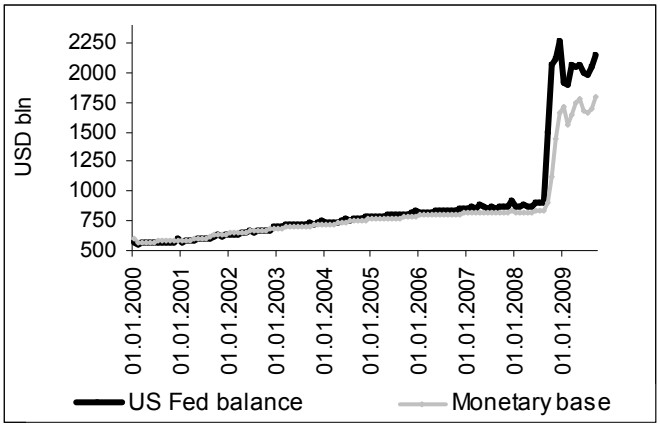


Fig. 3.20. Monetary Base of the USA and US Fed Balance (USD bln)

Source: US Fed.

We should note how decisively regulators behaved in the critical situation, when it took them a few months (or sometimes weeks) to change drastically the approaches which had been practiced for many years before.

It is also implied that, apart from the repurchase of mortgage-backed securities, growth channels will include the purchase of treasury bonds by US Fed. This practice has been persistently used by US Fed for many years, primarily in creation the monetary base, which serves as a basis for the balance and the entire money supply (Fig. 3.21). What stands out is that the two most mature global economies practice identical approaches, in which **national monetary authorities** are the pillars of money resource-creation in the economy whereas budget priorities permeate the above-mentioned approaches.

The two most mature global economies practice identical approaches, in which **national monetary authorities** are the pillars of money resource-creation in the economy whereas budget priorities permeate the above-mentioned approaches.

[73] We should also point out that, for a long time, both the monetary base and US FED balance evolved almost symmetrically and were generally identical in values. Changes became visible by late 2008, when additional liquidity was often placed in special accounts in US Fed, which, on the one hand, increased its balance, but simultaneously decreased the monetary base since these resources were virtually withdrawn from money in circulation.

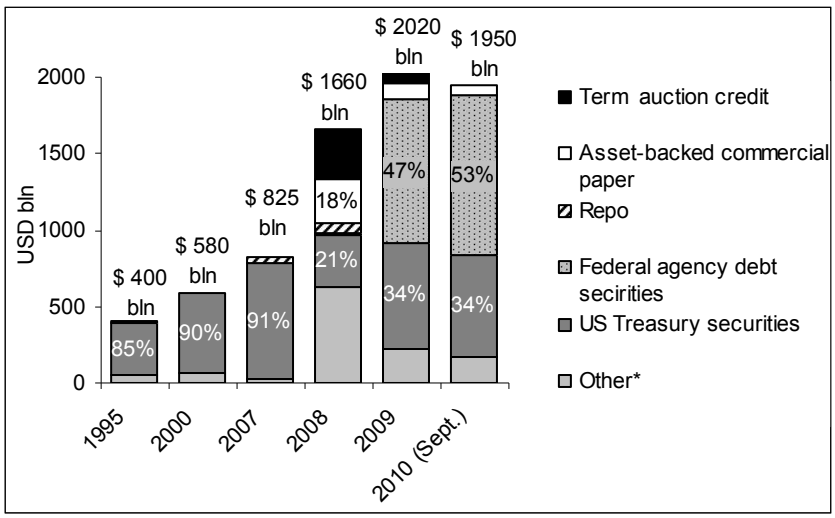


Fig. 3.21. Structure of the US Dollar Monetary Base (USD bln and %)

* Other includes cash in settlements, swaps, gold, loans, etc.
Source: US Fed, calculated using data from US Fed.

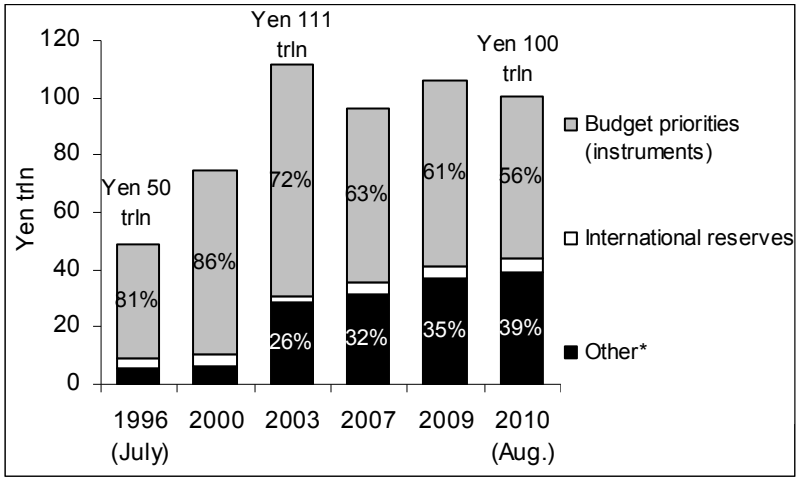


Fig. 3.22. Structure of the Monetary Base of JPY (Yen trln and %)

* Incl. financing secured by various instruments (bonds, commercial papers), etc
Source: Bank of Japan.

That being said, crisis events made US Fed not only to significantly increase the monetary base itself (virtually 3-fold by now) but also to drastically change the structure of its components. The manageability of money flows and the predictability of their trends seem to be slightly declining in the new environment. Furthermore, the growth of monetary base and hence money supply, should be connected with the relevant growth of GDP, which is not the case at the moment.

Changes in monetary base by maturity of its components are quite characteristic. For many recent years, issue has been backed by long-term instruments (accounting for at least 40% of the total monetary base which was created). This allowed shaping a more sustainable long-

term basis for financial resources in the economy. During the acute phase of the crisis, short-term instruments came to the forefront as a necessary source of emergency funds for the market. However, by mid-2009, the component of long resources regained its dominant positions (instruments maturing in more than 1 year account for over 70% of the entire portfolio). Let us note, however, that, currently, most long papers are mortgage-backed securities repurchased from the market as it was needed to support this market segment. Therefore, although the percentage of long papers generally regained its common levels of the mid-1990s and the 2000s (adjusted for mortgage instruments), US Fed balance appears to be less stable than before (Fig. 3.23).

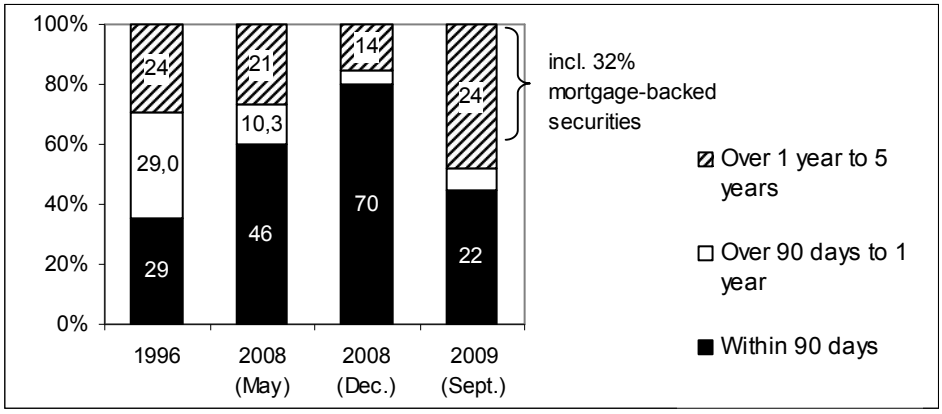
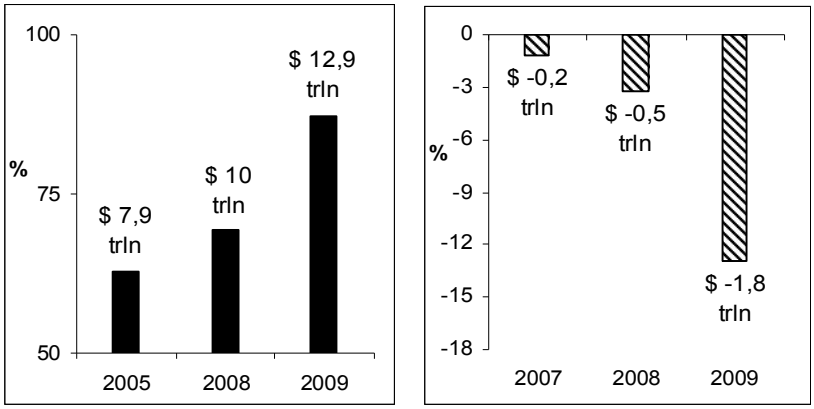


Fig. 3.23. Structure of the US dollar Monetary Base by Maturity (%)

Source: calculated using data from US Fed.

Given a sharp increase in the U.S. budget deficit and the amount of government debt (Fig. 3.24), solutions of the problem can give rise to new risks.



a) government debt **b) budget deficit**

Fig. 3.24. USA: Government Debt and Budget Deficit (% of GDP)

Source: calculated using data from US Treasury, Congressional Budget Office.

In general, such a large-scale anti-crisis issue caused significant fall of the US dollar against the euro and a number of other currencies as well as the growth of gold, silver and crude oil prices.

Russian approaches to creation of money supply also underwent certain changes in the context of the crisis.

We would remind that during the 2000s (and earlier) the monetary base of the Russian Federation relied exclusively on currency inflow into the Russian economy (export revenues, foreign loans).

The above-mentioned approach is exposed to serious risks (we emphasized some of them in considering refinancing issues):

- first, the Russian economy will remain dependent on the global economic and political situation. Thus necessary financing of **domestic processes** will depend on the decisions of international lenders, the situation in global markets and international prices, etc.;

- second, the raw material profile of the economy strengthened. The raw material industries become the main suppliers of hard currency and principal sources of demand and growth as a result. Moreover, such fuel- and energy-sectors generate demand for the rest of the economy (including non-raw-material branches) when their goals and objectives (R&D, demand for necessary equipment, etc.) shape up economic growth-at-large. This results in a kind of "pyramid" that emerges where the whole economy aims at satisfying the interests of its top, i.e. fuel and energy industries, which shape money demand for the rest of the economy.

A kind of "pyramid" emerges where the whole economy aims at satisfying the interests of its top, i.e. fuel and energy industries, which shape money demand for the rest of the economy.

- third, **refinancing rates**, which determine the prices of financial resources, become dysfunctional. In our environment, these rates, for a long time, have performed nominal and fiscal functions and followed the market instead of forming it, as it should be. This considerably limits the ability of monetary authorities to pursue active financial and monetary policy, thus affecting the nature of economic development and the structure of economy.

Ultimately, rubles as if from an ‘exchange office’ which purchases foreign currency and sells rubles. Furthermore, it is irrelevant where did this ‘hard cash’ come from and how critical or negligible these processes are for economy (figuratively speaking, it can be currency

obtained from the sale of "cans". Does this imply that, as a result, the exporters of such "products" should broadened their positions in the economy to spur-up its growth?)

In 2005, we wrote: "Unless the Central Bank applies its instruments to the creating of financial resources (refinancing mechanisms, emission, management of interest rate, etc), in such an environment, businesses and the economy in general, virtually, can only use the external sources of financial resources, thus increasing the external debt."[74]

In fact, such approaches are similar in their philosophy to the approaches used in the so called "currency board" (implying external management of emission). As a result, in recent years, the entire amount of created Russian currency has been covered by gold and foreign currency reserves by a multi-fold basis (Fig. 3.25).

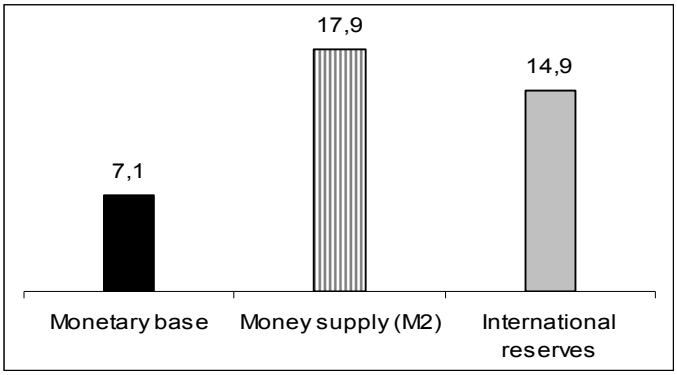


Fig. 3.25. Russian Federation: Monetary Base, Money Supply, International Reserves (as of October 1, 2010, Rub trln)

Source: the Central Bank of the Russian Federation.

We would remind that such approaches were used by small economies (an example of a larger economy is Argentina, where this attempt has failed), former colonies or countries for which such external issuing center is the key economic partner. Furthermore, the central banks of such countries lose controls over main tools of monetary policy.[75] Virtually, their central banks give up their principal functions and, in fact, delegate them to the central banks who create the main currencies. The exchange rate of the country accepting the "currency board" regime is strictly linked to the "anchor currency" rate. This implies that such countries lose their economic independence, which has been emphasized by qualified international experts, saying, in particular, that "in both - Argentina and Hong Kong, [countries with currency board. – M.E.], - domestic monetary policy is pursued, in fact, by A. Greenspan" [76]

The approaches practiced by developed countries rely on budget priorities as a crucial to money demand creation. This allows forming more evenly the "epicenters" of growth and demand. It should be mentioned that, economic policy priorities are financed through budget channels and then these resources are multiplied and penetrate the other sectors of economy,

[74] M.V. Ershov. Economic Sovereignty of Russia in Global Economy. – M.: Nauka. 2005, p. 201.
[75] For example: IMF. Frameworks for Monetary Stability. Wash., 1994, pp. 198–203.
[76] Forbes Global. 1999. July 26. P. 108.

creating ‘chain formation’ of demand and encouraging the growth of adjacent and other industries. We would remind that the long-term government bonds (among other instruments) underlying the creation of currency account for 50-70% of the total portfolio of government securities held by central banks, thus laying the foundation for investment processes and ensuring the inflow of ‘long’ money into the economy. In the crisis period, these approaches generally strengthened.

Consequently, monetary authorities are those who lay basis for long money even in mature financial systems.

Monetary authorities are those who lay basis for long money even in mature financial systems.

At the next stage via credit multiplier this emission of long money spreads over the economy creating a multi-layer volume of long resources. This, in combination with the involvement in the process of insurance, pension and other forms of resources, results in the creation of real systemic foundation for long-term investment processes.

Note

When a central bank purchases from its ministry of finance, for example, a ten-year security, virtually, this implies that the budget obtains a 10-year loan. In addition, even after the paper matures, a new issue is often performed and purchased again by the central bank. (Typically, such operations are done indirectly through "affiliated intermediaries" operating in the secondary market. However, it is irrelevant whether such purchase is made in one or several steps. What is more important is that the Ministry of Finance, issuing securities, receives for them the dollars issued by US Fed and in turn US Fed receives securities in exchange for dollars.) Interestingly, even when developed economies (the US) faced budget surplus (as was the case in late 1990s), the amount of government securities recorded in the balance sheet of US Fed, never decreased (although needs of budget financing formally declined and the amount of government securities in the economy could have been reduced). The amount of government securities recorded in the balance sheet of US Fed was maintained in order to avoid adverse implications of withdrawal from the economy of resources which already function properly. Their withdrawal would have implied interruption in economic processes in the economy which has worked with this money.

In this regard, it appears that long money, which the Russian economy needs, may be formed if the mechanisms for creating money demand are fundamentally revised and the role of monetary authorities in the process is strengthened. On important features of long-money creation in Russia wrote academician V.I.Maevsky[77]. Many years of experience in using such approaches in mature financial systems give serious cause for reflection.

[77] V.I. Maevsky. Real Sector and the Banking Sector // Journal of New Economic Assosiation. 2009. #1-2. P. 245-249.

Otherwise, the solution to the problem of creating long resources will be fragmentary (rather than systemic and covering the whole economy) and will essentially depend on the possibility of raising long money from abroad (where it is created based on the above mechanisms).

> Long money, which the Russian economy needs, may be formed if the mechanisms for creating money demand are fundamentally revised and the role of **Russian** monetary authorities in the process is strengthened.

> Otherwise, the solution to the problem of creating long resources will essentially depend on the possibility of raising long money **from abroad.**

Initially, the crisis adjusted the approaches of the Bank of Russia to create money demand. As early as late 2007 (when the first signs of crisis process in the world wew seen), virtually for the first time in many years, "Guidelines for the Single State Monetary Policy in 2008" provided for gradual weakening of the role of international factor in monetary base (up to 2010). A year later, in 2008, the Monetary Policy for 2009 strengthened focus on the growth of *domestic* resources (net domestic assets) whereas weakening role of the external factors in money demand creation was also planned (Fig. 3.26-a-b). It was expected to allow "use more efficiently the interest rate instruments of monetary regulation and make the interest rate channel of the monetary policy transmission mechanism work"[78]. Besides it was implied that the Bank of Russia's presence in domestic foreign exchange market will be diminishing which will "help make the exchange rate policy more flexible and help implement a gradual transition to the free floating exchange rate regime"[79].

In fact, the role of external factor in 2008 weakened indeed and the role of domestic factor grew (Figure 3.26-e).

However, the 2010 monetary program was presented assuming that the growth of net international reserves will be the principal source of monetary base expansion. In general, this implies the Central Bank's departure from its approaches declared earlier which were adopted when the crisis was in full swing and aimed at diminishing external risks thus relying on domestic sources of monetization.

[78] Guidelines for the Single State Monetary Policy in 2009 and for 2010 and 2011 / Bank of Russia. P. 27.
[79] Idem.

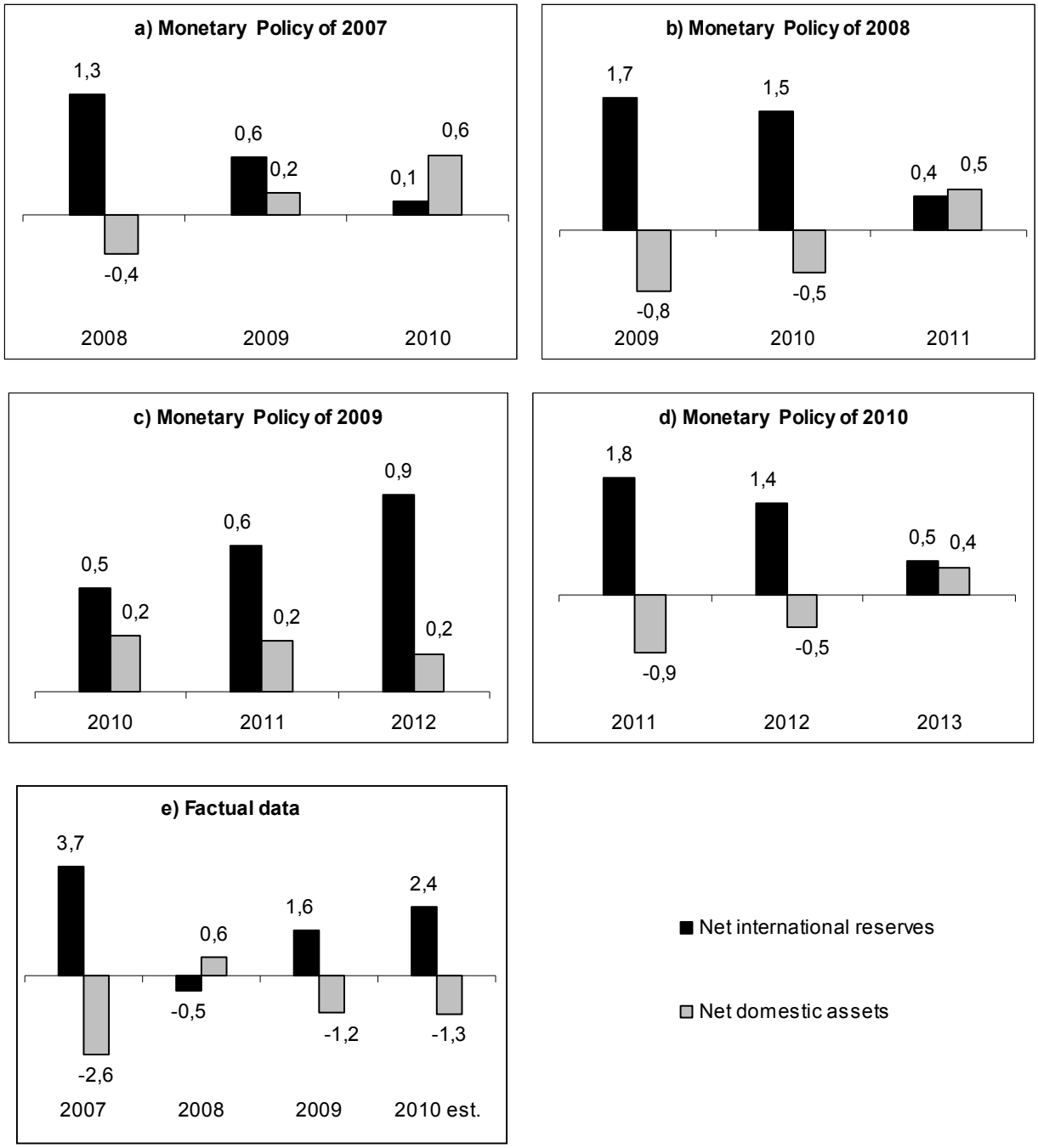


Fig. 3.26. Growth of Net International Reserves and Net Domestic Assets in the Monetary Policy of the Central Bank (Rub trln)

Source: according to Guidelines for the Single State Monetary Policy in 2008 (the basic second version), 2007; Guidelines for the Single State Monetary Policy in 2009 and for 2010 and 2011 (the basic third version), 2008; Guidelines for the Single State Monetary Policy in 2010 and for 2011 and 2012 (the basic second version), 2009; Guidelines for the Single State Monetary Policy in 2011 and for 2012 and 2013 (the basic second version). Draft, October 2010 / Bank of Russia.

Now, external sources again become dominant in monetary base creation. Although their values are expected to decrease, the absolute contribution of the external factor to the shaping of monetary base will remain crucial (Fig.3 .26-c).

Is it safe to say that the goals listed in the 2008 document lost their importance? Or the world economy risks which made the regulators modify its approaches disappeared?

And what are the ways of accomplishing systemic structural tasks faced by the economy? The external monetization channel means, first, external risks associated with raising resources (or their unavailability, as was the case during the crisis). Moreover, the above-mentioned approaches contribute to the conservation of focus on export and raw materials in the Russian economy, departure from which is seen as a critical systemic objective (a raw materials exporter, when selling currency gains and receiving additional rubles, actually shapes demand for the rest of the economy, which starts servicing the needs of oil and gas sector to an increasing extent, expanding its positions both – in exports and GDP. This situation has been observed for many years.). At the same time, the inflow of financial resources to non-export industries grows, transmission mechanisms cannot effectively secure resource flows and interest rates inadequately reflect the price of resources for the economy.[80]

The accumulation of gold and foreign currency reserves, obviously, creates a certain safety net for the economy, and their stabilization role was proven by crisis developments. Yet this does not imply the necessity of switching to the *currency board* mechanism (or close in meaning if not literal), when the entire domestic liquidity is created only based on the currency inflow and the central bank virtually abandons its key function of the primary source of monetary resources which are equally available to export and non-export industries. Exports revenue and external loans will flow into the economy in any event. However their role in creating monetary base should be balanced by internal mechanisms and adjusted for the needs of national economy participants, primarily non-export industries. Their development is a prerequisite for the real economic diversification and overcoming of its focus on raw materials.

Certainly, raw materials supplies are necessary for the world economy. In the absence of effective alternatives, Russia has to act as such supplier.

Yet is this function sufficient for the country and will it allow ensuring its long-term systemic role in the world? And what should the Russian economy rely on when non-renewable resources decrease?

That being said, the monetary program for 2010-2012 includes the reduction of both - net loan to banks and "net loan to broadened government" (table 3.12), implying additional withdrawal of funds from the economy and, as previously, necessitating the raising of funds from external sources exposed to all relevant risks.

[80] We have repeatedly pointed out these and other drawbacks of such approaches earlier (see, for example, *M. Ershov.* Economic Growth: New Challenges and New Risks / / Voprosy Ekonomiki. 2006. # 12).

	2010	2011	2012	2013
Monetary base (narrow definition)	5.8	6.7	7.6	8.5
Net international reserves	15.1	16.9	18.3	18.8
Net domestic assets	-9.3	-10.2	-10.7	-10.3
including				
Net loan to broadened government	-4.7	-4.6	-4.7	-4.8
Net loan to banks	-2.1	-3.1	-3.5	-2.6

Table 3.12. Indicators of 2010-2013 Monetary Program*
(as of Period End, Rub trln)

* 2010 – estimate of the Central Bank of the Russian Federation; 2011-2013 – forecast of the Central Bank of the Russian Federation, the basic (second) draft monetary program of 2010

Source: the Central Bank of the Russian Federation, the Principal Areas of Common Government Monetary Policy for 2011and the Period of 2012 and 2013.

If the balance of payments is still positive (which is highly likely if crude oil prices remain relatively high), the external monetization being important as it is should not be the dominant source of monetary resources in the national economy. If the objectives of improving the structure of economy and mitigating external risks remain relevant, it is necessary to assess thoroughly the possibility of a combined approach, which focuses on the task of supplying resources to the branches of "domestic" economy and simultaneously maintaining the optimal exchange rate level.

In such approach, foreign exchange gains, for example, can stay in the currency market instead of being purchased by the regulator in full (thus contributing, on the one hand, to the growth of the ruble rate, and, on the other hand, to partial money demand creation based on currency inflows). To neutralize these implications, lower-than-planned monetization can be offset by the replenishment of resources through domestic channels. To that end, a combination of **such mechanisms as refinancing, foreign exchange lending to banks, budget monetization channels, etc. can be used.**

Additional liquidity received through the above-mentioned channels can foster more even (equitable) allocation of resources among export and non-export industries and adjust the exchange rate dynamics (since this liquidity can partly return to the currency market, putting downward pressure on the strengthened ruble).

Another option is to use the currency instruments (with sufficient yield) of the Ministry of Finance or the Central Bank for accumulating a portion of currency revenue. It should also be assessed how feasible is subsequent direct sale of this currency by the Ministry of Finance (if purchased by using the instruments of the Ministry of Finance) to the Central Bank at the market

rate as of the operation date. (Such transaction may, first, replenish the ruble liquidity in the market and, second, would not directly affect the exchange rate).

Such approaches to monetization, however, imply much more subtle management of financial flows, where mechanical "single-channel" approaches (which is the case in Russia) give way to a whole range of diverse, heterogeneous mechanisms of interaction between the financial economy and the real sector (as can be seen in countries with a far more mature level of financial development).

However, if we want to position ourselves as a serious systemic player in the world economy, we should seriously asses the possibility of similar approaches in the Russian economy. Obviously, it is time to start using "reasonable practicism" in shaping our economic approaches without referring to the "dogmas" and "prohibitions," which, typically, come from the principal competitors and were abandoned by developed countries long ago. It should be noted that previously, too, such recommendations were targeted towards "external users" whereas "inside" everything was done as it should be. Crisis risks and responses only made it more obvious. The sooner we begin to rely on common economic sense, the wider will be the range of opportunities for the successful development of our economy in the new environment.

4

ON THE FOREIGN EXCHANGE POLICY

The exchange rate policy actually interconnects the foreign and domestic economy, which makes the exchange rate a kind of "filter" of such interaction. In a crisis situation, the exchange rate can both - translate external shocks on the domestic economy as well as to mitigate them.

In a crisis situation, the exchange rate can both - translate external shocks on the domestic economy as well as to mitigate them.

In a normal non-crisis situation, a well-balanced exchange policy is an important factor ensuring sustained internal development[81].

In global environment a number of countries continuously maintain approaches when their currency is maintained overvalued against the US dollar (based on purchasing power parity, PPP) (table 4.1).

[81] For details, see: M. V. Ershov. Currencies in World Trade. M.: Nauka, 1992; M. V. Ershov. Financial and Monetary Mechanisms in the Modern World (Crisis Experience of the Late of '90s). M.: Ekonomika, 2000; M. V. Ershov. Economic Sovereignty of Russia in the Global Economy. M.: Ekonomika, 2005.

	1980	1990	2000	2005	2006	2007	2008	2009
Canada	7.6	10.5	-22.4	0.2	6.7	12.7	15.4	4.3
Japan	11.4	25.9	31.3	17.7	7.5	1.9	13.2	22.8
Denmark	32.8	34.1	5.9	43.3	40.2	53.1	61.1	52.5
France*	24.8	-17.7	-8.9	6.9	4.5	13.1	19.4	11.9
Germany*	28.9	22.6	-9.7					
Italy*	-3.7	15.7	-31.9					
Sweden	40.0	34.2	12.1	25.5	23.3	31.6	34.3	15.1
Switzerland	30.8	36.8	15.5	39.9	32.5	33.3	45.1	40.9
Great Britain	17.5	6.9	0.2	15.8	15.6	28.3	17.2	-3.1

Table 4.1. Level of overvaluation (+) or undervaluation (-) of a number of currencies against the US dollar (%)

* Starting from 2005, the estimates are shown for euro.
Source: Estimated according to data of OECD, US Fed.

Meanwhile, the currency exchange rate in developing countries is, as a rule, considerably lower than the purchasing power parity level (with regard to USD). This fact is usually brought forward by currency depreciation supporters as an argument that this is the 'reality' of developing countries. They, however, often discard the fact that many such countries are small-size economies that are extremely exposed to exports[82] and the low exchange rate of their national currency is their only means to ensure foreign currency inflow to solve their domestic growth problems.

	2001	2005	2006	2007	2008	2009
Poland	-110.2	-42.2	-40.5	-33.2	-23.5	-40.8
Hungary	-61.4	-35.4	-38.9	-28.6	-25.0	-36.5
Turkey	-64.9	-38.2	-41.0	-33.9	-31.4	-40.0
Mexico	-32.4	-34.6	-33.7	-32.9	-33.0	-42.8

Table 4.2. Level of overvaluation (+) or undervaluation (-) of a number of currencies against the US dollar (%)

Source: Estimated according to data of OECD, central banks.

For the Russian market, it is important that with all the variety of objectives in place its foreign exchange policy should be aimed at strengthening the foundation of the "rouble economy". It must be focused on the rouble as the national currency, the national bank should use in full its core functions as the lender-of- last-resort, issuing centre, and principal money regulator.

[82] They are sometimes 'monocultural' exporters.

Exchange Rate Policy

Similarly to monetary approaches, the current exchange rate policy considers exports and the external sphere in general as the main factor of economic growth.

Recall that in the course of creation of the exchange market back in the end of 1980s and early in 1990s, the rouble/dollar exchange rate reflected the price relations of only a limited group of then prestigious consumer import goods. As a result, the rouble exchange rate was **significantly undervalued,** when considering not the indicators characterising limited market segments only, and reflecting its "marginal economic efficiency" (as some economists do sometimes), but rather take into account complex and balanced economic assessments (such as price ratios for a wide GDP basket).

Note

We would remind of inaccurate market estimates of the exchange rate that was set at first currency auctions that were first launched in November 1989. The rouble exchange rate that existed at that auctions (Rub 15 – 20 per USD in average) only reflected a narrow basket of the prestigious consumer imports: jeans, cosmetics, etc. (We remember that a pair of jeans then cost up to 200 roubles in the Russian black market, while their price in the US could be about 20 dollars in average). However, a whole range of other products and services were many times cheaper in the Russian market. The metro fare was 5 kopecks, while the New York subway fare cost about 1 US dollar; bread cost about 20 kopecks in Russia against 1 or 2 dollars in the US. Comparable level housing and utility fees are many times lower even today. Back in the 1980s, with the average amount of housing fees of about 15 to 20 roubles per month in Russia, this value was **hundreds of times (!)** lower than prices for similar housing in Western capitals.

We also need to take into account the share of the respective product in expenses. While we typically buy a pair of jeans once every six months or once every year, and they accounted for less than 10% of annual income at that time (in case of Russian consumers), the utility fees are paid on a monthly basis and reach at least 20 to 30% of monthly costs in case of Western economies. In other words, the 'weight' factor of this component plays an important role.

Even more important, the cost of our industrial assets was also many times lower.

The cost of our industrial assets was also many times lower.

As a result, the course towards the economic 'openness' and liberalisation of capital operations in such context gave rise to a risk that foreign investors would get control of our real assets at highly underestimated prices.

Note that even now we are talking about the fundamental undervaluation of the Russian currency by as much as 80% (!) [83] (table 4.3).

Year	1990	1991	1992	1995	1998	2004	2006	2007	2008	2009
Exchange rate/PPP	38.2	50.2	13.0	1.8	2.9	2.5	2.0	1.8	1.8	1.8

Table 4.3. Level of rouble/US dollar undervaluation (times)*

* Subject to the GDP basket (according to internal use parameters).
Estimated according to materials of the MICEX, State Statistics Committee, and IMEMO for the relevant periods.

[83] In other words, considering the PPP-based exchange rate, if it depreciates by 80%, we obtain the current level of the nominal market rouble/dollar exchange rate (about 30 roubles).

Clearly, such enormous undervaluation from the very beginning was a great stimulus to strengthen the profile of the Russian economy as an export-oriented one, making exports exceedingly efficient. Obviously, given such exchange rate distortions, export operations were becoming much more attractive than domestic ones (particularly bearing in mind the lower level of domestic prices for a significant part of manufactured products). It is also clear that fuel and energy products were becoming the most "competitive" goods in such situation, as they generally met the requirements of the world market. Taking into account that fuel and energy products have always accounted for a significant part of the national exports, the opportunities to perform superefficient export operations, which opened up as a result of the large-scale undervaluation of the rouble exchange rate, have determined the primary export orientation of the Russian economy for a long time. In turn, the money supply mechanisms strengthen the "translation" of such domination on the domestic economy where even non-primary non-export industries started focusing to a greater extent on servicing for the fuel and energy industries[84].

The opportunities to perform superefficient export operations, which opened up as a result of the large-scale undervaluation of the rouble exchange rate, have determined the primary export orientation of the Russian economy for a long time. In turn, the money supply mechanisms strengthen the "translation" of such domination on the domestic economy where even non-primary non-export industries started focusing to a greater extent on servicing for the fuel and energy industries.

It is also clear that for many years the undervaluation of the Russian currency created perfect conditions for dollarization, when the rouble and all rouble-denominated assets appeared to be fundamentally undervalued for holders of dollars. Naturally, such enormous "efficiency" made the dollar extremely attractive.

Everyone would like to have the currency that will make all rouble assets by many times cheaper than they actually worth. Besides if there are continuous talks about the future depreciation of rouble, it is clear that no one will invest into the depreciating assets.

The undervaluation of the Russian currency created perfect conditions for dollarization, when the rouble and all rouble-denominated assets appeared to be

[84] M. V. Ershov. Economic Sovereignty of Russia in Global Economy. M.: Ekonomika, 2005. Pp. 198-222.

fundamentally undervalued for holders of dollars. Naturally, such enormous "efficiency" made the dollar extremely attractive.

The exchange rate established thereby was used as the basis to determine the official rouble exchange rate.

The subsequent accession to Article VIII of the Charter of the IMF obliged Russia to introduce a “unified” rouble exchange rate, which applied to current account as well as capital transactions (investments etc.), which meant a notable drop in the efficiency of investments and relative depreciation of sold assets.

Potentially, it created a risk that, following the opening of the Russian economy and unrestricted access for foreign investors to this country, its assets could become much cheaper for such foreign investors than they actually cost.

It created a risk that, following the opening of the Russian economy and unrestricted access of foreign investors to the country, its assets could become much cheaper for such foreign investors than they actually cost.

The environment for structural transformations in the economy became even more complicated due to the fact that, given the big differences in the world and domestic prices for certain goods and commodity groups, the system of differentiated foreign currency coefficients - actually, the system of "multiple exchange rates", which were developed to eliminate such distortions, was abolished. In essence, this measure meant "shock therapy" in foreign trade.

In this regard, the exchange rate was given the central role in the regulation of **all types** of foreign economic operations (notwithstanding the diversified nature of its effects and the differences in the domestic and foreign prices for certain commodity groups). At the same time, the role of other instruments (duties, tariffs, export bonuses, etc.) that could alleviate the price distortions was, on the opposite, continuously declining.

At the same time, the rouble exchange rate was firmly tied with the dollar, which in essence merely reflected the monetary policy of the FRS.

Currently, such tie has slightly weakened: the currency basket used in the determination of the exchange rate now includes both - the dollar and euro - and the rouble exchange rate dynamics can a little better reflect the situation in the Russian exchange market.

All the aforementioned characteristics have laid basis of the present foreign exchange market.

Both - at the early stage and in the later years - systemic rouble undervaluation was also accompanied with the gradual depreciation of its nominal level (and, as a rule, without any links with the interest rate differential for the relevant pair of currencies), which even more impaired operations with roubles (as a depreciating asset).

Such approaches still find a lot of support, and the discussions between the supporters and opponents of a "cheap" rouble continue. Basically, **they are founded on deeper, conceptual differences in approaches determining the general trend of economic development.**

Apparently, the supporters of high importance of exports and external sphere as the main source of growth are interested in the depreciating currency. However if domestic factors, domestic solvent demand, are considered as the main sources of growth, in this case it is particularly important to transform the rouble into the full-fledged national currency for savings and investments, creation of a more stable exchange rate which reflects objectively the economic situation and is determined to a considerable extent under the influence of market trends.

The supporters of high importance of exports and external sphere as the main source of growth are interested in the depreciating currency. However if domestic factors – domestic solvent demand – are considered as the main sources of growth then it is important to transform the rouble into the full-fledged national currency – for savings and investments.

Pros and cons

The supporters of reliance on a weak rouble and its depreciation at a higher rate than the price rise refer to a number of advantages of such approach.

The policy of currency depreciation is usually substantiated by the need to promote the national exports and inflow of currency earnings into the country. At the same time, it should be kept in mind that in our situation the undervaluation of the rouble by itself actually will not result in increasing export earnings in foreign currency. The opportunities to increase the physical volume of exports to promote external demand are limited by the throughput capacity of our pipelines and ports. Manoeuvring the prices for primary goods to promote demand is difficult due to their low price elasticity, and a reduction of prices for finished goods can be (and is) impossible by reason of tough antidumping restrictions in other countries (and the very fact

of antidumping lawsuits means the recognition of the undervalued level of the rouble exchange rate).

The undervaluation of the national currency is only contributing to a rise in the rouble earnings of exporters after the sale of foreign currency earnings (which can also be achieved using exclusively internal mechanisms of the economic policy to support exporters). At the same time, the efficiency of borrowing in foreign currency is decreasing and, owing to the exchange rate dynamics, the shares of Russian exporters have become relatively cheaper for foreign investors (and more shares are required to be pledged to secure the loans).

How, in this connection, the undervaluation of the rouble meets the plans of attracting foreign investments? A "dearer" rouble perhaps would be in our interests in that case?

In general, a cheaper rouble in a broader sense means a declining foreign currency evaluation of our national wealth, GDP and other indicators characterising the level of development of the country.

In general, a cheaper rouble in a broader sense means a declining foreign currency evaluation of our national wealth, GDP and other indicators characterising the level of development of the country.

There exist a number of additional adverse consequences of undervaluation of the rouble for the country. For instance, the cost of service of the external debt is growing due to the depreciation of the rouble.

Moreover, the depreciating rouble impairs the incomes of the households, thereby restricting the solvent demand, and such important component of the economic growth remains inactive.

When someone tries to convince us that a weak ruble is good for us it is just as absurd as saying that the smaller the salary we get and cheaper the rubles we have in deposits or in our wallets and the less we can buy with them, the more beneficial it is for us. Lack of logic in this phrase is obvious.

When someone tries to convince us that a weak ruble is good for us it is just as absurd as saying that the smaller the salary we get and cheaper the rubles in our deposits (or in our wallets) are and the less we can buy with them, the more beneficial it is for us.

From the perspective of consumer sector this issue has another aspect of a geoeconomic nature. It shows how the results of our work (rouble salary, income in general) are evaluated by

world markets; what quantity of goods we can buy there with the money we get for our day's (week's, month's, year's) work. In other words, what demand can we offer to world markets in return for the results of our work efforts? Will we be able (for example, at the end of a work day or week) to purchase some significant consumer goods abroad. Or if the rubles are exchanged based on 'depreciating coefficient' the maximum we can acquire will be – food (to regain energy after work) and minimal pleasures ("cinema and ice cream"). Considering the problem more seriously, we shall emphasize that the more groundless is the cheapening of the ruble, the more unequal our exchange with the rest of the world will be. (It will be similar to the principles used in the past in relations between a parent-state and developing territories.)

> The more groundless the cheapening of the ruble is, the more unequal our exchange with the rest of the world will be and to the greater extent it will be similar to the principles used in the past in relations between a parent-state and developing territories.

It is certainly necessary to apply mechanisms for domestic market protection and export encouragement. But who said that they shall be confined to the exchange rate only (especially since it is a **'counter-directional'** (i.e. acts in opposite directions) tool, which encourages some things while constraining the other? There is large number of economic policy tools that allow to reduce this 'counter-effect'? Some potential of such approaches are presented below.

Note

On the other hand, a weak rouble means a higher estimated rouble equivalent of foreign currency earnings, hence increased tax revenues.

This aspect is important, **if the growth strategy is primarily based on foreign demand.** However, any large diversified (and, hence usually self-sufficient) economy must rely in the first place **on domestic demand as the main source of growth**. And the strong non-depreciating rouble is important for domestic demand.

There is another aspect of this problem. Indeed, since in the final analysis there are losses stemming from purely from "effect of calculation", the relative "shortfall" that arises can be compensated for through mechanisms of national monetary authorities (e.g. the use of deficient financing that is widely used in developed economies (we discuss this problem in Chapter 3)). There are no systemic cross-border losses having a non-renewable nature on the balance of trade channels.

However, as concerns capital transactions, the picture is quite different. The undervalued rouble exchange rate automatically means that Russian assets will be sold to foreign buyers at a discount to the actual cost (and, in this case, due to purely "arithmetical" reasons).

Hypothetically one may assume that when seeking for extra export revenues the exchange rate could devalue so strongly that some exporters could be completely bought out by foreign investors.

Financially, the "under-received" revenue in principle (purely in theory such possibility exists) can be compensated for to the Russian sellers, and, as a result, they will finally obtain

some "more objective" rouble amount after the transaction. However, systemically, it means the opportunity for foreign participants to establish external control over our assets at a lower price, and they may not necessarily desire in the future to sell the most profitable assets, even if more profitable conditions will be offered to them.

Moreover, in general, the confidence in the national currency (as a depreciating asset) will be falling, contributing to the transfer of funds into more stable and appreciating currencies, which results in "dollarization".

It is also obvious that the current anti-inflationary policy is hardly in line with the use of such mechanisms (currency depreciation and undervaluation) that represent a direct stimulus for inflation. It is particularly important, taking into account that the share of imports in the **final consumption** is more than 10%, so any depreciation of the rouble exchange rate results in appreciation of imports and directly results in increasing domestic prices. The same occurs with other imports (half-finished products, spare parts, etc.), which also results in rising costs and appreciation of final products.

How could we arrange a more active participation in international globalization processes in such situation? Shall we suffice with the role of a raw material supplier or make more emphasis on the capital, investment component, where a stable rouble, the level of which is determined by the market, is an important tool both - to attract capital and for our systemic presence in the world economic domain?

Indeed, due to a dearer rouble, competition with imported goods increases. However, it is an incentive to increase the competitiveness of our manufacturers. In case where domestic manufacturers are unable to be in competition with foreign suppliers, it would be expedient to engage trading policy mechanisms that will **ensure the protection of the relevant industries** (because, it will be recalled, the exchange rate is not a universal tool and its effective use for the purposes of external economic regulation is only possible in conjunction with other trading policy measures).

At the same time, cheaper imports have positive effects by making cheaper the import component for domestic production, thereby reducing the costs. Again, in accordance with the priorities of the economic and structural policy, a selective approach is possible by ensuring a low level of prices for imported goods of particular importance for domestic manufacturers and, on the opposite, introducing protective measures in respect of goods that must be produced domestically in the first place.

Similar approaches should also be applied to capital movements, all the more so that the strengthening of the rouble in general results in higher efficiency of attraction of foreign investments; however, new risks arise, connected with their speculative flows (especially if such appreciation is expected and continues on an on-going basis). Indeed, the immense resources

available on international financial markets open up a lot of opportunities to finance the economic growth. At the same time, such resources are subject to the volatility of the world environment, as well as political factors, and can be withdrawn from the country within a short period of time. As a result, a crisis situation can arise on the currency and financial markets, which may endanger the stability of the national economy in general and halt the economic growth for long.

According to international experts, risk of high exposure to international capital movements, especially short-term capital, is particularly high for countries conducting an inconsistent macroeconomic policy, as well as for insufficiently capitalised or inadequately regulated financial systems (which is especially important when monetization (the M2/GDP ratio) of the Russian economy is low).

In this connection, **not only the capital outflow, but also the capital inflow**, as well as the nature of attracted resources must be closely monitored.

In general, the policy of attraction of foreign investments (given all their importance) cannot be spontaneous, based on the principles "any investments will be good" or "the more will be the better". Essential indicators are the share of the attracted external resources in the total money supply and their relation to the GDP. If "short", liquid foreign money dominates in the money supply, their movement of any kind can result in destabilization of the entire economy (in almost all "crisis economies" of Latin America and South-East Asia, the share of foreign resources in M2 and their ratio to the GDP before the crisis were very high). The factors of "geoeconomic" and strategic nature must also be taken into account.

We will point out that in the current situation, when there exists abundance global liquidity which is seeking where to go, a dearer rouble is a kind of barrier for the entry of such "hot" liquidity to the market, increasing the efficiency of such entry, because the price of entry increases and all rouble-denominated assets become more expensive for external speculators (and other investors).

We will point out that in the current situation, when there exists abundance of global liquidity which is seeking where to go, a dearer rouble is a kind of barrier for the entry of such "hot" liquidity to the market, increasing the efficiency of such entry, because the price of entry increases and all rouble-denominated assets become more expensive for external speculators (and other investors).

Unfortunately, the mechanisms for the support of national exports, protection of the domestic market, structuring the inflow of investments, which can be determined and used

domestically, without the creation of external risks, are still generally ignored when pursuing the economic policy (we are talking about tax, tariff, monetary, and other measures).

In this case, if the market understands that the rouble exchange rate dynamics will not be artificially adjusted downward and objective market factors will play a bigger role in the determination of the exchange rate, then the situation on the exchange market could gradually change encouraging to withdraw from dollars and use more actively roubles and rouble instruments (especially if their amount extends). This is what we saw during changes in the exchange rate policy in 2003-2004, when both - the households and corporates - caught the trend to appreciation of the rouble and started rebuilding their currency portfolios, decreasing the share of dollars and increasing the rouble component.

At the same time, note that the devaluation of the rouble in the end of 2008 – early in 2009 significantly influenced the currency breakdown of deposits of corporates and households, and actually during several **months** brought back to were it was several **years** ago (Fig. 4.1).

We shall point at the very close relationship between the exchange rate dynamics and "currency preferences", (as the rouble appreciated, rouble deposits increased, and vice versa), which should be kept in mind in implementing the exchange rate policy.

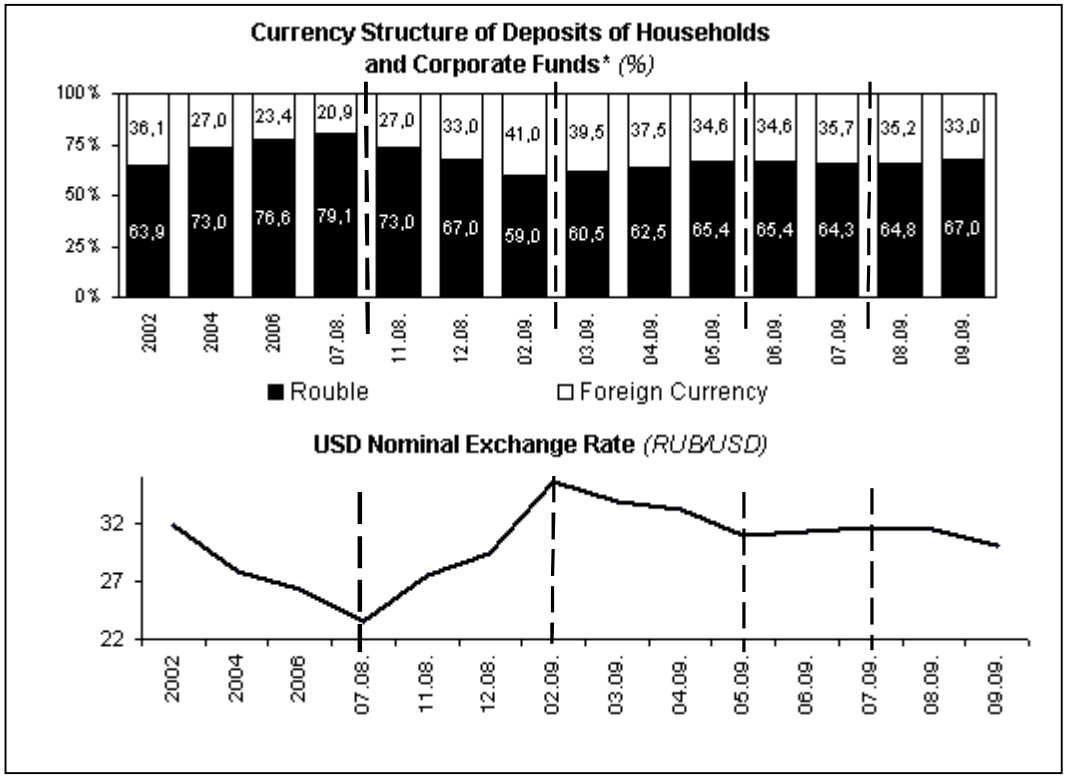


Fig. 4.1. Structure of deposits and exchange rate, Russia

* Funds of organisations include funds on deposits, settlement and other accounts.

Source: Central Bank of the Russian Federation; estimated based on the information of the Central Bank of the Russian Federation.

Obviously, if the trend of non-depreciation will persist, then, in general, it will contribute to widening the domain of the rouble and substitution of the dollar, i.e. de-dollarization, which will also lead to the strengthening of the national currency, higher market confidence in it.

In fact, market trends accomplished what all previous efforts of various "decrees" and "decisions" of regulators were unable to do - de-dollarization of the economy.

Note

We repeatedly mentioned that the use of dollars in the domestic circulation substantially limits the opportunities of expansion of funds via multiplier and in general undermines the positions of the rouble as the national currency. In addition to objective reasons connected with a sometimes obscure economic policy, the expectations of market participants about further nominal depreciation of the rouble contributed to the existence of such situation. Since they understood that such exchange policy was conducted for the purpose of promotion of exports and the increase in the foreign exchange reserves of the Central Bank actually shows that interventions are done to support the dollar and prevent a decline in its exchange rate.

The strengthening of the economy and national currency is a serious incentive for market participants to make operations in roubles and it creates an additional basis for investment activities.

Moreover, before the crisis, as early as in 2005, changes were observed in the growth structure, when the growth rates in manufacturing notably exceeded the growth rates in mining operations.[85]

This trend continued in later years. For instance, during the 5 months of 2008, given the industrial production growth rate of 5.6% and mining operations growth rate of 2.5%, the growth rate in manufacturing was more than 8% (Fig. 4.2).

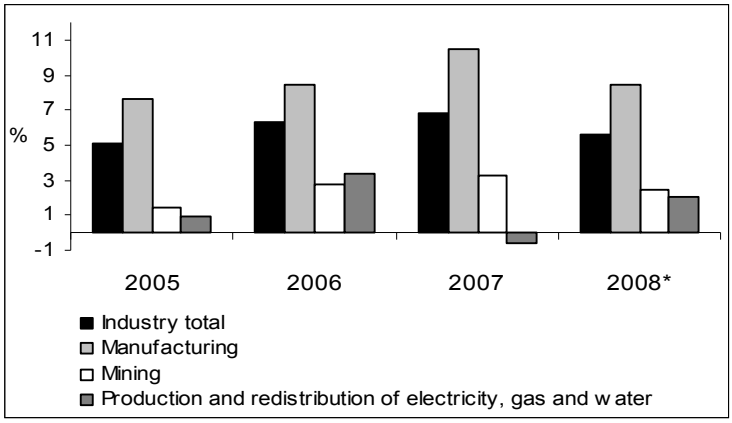


Fig. 4.2. Industrial growth rates in 2005- 2008, Russia (in %, y-o-y)

* January-May 2008/January-May 2007.
Source: Rosstat.

[85] " Guidelines for the Single State Monetary Policy for 2006 ". Central Bank of the Russian Federation. P. 5.

According to estimates of the World Bank, as early as in 2005, a fast growth in the domestic demand and steady growth in industries focused on the domestic market was seen. As a result, a conclusion was made that "the observed changes in the structure of industrial growth (especially manufacturing) suggest strong effects from the real appreciation of the ruble"[86].

A number of branches of the processing industry, focused on domestic demand, could have grown even further on condition of strengthening the rouble.

These trends persisted in general before the crisis, and although the World Bank's experts asked the question about how long the reversal of the trend in the manufacturing will continue, nonetheless, they stated that a number of branches of the manufacturing, focused on domestic demand, "may continue to thrive in Russia's booming domestic market"[87].

Hence, a trend took shape at that time to increasing **growth quality** and gradual (though slow) reorientation of the "growth drivers", firstly, **from mining operations to manufacturing,** and, secondly, **from external demand to domestic demand**.

Already after the crisis – in 2010 – the conclusion was made that drivers of economic growth in Russia are manufacturing industry and domestic demand[88] (Fig. 4.3, table 4.4).

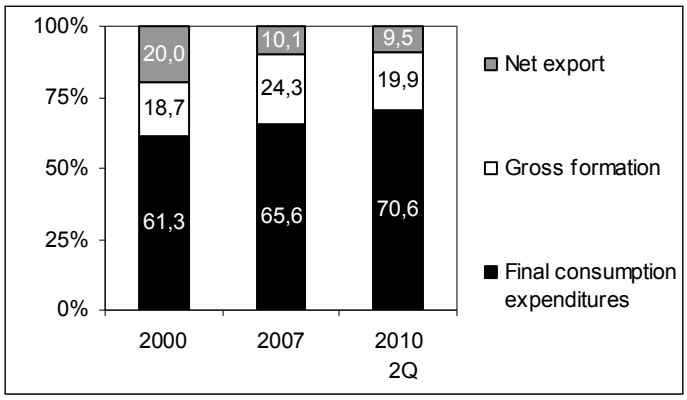


Fig. 4.3. Use of GDP Structure, Russia (%)

Source: Estimated by CSA of Rosbank according to data of Rosstat, World Bank.

[86] The World Bank. Russian Economic Report, November 2005. No. 11, p. 6.
[87] The World Bank. Russian Economic Report, June 2007., No. 14, p. 5.
[88] The World Bank. Russian Economic Report, November 2010., No. 23, p. 5.

	2009	2Q 2010
Tradable sectors	27,1	55,2
Extraction industries	0,9	9
Manufacturing	26,3	45,8
Non-tradable sectors	24,6	28,9
Other	48,3	15,9

Table 4.4. Contribution of sectors in the GDP growth, Russia (%)

Source: Estimated by CSA of Rosbank according to data of Rosstat, World Bank.

If such trends persist, they will need to be strengthened and supported with all economic policy tools available. It will allow the Russian economy to start gradually diversifying away from its commodity exports profile and start developing on a more advanced basis where manufacturing will play a higher role, thus increasing the quality of economic growth.

On Increasing Role of the Rouble in Unstable Global Financial Environment

The international liquidity crisis and falling dollar rate have again underlined the importance of stability of the world financial system in the situation of global turmoil. The focus was made on prospects of the dollar, as well as more systemic problems of improvement of the international financial architecture in general. The crisis highlighted the need in creating additional footholds for the world economy, which will permit it to overcome crisis shocks more efficiently. Indeed, the world monocentrism, i.e. reliance on a single currency, the dollar, which prevailed all over the world for years, as well as the succeeding system based on two currencies (dollar and euro) was acceptable in the absence of real currency alternatives, as well as in the situation when global risks were less critical. However, when the US and euro zone also entered a serious sequence of crises, the currency polycentrism and other balancing approaches clearly became an issue.

The introduction of several reserve currencies and several financial centres could be a step in this direction.

Naturally, an international financial centre is a long-term and "multi-level" problem and the solution must cover issues of legal, infrastructural, regulatory nature, the need to take into account the factor of global and internal risks, and much more.

In this connection, it becomes important to discuss the **beginning of the use of the rouble in settlements in respect of export operations**.

Let's remember that in developed countries payments for their exports are made, as a rule, in the national currencies. This is quite logical – the exporter already paid the costs connected with a production of its goods (wages, raw materials, etc.), so it is much more vulnerable to changes in the exchange rate and it is interested in minimising its risk by making payments in its national currency.

Although the full picture of all consequences and peculiarities of such step for Russian exporters will be clear only when the real transition to external trade settlements in roubles occurs, some obvious consequences can already be outlined.

First, the exchange risk will be transferred from exporters to foreign importers. It will be the buyers of our exports who will be concerned of the future exchange rate between their currency and rouble and, hence, bear the hedging costs.

Second, the world practice of settlements in roubles will be gradually taking shape as a result, and the rouble will be more and more recognised as an international medium of exchange (even though initially on a small scale). Furthermore, such step will contribute to the creation of foreign exchange reserves in roubles in foreign central banks, because in the event of stable and large-scale payments they will need to have some "stock" of such currency, ensuring a gradual integration of the rouble into the world currency system, which is extremely important for the attainment of convertibility.

Third, all payments will be transferred into the "rouble zone" as a result, where foreign buyers will have to open the relevant rouble accounts in the Russian banking system to make payments, which in general will increase the liquidity in the Russian economy. Even in cases where foreign importer asks its bank to purchase roubles, such foreign bank will need in the first place to open a correspondent account with a Russian resident bank, into which the rouble funds purchased by the foreign bank will be placed. The foreign exchange funds converted by foreign buyers into roubles for the purpose of buying our exports will be thus placed in the Russian financial system will start working for the Russian economy.

Fourth, the tax control efficiency will increase. All payments will be made from rouble accounts opened in the rouble financial system and, thus, could be easily monitored by our regulators. As a result, the tax collectability will increase, because the entire income base will become much more transparent.

Fifth, "exterritorial" risks of exporters (connected with possible sanctions that may apply to their financial resources - freezing of funds, moratorium on payments, etc.) will decrease,

which could be the case if the funds are kept in banks abroad. We are aware that such sanctions are being increasingly used in recent times.

At the same time, we need to consider some possible risks and other circumstances that can accompany the use of the new approaches, in particular:

1. The transition from dollars to roubles in some financial or foreign trade operations will mean the relevant growth of the rouble money stock and may create inflationary risks. However, as long as such roubles are used to service the aforementioned operations, the inflationary effects may be insignificant.

2. A gradual shift of the focus from the foreign financing of export supplies to domestic financing must be expected, causing a gradual increase of internal borrowings (loans, etc.) by Russian export companies (with decreasing foreign borrowings). As we know, currently a large number of loans are obtained by Russian exporters in foreign markets in foreign currency. Then, such loans are paid-off as export sales are done and foreign currency earnings are obtained. If export earnings are denominated in roubles, the exporters will bear currency risks. To reduce such risks, a greater emphasis must be made on the attraction of rouble resources from the domestic market. The latter implies that, first, our internal financial market must become more capacious and cover the additional demand, and, second, mechanisms of creation of money supply (e. g. refinancing) should start working to the full, first of all on the basis of domestic demand of market participants.

Eventually, additional incentives will arise for development of the internal financial market and further improvement of monetary policy instruments. All that will contribute to the strengthening of the Russia's financial standing.

3. Under such approach, exchange rate preferences of exporters' will change. They will be interested in strengthening the national currency, because they will benefit from receiving payments in a stronger currency.

Exchange rate preferences of exporters' will change. They will be interested in strengthening the national currency, because they will benefit from receiving payments in a stronger currency.

4. The creation of some segments of the market of export goods, where the rouble would serve as the currency of price, has not only a "technological", but also geoeconomic, as well as political aspects. Its accomplishment also depends on what place is occupied by Russia in

international markets or in integration mechanisms (for example, the CIS could set the basis for such processes); what is the demand for roubles in third countries; what is the macroeconomic situation in Russia, and what could be expected in the future.

	Crude oil	Gas
production in progress	14.0	18.2
exports	14.6	22.9

Table 4.5. Russia's share in various fuel and energy segments worldwide (%)

Source: Estimated according to the information of OPEC, Russian Customs Statistics, Russian Ministry of Economic Development.

In addition, the solution of the problem of export payments in roubles will imply changes in many existing rules, such as payments in dollars for oil and some other commodities (which is beneficial in the first place for the US). However, it would be desirable to hear any reasonable arguments (except that 'such practice is customary'), which would really proof that such practice is unchangeable.

In general, any new system must be, first, clearly communicated in advance to market participants and must be understandable and transparent. Second, such approaches must be applied stepwise, for instance, at first, the rouble could be used in settlements with the CIS countries, and then, with the rest of the world. Furthermore, the transition to the use of the rouble in payments must take into account the currency structure of existing contracts, and the approaches cannot be applied in full until the expiration of the term of such contracts. Finally, third, the new system must be based on incentives making the participants more interested in using it. Therefore, a multi-level approach is required, where all regulatory mechanisms and leverages e. g. - taxes, regulatory norms and other measures treat rouble operations on **preferential** basis. In other countries, for instance, lower standards are used to estimate the capital adequacy in the case of operations with the national currency, making them more attractive. Perhaps, we should think about similar approaches, as well? Market participants must be interested in making operations with roubles, and the number of such opportunities and instruments must increase over time.

In any case, problems will naturally arise, the problem is too large. And it involves too many global and local factors and "centres of interest". Apparently, the process of adequate substitution of the dollar by other currencies cannot be quick. It is also clear that it will face a

powerful counteraction both - on geopolitical and geoeconomic levels (despite its utmost importance, it was never included in the official agenda of the G-8 or G-20 meetings).

> The process of substitution of the dollar by other currencies will face a powerful counteraction both - on geopolitical and geoeconomic levels.

However, the objective necessity of such process is more and more apprehensible. It was announced in the first half of 2009 that the amount of loans in the national currency (Yuan), extended by China to such countries as Argentina, Indonesia, Malaysia¸ Belarus, South Korea for payments in respect of Chinese exports to these countries, exceeds RMB 600 bln (nearly USD 100 bln). At the same time, we hear about the need to decrease the reliance on the dollar and transform the Yuan into the regional reserve currency. Russia has repeatedly announced similar interests.

Obviously, before the question is resolved in full it may take quite some time. But it is important to start immediately a sober and objective analysis of the problem, considering any possible steps and incentives, weighing all pros and cons, in order to reduce the possible risks and ensure the uninterrupted development of the economy in the case of increasing instability in the conditions of growing global risks.

In this connection, a number of core issues must be underlined:

1. The exchange policy must contribute to increase of confidence in the national currency. Market participants must understand that the determination of the exchange rate is based on real economic processes, but not on subjective intentions to support certain industries to the detriment of others, thus impairing the positions of the national currency and reducing the confidence in it.

2. A strong rouble with the market-based exchange rate will contribute to higher confidence in the national currency, de-dollarization, and higher efficiency of investments.

In the current situation, it means that the **trend to appreciation of the rouble and bringing it closer to the level determined by the real market conditions (rather than subjective short-term goals) in an objective trend.**

3. The strengthening of the rouble was much more efficient than any decrees related to de-dollarization in the dollar substitution process.

Our interests dictate the creation of a rouble- rather than dollar-based economy, and as the rouble-denominated assets held by the households and corporates become stronger and

dearer, the households and corporates will become more prosper and more prone to operate with roubles.

4. In the "geoeconomic" sense, it should also be kept in mind that the rouble environment is something that is created and managed by national monetary authorities and national economic entities, and the extent of significance and stability of such rouble environment in the international financial system determines the significance and place of the country (and, hence, its companies and banks as well) worldwide.

5. The exchange rate influences the economy in different ways, so **it must be used together with other regulatory mechanisms and tools** (ensuring, among other things, the promotion of export, protection of the domestic market, and accomplishment of other external economic and internal tasks).

Moreover, the well-balanced use of additional tools can also contribute to the implementation of the structural policy by stimulating the inflow of necessary types of imported goods (for instance, if no similar goods are available in the domestic market) and restricting the inflow of goods that must be manufactured domestically. A similar price policy can be conducted to support export operations.

6. In the situation of abundance of global liquidity arising from large-scale anti-crisis injections in the developed countries which seeks where to be invested, dear (but not unjustifiably appreciating)[89] rouble is a kind of buffer which neutralises undesirable inflows of hot speculative money, increasing the cost of rouble-denominated assets and, thereby, the cost of "entry" in general into the Russian economy. In this connection, it would be necessary to evaluate the possibility of a number of one-at-a-time appreciations, making the exchange rate closer to the level which to a larger extent reflects the general price level of the economy (with allowance for PPP) and solves the tasks of neutralizing the inflow of abundant and short-term global liquidity.

The foreign trade consequences of such measures can be balanced by customs and tariff policy arrangements, as well as measures supporting exporters. The simultaneous or pre-emptive use of leverages which discourage destabilizing impact of speculative inflows and outflows should also be considered.

[89] The term "appreciated" rouble implies a static estimate of its absolute value, while "appreciating" in this case emphasises the dynamic component. Where such dynamics goes ahead of changes objectively determined by the market, it is an incentive for speculative currency operations, when foreign resources are invested into a given currency and then, following its appreciation, sold in order to gain profits. The lesser are the market grounds for such appreciation, the higher is the potential for speculative gains.

At the same time, the opportunities of Russian business companies will extend thereby, as concerns their entry into the markets of other countries, because, given a stronger rouble, purchases of assets in other countries will be less costly.

As a result, it will mean a gradual expansion of the presence of Russian business in foreign markets where it will play not so much the role as raw material suppliers (the latter is achieved via currency devaluation) but rather as systemic investors. Naturally, such presence will expand Russia's opportunities in terms of its influence on global development and in terms of support of its interests in the markets of other countries.

It will mean a gradual expansion of the presence of Russian business in foreign markets where it will play not so much the role of raw material suppliers (the latter is achieved via currency devaluation) but rather as systemic investors.

Note

Generally, it seems quite strange that the stimulation through the rouble exchange rate is considered, as a rule, solely in terms of supporting our export supplies (as we remember, these consist mostly of oil and gas). Almost no one considers opportunities to stimulate our investments abroad. Understandably, for overseas markets we are important only as raw material suppliers or as a market for their products and no one is waiting for us there as buyers or shareholders of their companies (and a number of attempts of large Russian participants to acquire serious Western assets show the obstacles frequently faced). Moreover, a cheap rouble in general is a kind of protection of Western markets from our entry into their market of real assets.

Understandably, for overseas markets we are important only as raw material suppliers or as a market for their products and no one is waiting for us there as buyers or shareholders of their companies (and a number of attempts of large Russian participants to acquire serious Western assets show the obstacles they frequently have to encounter with). Moreover, a cheap rouble in general is a kind of protection of Western markets from our entry into their ‘real assets’ market.

However, it does not mean that we must take such interests of our ‘partners’ as something ‘to live with’ for years and not try to change the situation in the direction of expansion of our real and more systemic presence in Western markets.

7. At the same time, the exchange rate must not be allowed to move upward excessively without a good reason. In addition to the speculative pressure on the exchange rate, which arises alongside with general macroeconomic consequences that emerge (when, in the absence of necessary measures supporting the economy, an unjustified growth of imports and hampering of exports can have a systemic nature), this trend also creates a higher potential for depreciation of the exchange rate (and, in the situation of underdeveloped anti-crisis stabilising mechanisms, such depreciation can be significant), which can increase the unjustified volatility in the market.

In this connection, the appreciation must be carried out in conjunction with general economic indicators (growing productivity of labour, inflation and general price level, economic growth).

8. It is important to be ready to use **exchange control mechanisms**, so as not to allow the new financial stability to be undermined by speculative operations or fluctuations in the global market conditions. The risks of "bull speculations" must be reduced, when international speculators purchase roubles for a short term only, in order to use the appreciated rouble for the subsequent sale, to gain profits and withdraw from market, thereby undermining its stability.

In general, particularly in the after-crisis environment, **the issues of capital outflow deserve no less attention than capital inflow.**

9. The possibilities to use the rouble as the currency of denomination and currency of transactions for Russian export supplies must be developed.

10. The experience of financial crises of last years shows that the "global rules of the game" implying fast and large-scale capital flows can seriously undermine the economical stability and provoke large-scale crises.

In this connection, the measures aimed at the currency liberalisation must be accompanied the development of mechanisms and tools of 'contingency' nature, which could be easily activated upon the occurrence of crisis events.

Even countries with strong economic and financial systems (US, Japan) had to use a wide range of regulatory actions to maintain stability of their financial and exchange markets, and the real liberalisation in many of those countries did not start until the end of 1980s (Western Europe, US) or the end of 1990s (Japan), when they attained firm positions in the world economy. Note that, for instance, in the case of Japan, the currency liberalisation and capital movement liberalisation occurred **more than 30 years (!) after** the liberalisation of current account transactions in the mid - 1960s.

Note

As world experience shows, long- and short-term technical and regulatory tools that may reduce destabilizing effect in the financial market is wide: from tax rates depend on the duration of presence to reserve requirements to direct quantitative restrictions on investment of short funds.

Similarly, in order to prevent a destabilizing inflow of foreign currency, quotas on the volumes of exchange of foreign currency into the national currency could be used as well as more strict levels of the foreign exchange position for foreign banks. Where it was necessary to maintain the balance, the asset structure was regulated and quantitative parameters were used, prescribing the percentage ratios of investments in foreign and national currency for banks in the asset structure. The liability structure can also be regulated.

As the Russian economy has already been liberalised to a large extent, the main emphasis in this sphere of questions must be made on the development of anti-crisis mechanisms that could neutralize the impact of "external shocks".

11. In general, measures must play an important role, stimulating the development of the internal financial market and making operations in it more attractive compared to foreign investments. Reserve requirements, balance sheet ratios, tax tools that will treat domestic rouble operations as more preferable compared to external foreign currency resources (the attraction of which in the situation of instability may be connected with a wide range of geoeconomic and political risks) must play an important role.

12. A sound currency policy must lead to the creation of a stable rouble environment required for a normal economic activity in the country and increasing investments. The currency policy must also be correctly coupled with the main economic lines contributing to the strengthening of the economy (mortgages, small businesses, financial sector, etc.), which shall lead to the strengthening of the position of the national currency in the country and its gradual integration into the world economy. It is required both - in terms of creation of conditions for convertibility and in terms of transformation of the rouble into a full-featured financial instrument.

13. The currency policy itself must be closely integrated into monetary and budgetary mechanisms. It will give a positive effect in terms of strengthening the geoeconomic positions of the country and creating conditions for sustained economic development.

14. The diversified nature of these tasks requires the precise coordination of their accomplishment. If global financial risks are counter-poised by non-coherent actions of regulators in separate market segments, no success can be expected. In this connection, in developing and implementing the approaches, efficient coordination on the part of regulatory bodies (the Ministry of Finance, the Central Bank, the Ministry of Economic Development and Trade, the Federal Service for Financial Markets, etc.) is required for the development and successful implementation of the necessary measures.

***

Obviously, all those tasks cannot be accomplished at once – their accomplishment requires the consolidated motivation of economic participants, willingness of economic authorities, objective economic conditions, and much more. In any case, however systemic work

is required, so as to create a strong basis for sustained and long-term development of the country, providing for an opportunity to integrate efficiently into the global economy and strengthen the positions of national markets and domestic business.

5

STOCK MARKET

The stock market is one of the most sensitive areas immediately responding to crisis events. In the global economy, when market interconnection is strengthening, stock markets of many countries often move in a synchronized manner.

We would like to remind you that, in recent years, global financial markets, in general, have been somewhat alert: markets have not fully settled down after the crisis events of the late 1990s. These moods have been supported by geopolitical factors (the Middle East, etc.) and a number of economic reasons such as strengthened global imbalances, which manifested themselves in erratic growth and the emergence of new centers of competition (BRIC, etc.), which intensified competition for markets and the sources of finance.

In this context, any negative trends or news can destroy financial stability, especially in sensitive markets such as the stock market, which has acquired clear features of the global market, when the evolution of key indexes in different countries is often virtually symmetrical (Fig. 5.1).

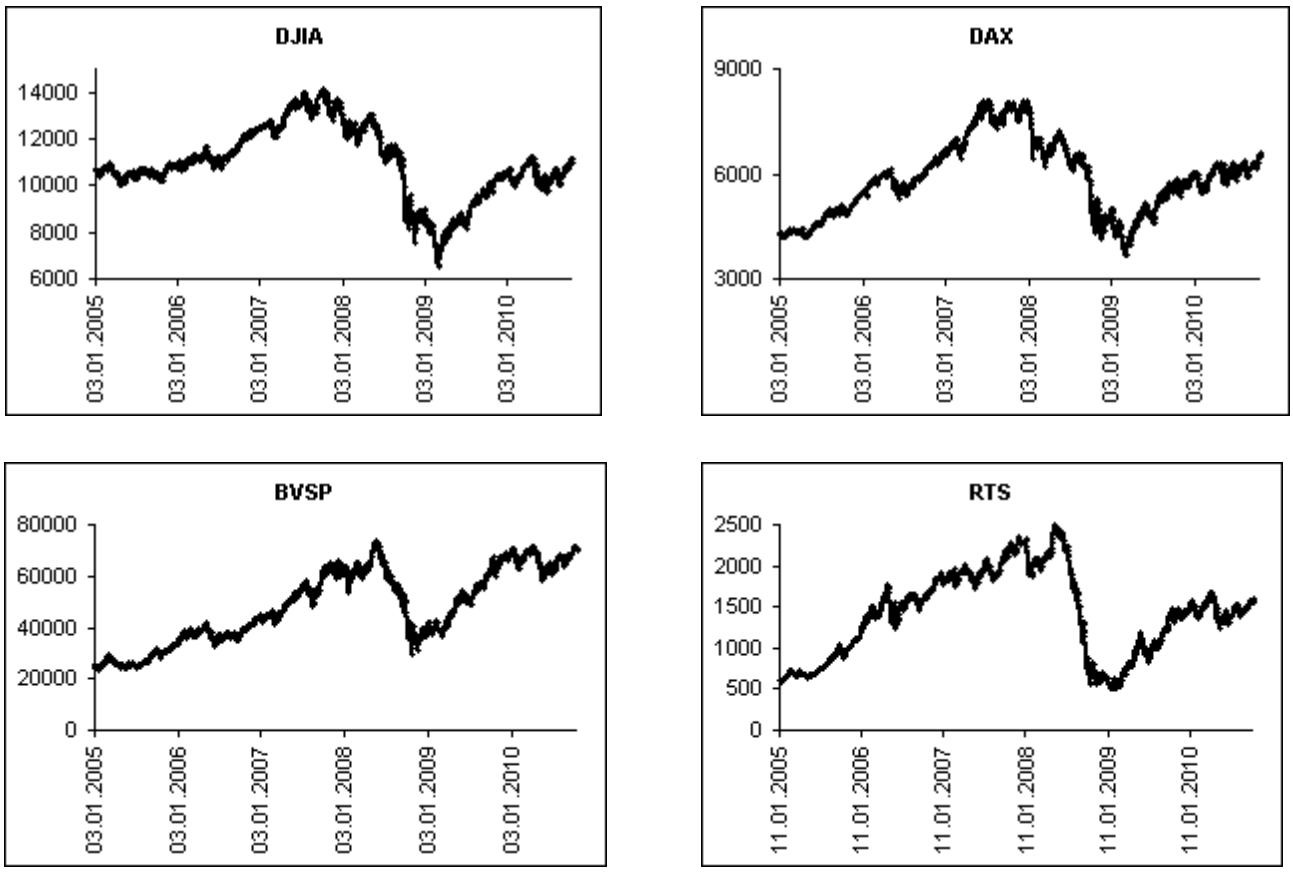


Fig. 5.1. Stock Index Performance

Source: Bloomberg.com, rts.ru

At the same time, the global scope of stock markets is the strength feature of the world economy only in an environment of stable development. By contrast, when the world at large as well as particular countries face economic problems, in this case the favorable features which are given by economic openness in terms of efficient allocation of resources turn into its opposite – large scale flows of 'hot' money, dropping of stock markets, strengthened instability.

The current phase of global development sees sharply strengthened role of financial markets in the economy, which considerably exceeds the scope of GDP (for instance in the US the share of stocks, debt instruments, derivatives, etc. accounts for at least 400% of GDP). In fact, we have the situation where financial markets being secondary to the real economy and depending on it often affect the economy in the crucial way.

In fact, we are facing the situation in which the financial market, as a secondary market derived from the economy, often affects it crucially.

Moreover, presently, this market is often capable of influencing the economy even stronger than the economy influences the financial market (as was many times the case in Russia as well as worldwide). Furthermore, the stock market itself has frequently seen even more contradictory dependencies. For example, the period of overheating shares of the "new economy" in the early 2000s in the US could be characterized by the following "link": the world economy, to a great extent, depends on the US economic situation, which, in its turn, depends on the US stock market, which is considerably affected by the shares of 10-15 companies. Most of these companies represented the new economy and their role in the market was perceived as controversial. (It should be noted that this was followed by large-scale adjustment, when the Nasdaq index went down by more than 60%.)

The quotation of Russian shares also dropped considerably, showing that even seemingly satisfactory fundamental indicators (economic growth, inflation reduction) do not play a primary role in our environment. This made the following issues high on the agenda: what are the stock market fundamentals? how can its speculative nature be smoothed and, finally, what possible stabilization measures can be taken in case of a crisis?

The processes in the Russian share market are triggered, to a significant extent, by foreign players withdrawing their resources from the Russian market (which only reminds such obvious things, that any resource inflow can be followed by its outflow and the reasons for changes of the mood can be far away from the target of investment). This necessitates reviewing the issues of external risk mitigation in general. Furthermore, it should be assessed to what extent our economic mechanisms and approaches are ready, in principle, for crisis events in the market in an environment of deregulation and global integration.

Given that the stock market is becoming an increasingly popular target of investment for individuals and, therefore, its evolution is gaining social as well as economic components, the above-mentioned issues need even more thorough analysis. For this reason, stock market trends are constantly drawing the attention of national leaders and put on the agenda the issues of development of stabilization mechanisms.

The risks of global bubbles in an environment of global integration are also being assessed worldwide. As early as the first half of 2007, investors faced stock market drops caused by tension in the US "sub-standard" mortgage loans market and increased bad news from Asian markets. Some time later, Alan Greenspan, former Chairman of the US Fed, spoke about the Chinese stock market overheating, which also affected international and Russian indexes. Finally, the events of 20 years ago, when the US stock market collapsed in October 1987, were

often cited. In this regard, the question almost constantly arises as to what extent the crisis management potential of the financial system is adequate to the new scope of global challenges? To what degree is it possible to create alternative footholds and new sources of growth to counter-balance to possible crisis trends?

The current post-crisis phase of the stock market can be characterized by its significant underestimation for a number of countries, including Russia. This has almost always been the case, at least in Russia. As early as 2000, we highlighted this phenomenon and emphasized the "underestimation of a considerable portion of Russian assets."[90] In general, the situation remains the same.

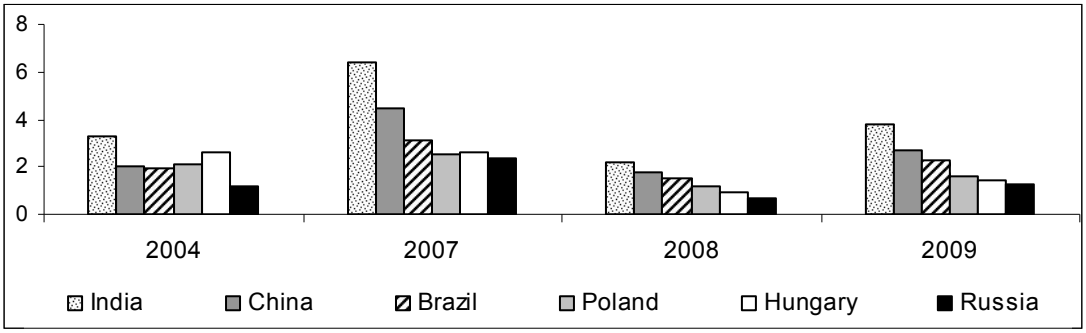


Fig. 5.2. Price-to-Book Ratio (P/B) in a Number of Countries

Source: IMF, 2008, 2010.

This is also shown by price-to-book ratio, in which Russia is listed in the second part of the "standings." The underestimation effect is also boosted by the factor of undervalued ruble rate, which, when recalculated, makes the final price (denominated in foreign currency) of Russian shares lower. (We discussed exchange rate trends in Chapter 4.)

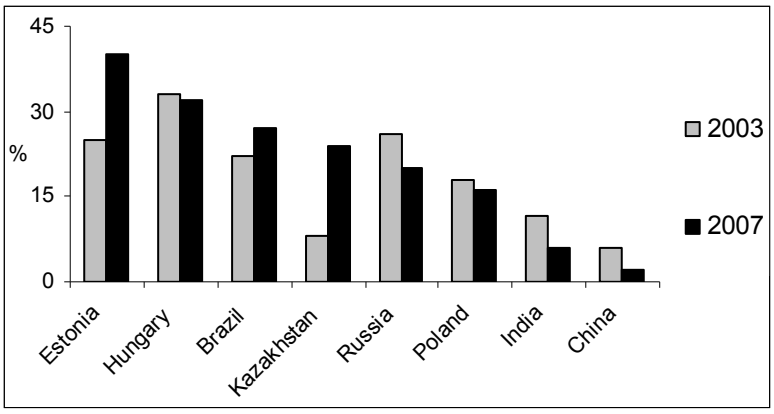


Fig. 5.3. Foreign Participation in the Securities Market (% of Market Capitalization)

Source: World Bank, 2010.

[90] M.V. Ershov. Financial and Monetary Mechanisms in the Modern World (Crisis Experience of the Late 90s). M.: Ekonomika, 2000. P. 315.

In general, a number of important circumstances should be emphasized:

1. Traditionally, non-residents have played a greater role in the Russian stock market (figure 5.3). Furthermore, in the threshold of the 1998 crisis, this role was absolutely dominant, affecting the market in general and ultimately causing its collapse (when foreign investors started selling Russian papers and transferring their funds abroad quickly and on a large scale).

Note

According to certain estimates, in the threshold of the 1998 crisis, about 90% of circulating shares (free-float) were owned by non-residents.[91]

Moreover, given modest financial resources available in the market, quotes could be considerably affected even by small amount of money. For example, spending the sums within USD 20 mln could bring down the quotations of any issuer by dozens percent[92]. Furthermore, when volume of sales in the market in crisis conditions declined sharply, this could be achieved with much smaller amounts, possibly influencing not only the quotations of a single issuer but the entire market.

Similarly, non-residents accounted for over USD 20 bln in government short-term bonds (GKO), which is an important segment of the financial market totaled slightly more than USD 60 bln.[93]

By now, the Russian stock market has, certainly, matured and the role of national participants has grown. Before the crisis, non-residents formally accounted for about 30%. However, it should be taken into account that foreign ownership is exercised through Russian holders too (including resident banks with foreign equity) and other Russian participants which can act as nominee holders acting on behalf of non-residents.[94]

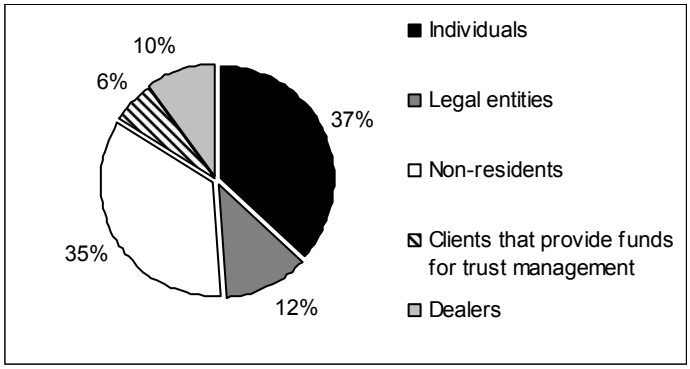


Fig. 5.4. Structure of MICEX stock market (by type of participants)* (October 2008, %)

* by sales volume.

Source: MICEX.

[91] Expert. July 13, 1998.
[92] Ko. July 21, 1998. P. 16.
[93] For details, see M.V. Ershov. Financial and Monetary Mechanisms in the Modern World (Crisis Experience of the Late 90s). M.: Ekonomika, 2000; M.V. Ershov. Economic Sovereignty of Russia in the Global Economy. M.: Ekonomika, 2005.
[94] It should also be considered that Russian financial resources earlier transferred abroad can also return to the country, having formal status of non-residents.

As a result, according to experts, non-residents account for at least 40% of the Russian share market. Obviously, foreign participants often rely not only on the Russian market situation but also on the global investment strategy of parent banks. However, the latter often make decisions on portfolio structure considering the situation in the international markets in general, and any events in developed or developing countries (even those that are not direct targets of investment) can significantly impact the amount of investments, causing the conversion of funds into assets considered more reliable.

For instance, the summer and autumn of 2007 witnessed a number of peculiarities associated with the worsening of liquidity for global investors whose funds became constrained (due to considered trends in the mortgage market and for other reasons). In this context, foreign investors in the Russian market sell a part of their Russian assets step by step (to avoid market collapse and not to lose on fall in shares). Typically, shares are sold during local quote increases, which ultimately disrupts the overall upward trend, preventing it from becoming more stable.

In terms of stabilization of the financial (stock) market conditions, the situation for Russian participants is also aggravated by the fact that they become increasingly dependent on external sources of finance.

2. Measures aimed at strengthening the national component of the stock market are important too. They have been taken by the Federal Service of Financial Markets for some time ago and already give some results (Fig. 5.5).

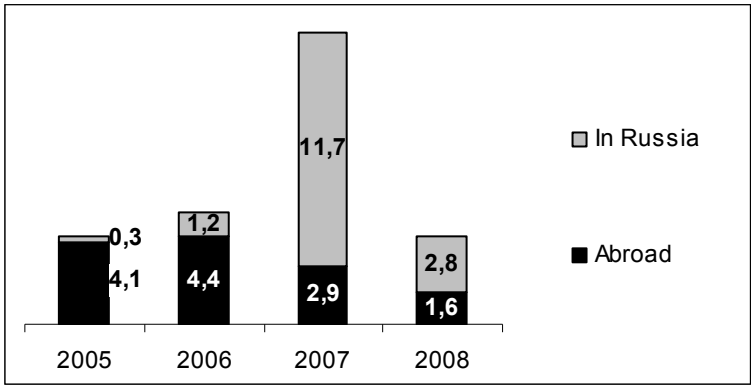


Figure 5.5. Volume of IPO/SPO of Russian Companies (USD bln)

Source: MICEX.

3. The stock market should be diversified and become an effective tool of resource allocation, more "integrated" into the real economy. (This will also be supported by the above-

listed measures aimed at strengthening the role of interest rates and expanding money supply channels.)

At the meantime, the Russian stock market is weakly connected with the real economy and is, in fact, composed of 7-8 large issuers, primarily representing the raw materials segment, whose position in the stock market does not reflect their role in the economy (in GDP). Mismatches like that have alarming historic analogies. We remember the distortions observed in the US stock market of the early 2000s when it entered the long-lasting downturn phase. At the time, the overall capitalization of the US stock market was slightly above USD 10 trln, with ten companies of the "new economy" accounting for almost 25%. Moreover, the gap between the prices of shares in "new" and "old" companies sometimes reached shocking levels. For example, the shares in US Steel, a highly reputable company, were valued by the market almost 200 (!) times cheaper than the shares in Intel or Microsoft. It is obvious that sooner or later real economic ratios and trends should have had an impact: as a result, in 2000 alone, the Nasdaq index went down by almost 60% and the general downturn lasted for more than three years. As mentioned earlier, in this period, the US Fed had to reduce discount rates 13 times to support the economy and the financial market alike.

Once Again About Forecast

In this regard, we would like to remind you that in 1999, when the US market was on an upward trend a few months **before** the stocks started fall we emphasized: "Obviously, the U.S stock market is "overheated" and, potentially, significant fall in stocks can occur"[95]. Academician N. Simoniya of the Russian Academy of Sciences, wrote at the time: "The book (by Ershov. – *Editorial comment*) was signed as "good for printing" in October 1999. When economic conditions in the US continued to improve, favorable indicators of economic growth as well as low unemployment rate were observed, continues growth of stocks was underway, such troublesome conclusion could seem overly alarming. Yet less than six months past and in mid-April the Nasdaq index demonstrated sharp decline" (Izvestiya, 04.25.2000).

However, back then, the domestic stock market had a relatively minor role to play in the Russian economy. Presently, given the degree of openness of the national economy and higher importance of the stock market itself, both - global trends and possible stabilization measures in the Russian market - should be assessed very thoroughly. Since global mortgage problems are

[95] M.V. Ershov. Monetary and Financial Mechanisms in the Modern World: Crisis Experience of the Late 90s. M.: Ekonomika, 2000, p. 23.

here to stay and the crisis was only suppressed and made less acute in its current phase, its future implications are likely to occur both - in terms of fall in quotations and high volatility in general. This makes the role of stabilization mechanisms even stronger.

High concentration of a small group of shares typical for Russian market makes it less stable compared to the markets of developed countries (Fig. 5.6).

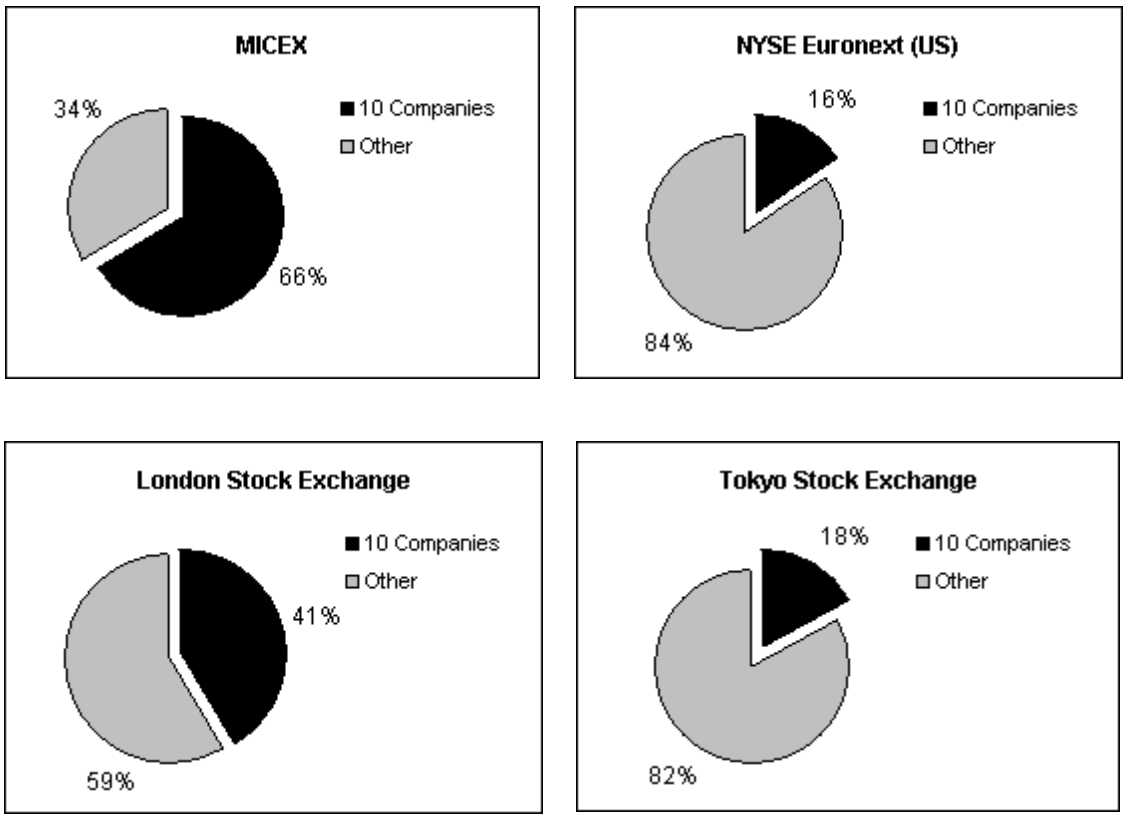
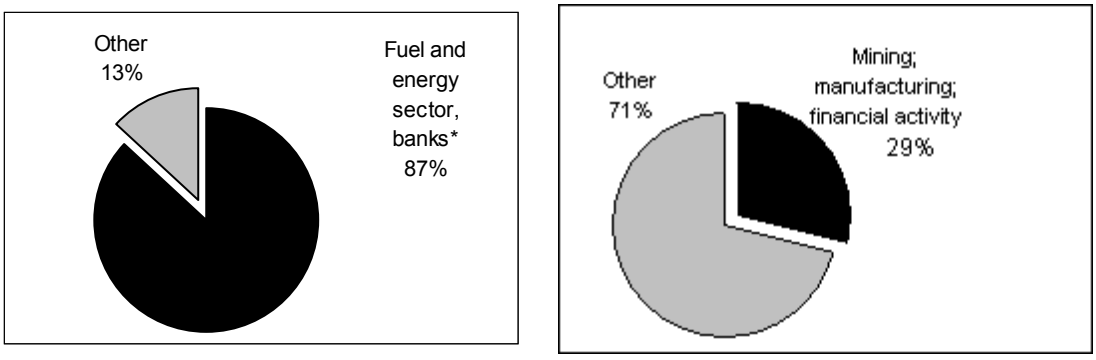


Fig. 5.6. Share of the 10 largest companies in total market capitalization (in 2009, %)
Source: MICEX, The World Federation of Exchanges.

Furthermore, the role of companies or industries in the market does not reflect their role in the economy or their share in GDP (Fig. 5.7), thus also actualizing the question about how efficient our stock market is as a tool for ensuring the necessary flow of resources and as a reflection of market trends in the economy in general.



a) Structure of trade in shares (by sector), MICEX

b) Share in GDP in 2009

Fig. 5.7. Principal Industries Shaping the Stock Market and Their Share in GDP (%)

* calculated based on the percentage of shares in the 8 largest companies representing the fuel and energy sector and the 5 largest banks in the total share turnover (data as of mid-December 2009).

Source: calculated using data from the Federal State Statistics Service, MICEX.

Obviously, instrument diversification in the stock market should increase its points of support, simultaneously expanding the opportunities for cash flows between instruments (and sectors). In its turn, the above-mentioned diversification should result from measures aimed at diversifying the economy in general and shaping more focused approaches of structured policy.

4. Obviously, foreign participation in the stock market in the context of global economy is inevitable. However, it is important that mature and developed market should rely on national participants and the leading role should be played by non-speculative resources.

This is a complicated multi-layer task which includes monetary and financial questions, currency control issues, etc.

However, even now, if we start creating an adequate domestic base of financial resources, simultaneously creating stimuli for Russian participants to work domestically, an excessive shift toward foreign participants and associated risks can gradually decrease. In general, when we talk about real investors rather than speculative capital, normally the preferences of "home market" dominate (phenomenon called **"home bias"**).

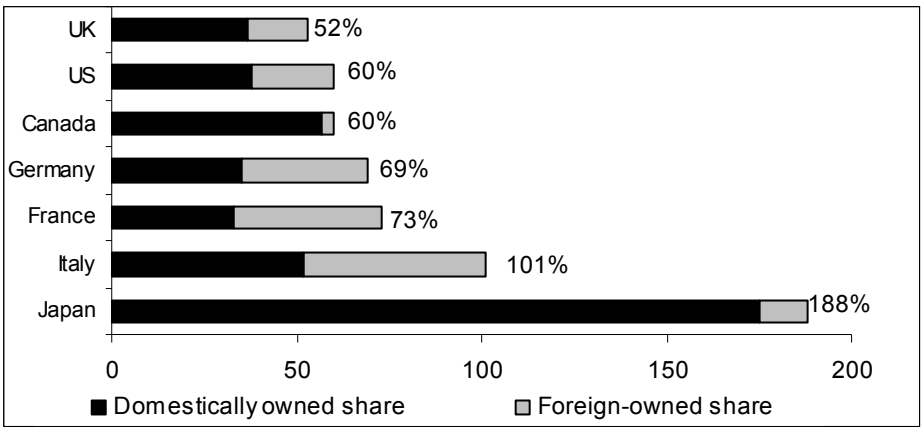


Fig. 5.8. Composition of Government debt ownership by nationality (2008, % of GDP)

Source: BIS; IMF; McKinsey; central banks.

This should be accompanied by the use of leverages aimed at discouraging speculative funds (for example, by using taxes during repatriation which are linked to duration of stay in the market) and at the same time encouraging the inflow of longer resources.

For instance, China introduced different types of shares for strengthening the national basis and non-speculative characteristics of the stock market (only residents were allowed to access 'A-type' shares whereas foreign participants were allowed to access 'B-type' shares only (issued by a limited number of public companies)). Although since 2003 foreigners have been permitted to access 'A-type' shares (when the principles of "qualified foreign institutional investors" were introduced), these investments were subject to restrictions on volume, duration of circulation in the market and the repatriation of funds. Specifically, a corporate investor had to have operated in the market for at least 5 years (for example for insurance companies) and manage assets worth at least USD 10 bln. The 'investment quote' even for major participants such as Citibank or HSBC is about USD 600 mln and USD 300 mln respectively. The relative amounts of investments are fixed (not more than 10% of the total quantity of shares in the company), the duration of stay of funds in the country (at least 1-3 years depending on the type of investments) and the conditions of repatriation which should be performed in parts within a period of 4 months to 1 year.

Possible measures for mitigating the undermining effect on the market include marginal trade regulation, "leverage" control, the use of insurance deposits, etc. Futures transactions should also be involved.

In principle, measures preventing the stock market and economic collapse have been tested repeatedly. When dealing with financial bubbles they 'boil down' to the two principal approaches. The first one implies measures hampering the growth of asset prices raising interest rate, regulatory actions, etc. The second approach is based on more radical solutions – the

"bubble" is allowed to explode and then the whole set of stabilization tools is used: liquidity is injected into the market, interest rates are lowered, etc. The same thing happens in case of unpredictable fall in quotations.

The stock market crises of the past decades, typically, have been resolved based on the second approach.

October 1987

"Central banks play a crucial role by responding to financial shocks," said Alan Greenspan at the US Congressional hearings in February 1988, underlining the fundamental role of regulators at the moments of crisis.

When in one day, on October 19, 1987, the S&P index fell by 20%, the US Fed took immediate stabilizing action by lowering the refinancing rate, which caused the reduction of other rates and the price of financial resources. This was accompanied by the injection of liquidity into the financial system through operations in the open market, the liberalization of treasury bond trading system, the extension of the trading system working hours. Commercial banks were granted resources for lending other financial market participants. To calm down the market, on the next day the US Fed said: "The Federal Reserve, in conformity with its responsibilities of the "Nation's central bank," confirms its willingness to act as a source of liquidity for supporting the economic and financial system." Measures were taken at a personal level too: key employees of the US Fed contacted the management of the United States' leading banks, coordinating the extension of loans to clearing houses and other participants. Soon, these and other measures brought the situation under control.

Autumn 1998

In order to stabilize the markets after the crises in Southeast Asia and Russia, in September-November alone, the Federal Reserve System lowered the rate three times for federal funds and the discount rate. To ease the pressure, necessary liquidity was injected into the financial system through the purchase of securities.

September 2001

The scope of shock over the events of September 11, 2001, and the peculiarities of the already global economy associated with a fundamentally new level of risks implied the need for approaches, which had never been used on such a scale before.

Everybody saw how many countries simultaneously lowered their interest rates: the US, the Euro area, United Kingdom, Switzerland, Canada, Sweden, Japan, Denmark and other countries. Moreover, the US lowered the rate several times in a short period.

Furthermore, for stabilizing the USD exchange rate, the Federal Reserve System and a number of central banks reached an agreement on limiting USD operations on the first business days of banks after September 11. Simultaneously, the market was given additional liquidity for easing the panic through all possible channels. For example, the Federal Reserve System opened a "swap line" to a number of central banks (ECB, United Kingdom, Canada) worth about USD 100 bln, implying the exchange of their national currencies into USD. About USD 300 bln more were injected into the financial system through the purchase of various financial assets by the Federal Reserve System and ECB.

A crucial role was played by the refinancing mechanisms, whose scope was greatly expanded. On September 12 alone, the value of resources obtained by commercial banks from the Federal Reserve System through the "discount window" exceeded the average indicators for ordinary days more than **200(!)-fold**.

To suspend the fall in share prices, it was decided to take a completely unconventional step, which, obviously, does not belong to market-oriented regulatory methods: self-restrictions on "short operations" were imposed "voluntarily" by market participants (hedge funds, etc.) - a measure supported by the principal regulator, the US Securities and Exchange Commission. We would like to remind you that "short" operations (taken pledge to deliver security that the seller does not own, with the purchase of this stock later in the market at a lower price for its future delivery) is a fundamental element of financial speculations and the whole financial market (their effect is multiplied when additional funds, i.e. leverage, are used). In 'bear' speculation, these operations increase the depth of market downturn. The same measures were also applied to oppose the recent crisis. Specifically, the US specified the list of companies on which these restrictions apply[96].

[96] The list consisted of 19 companies and included:

1	BNP Paribas Securities Corp.	11	HSBC Holdings PLC ADS
2	Bank of America Corporation	12	J. P. Morgan Chase & Co
3	Barclays PLC	13	Lehman Brothers Holdings Inc.
4	Citigroup Inc.	14	Merill Lynch & Co., Inc.
5	Credit Suisse Group	15	Mizuho Financial Group, Inc.
6	Daiwa Securities Group Inc.	16	Morgan Stanley
7	Deutsche Bank Group AG	17	UBS AG
8	Allianz SE	18	Freddie Mac
9	Goldman, Sachs Group Inc.	19	Fannie Mae
10	Royal Bank ADS		

Similar measures were taken by regulators in a whole range of countries, including Russia (Table 3.3 in Chapter 3).

It should be mentioned that the involvement of many countries in cross-country regulatory processes evidences that the current scope of problems is so significant that often they cannot be solved without necessary joint efforts using a vast range of measures.

Growing Role of Shares

The scope and volatility of the stock market have always made it a potential source of crises. This problem became especially meaningful by the mid-2000s, when the growing role of this market as a source of finance became more distinct (Fig. 5.9).

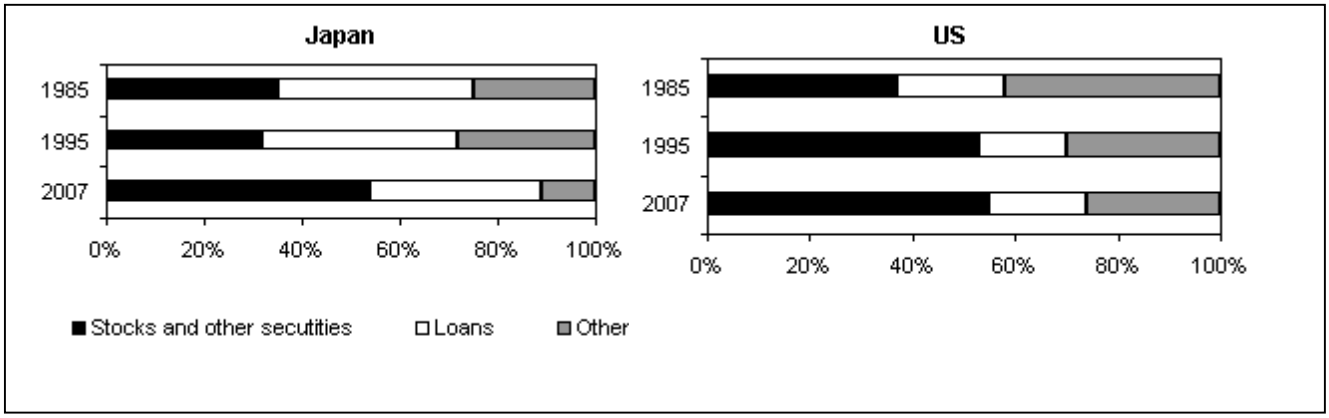


Fig. 5.9. Sources of Funds of Private Non-financial Organizations in Japan and the US (%)

Source: Bank of Japan; the US Fed.

Higher unpredictability of this market became even more evident due to the growing role of external investors. American participants were among those who started increasing their share portfolios in other countries in the 1990s and 2000s.

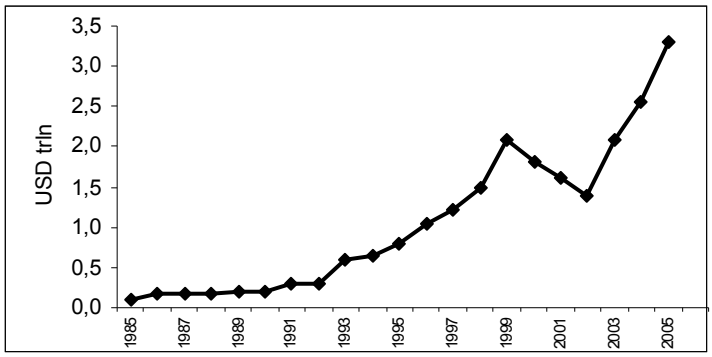


Fig. 5.10. Changes in the Value of Foreign Shares Owned by US Holders (USD trln)*

* As of end of the year.

Source: NBER, June 2006; US Department of Treasury; FRS of New York, Dec. 2005, Dec. 2006.

Despite the grown role of various types of securities in foreign investment, the percentage of shares in the investment portfolios of US market participants has increased most of all (Fig. 5.11).

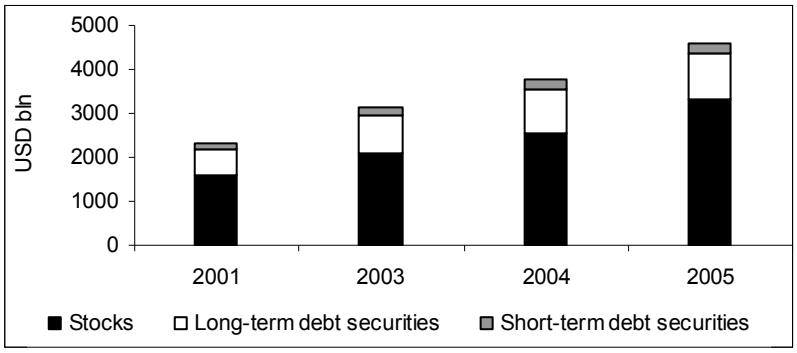


Fig. 5.11. Breakdown of Foreign Securities Held by US Residents (USD bln)*

* As of end of the year.
Source: US Department of Treasury, FRS of New York, Dec. 2005, Dec. 2006.

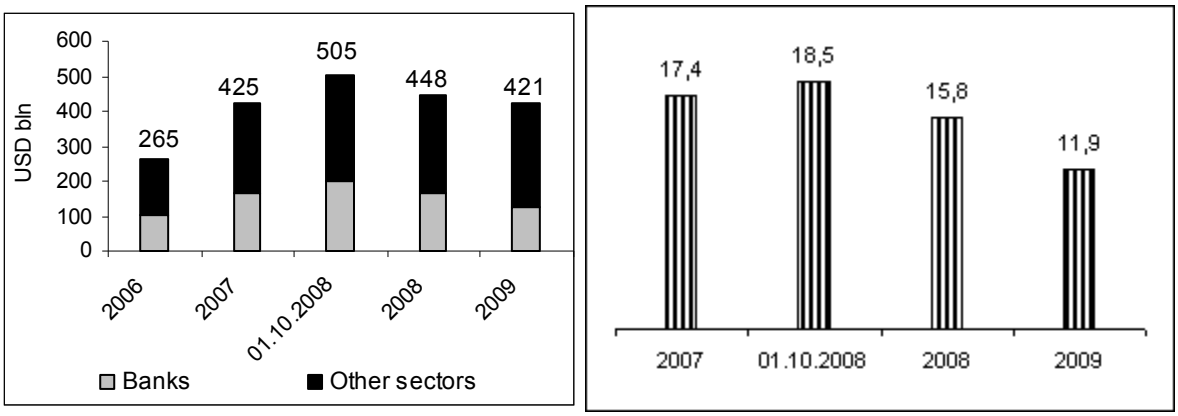
Non-residents traditionally have significant role in the Russian stock market (as mentioned before).

The situation is also aggravated by the fact that external funding plays an important role in the economy and the financial sector. Furthermore, it looks alarming that money supply creation is still based on currency inflow rather than domestic sources (which is discussed in detail in Chapter 3), thus intensifying the risks of external shocks and adding to the stock market instability.

It looks alarming that money supply creation is still based on currency inflow rather than domestic sources, thus intensifying the risks of external shocks and adding to the stock market instability.

Although the crisis, in general, somewhat reduced the scope of borrowings by Russian companies and banks from the external markets, the aggregate share of external funding for the banking sector still remained high (Fig. 5.12).

Given that non-residents play an important role in the market, for them the refinancing rate of their central banks (which determines the price of raised resources from their domestic markets) is important to them. Therefore, even if our refinancing rate works, its effect will be diluted by foreign participation. This is even more visible when domestic mechanisms of liquidity creation are underdeveloped and an increasing role is played by external sources of finance on which the Russian business, with its ever-growing external debt, relies.



a) External Debt of the Private Sector (USD bln)

b) Funds of non-residents as a percentage of the banking sector liabilities (%)

Fig. 5.12. Russia: funds raised from external markets

Source: Central Bank of the Russian Federation.

This gives rise to the fundamental systemic issues about the need for strengthening domestic base of liquidity creation and the financing of domestic economic growth. Moreover, steps in this direction will strengthen the link between the stock market and the economy.

5. Setting more clear economic targets in the stock market itself should be a stabilizing factor itself. Currently, there is almost no clear and economically justified dividend policy connected with the company's real economic indicators and reflecting the investment risks. It is obvious that in the current environment of growing share prices, with not-yet-settled market structure, the dividend policy is relatively insignificant in investment decision-making. As a result, the stock market becomes a "thing-in-itself" to an even greater extent and its link with the real economy and general economic indicators, virtually, cannot be clearly formalized in the language of figures, thus depriving investors of necessary guidelines. Due to the undervaluation of Russian shares and the dividend policy, P/E ratio for the Russian market is lower than in many countries (Fig. 5.13), reflecting possible higher market risks.[97]

[97] Given that the inversion of P/E, virtually, shows yield on this instrument (the factor on which the investor relies to the greatest extent in making a decision on the placement of funds) in the market, it can be concluded that the relative yield on Russian shares is higher than in other markets (where this value, generally, corresponds to yields of other instruments and, as can be seen in the figure, is approximately 7-10%).

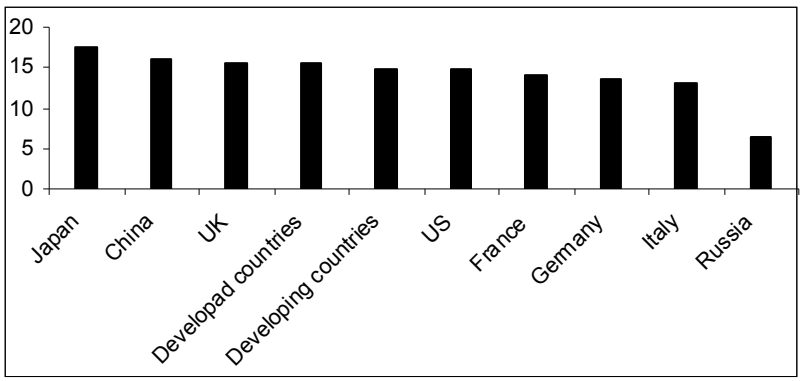


Fig. 5.13. Price-Earning Ratio (P/E) in a number of countries in 2010 (estimates)

Source: The Economist, Oct. 2010; Morgan Stanley, Feb. 2010.

6. The events of 2007 show possible emergence of fundamentally new phenomena on the global stock market. During the early phases of globalization, changes in the stock markets of developed economies (primarily the US), as a rule, immediately affected the rest of the world. However certain recent examples give ground to suggest that stock markets are becoming somewhat autonomous, when the fall in US shares did not always affect, for instance, the Asian or Russian market and the large-scale withdrawal of funds by investors from the shares in developing countries (for example, in late summer 2007) primarily concerned only speculative players. Strategic investors, possibly, started searching for markets (which could serve as " safe-heavens" for their assets) and let a part of their resources remain in the market. These were noticed as short-term phenomena. Moreover, the very concept of "decoupling" began to be challenged in general. However, if in the future these phenomena become stable, this will increase the chance of shaping national fundamentals of the market and make it possible to create stabilizers based on regional markets, mitigating the risk of global fall in general. In general, similar autonomy was more and more often demonstrated by general economic trends, which derives, among other things, from higher importance of domestic demand factors, diversification of the growth of national economies and new sources of growth. The very emergence of these market "autonomization" trends and the persistence of the above-mentioned phenomenon during a certain time deserve attention and can imply possible emergence of new stabilizers for the post-crisis world. This may be particularly important bearing in mind that autoimmunization may become more distinct if in the new risk environment protectionist trends intensify, capital flow control measures widen and the attempts of the "international community" aimed at preventing the introduction of such measures fail.

All of the above makes the creation of effective domestic fundamentals for functioning of the economy and the financial market even more important.

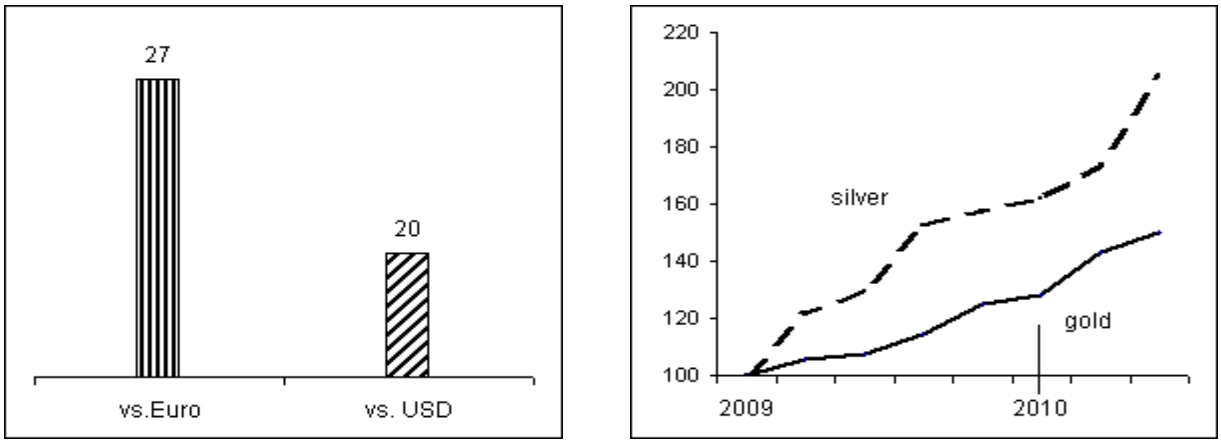
It is important that a systemic solution be found for improving the quality of growth of the Russian economy, creating new sources of finance, and designing effective stabilization mechanisms for the financial market. A crucial element of the above-mentioned processes should be the strengthened role of domestic sources for creation of financial resources, which will reduce dependence on the global conjuncture and create additional stabilizing points of support for future development.

6

REFORMS AND PROSPECTS

Obviously, markets remain perceive the current situation quite tensely. Despite the emerging shift in the negative trends of the world economy (beginning of economic growth, gradual increase in lending, renewed issue of securities), a whole range of indirect indicators, which typically illustrate well the real investor mood, show negative expectations of the market participants.

The prices of gold and silver are growing steadily and hit record highs, reflecting high uncertainty of investors about economic prospects and their willingness to invest funds in less risky assets. Excessive US dollar liquidity and the risk faced by the US dollar and the entire currency system cause the growing role of the Swiss franc, a traditional "save-haven currency" in crisis periods (Fig. 6.1).



a) Swiss franc strengthening vs. Euro and USD (July 2007 – September 2010)

b) Silver and gold prices (USD/troy oz, 01.01.2009=100)

Fig. 6.1.

Source: calculated using data from www.kitco.com

A lot of unresolved problems in the US mortgage market also create risks of future turmoil.

Due to low loan-to-value (LTV) ratio, future defaults remain possible and preconditions for new crisis peaks in the future are maintained (especially if mortgage prices go down).

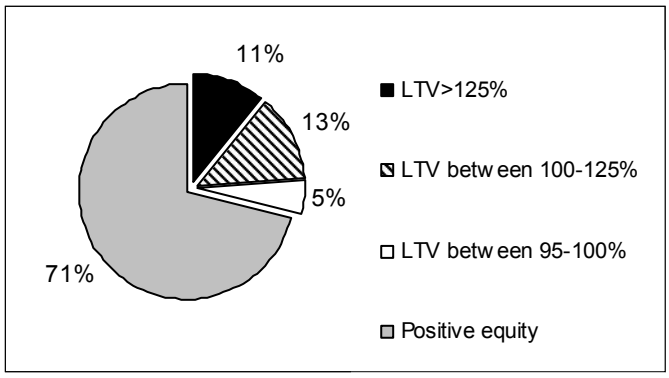


Fig. 6.2. Loan-to-Value Ratio (LTV, %)

Source: IMF.

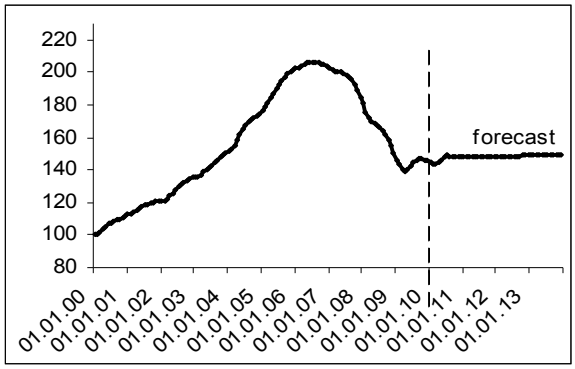


Fig. 6.3. S&P Case-Shiller and Forecast

Source: US department of Housing and Urban Development; US department of Treasury. Sept. 2010.

Although currently measures are being taken to support the mortgage market (including the possibility of refinancing and sale of inadequately collateralized loans), which can somehow calm down the market, more systemically, it should be remembered that sharp crisis-driven reduction of household assets, in general, significantly restricts mortgage demand.

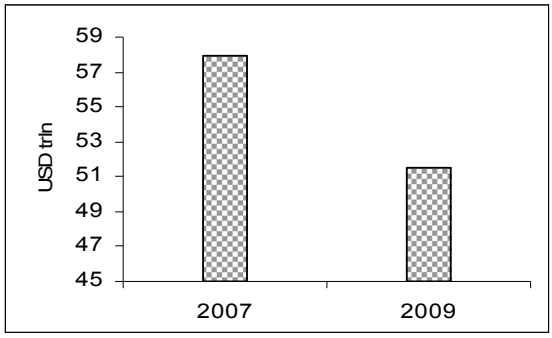
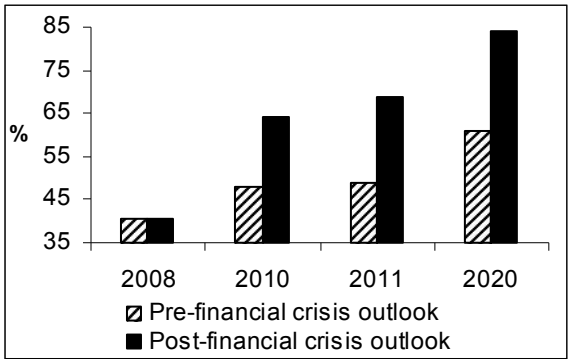


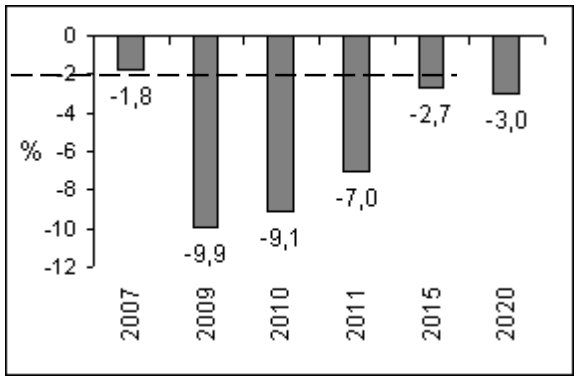
Fig. 6.4. US Household Net Worth* (USD trln)

* average annual.
Source: US Fed.

The growth of crisis management expenses aggravates the issues of budget deficits and government debt.

According to forecasts, despite the emerging trend toward the US economic recovery, deficit will not regain its pre-crisis level by 2020.





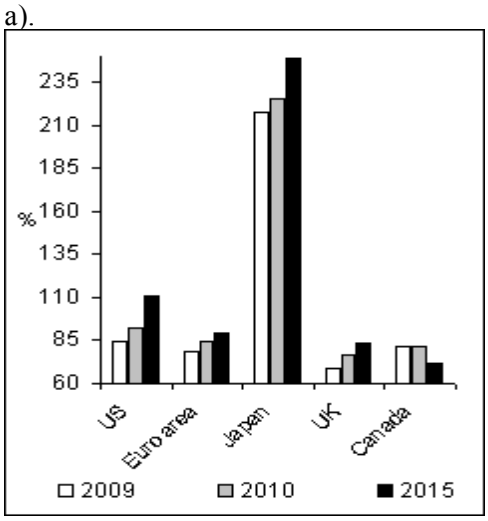
a) Budget outlook made before and after crisis * **b) Federal budget deficit**

* Forecasts were made in December 2007 and January 2010

Fig. 6.5. US Government Debt and Federal Budget (% of GDP)

Source: Hearings in Financial Crisis Inquiry Commission, January 13, 2010; Congressional Budget Office.

The estimate of prospects for most developed economies causes equal concern (Fig. 6.6-a).



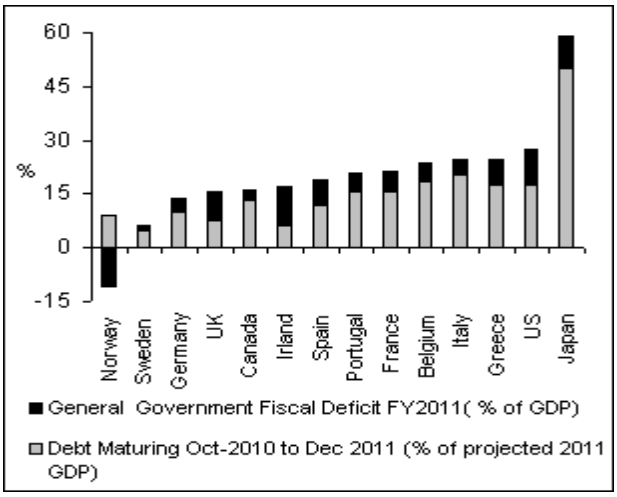


Fig. 6.6. Government Debt of Developed Countries (% of GDP)

Source: IMF.

However, in certain cases, the next year will see considerable amount of debt payments (Fig. 6.6-b).

Financial problems faced by a number of countries (Ireland, Portugal, Greece, etc.) in an environment of currency instability gave rise to active debate about the single European

currency. Perhaps, it does not make sense to discuss in detail how deep future problems will be and how tangible will be their impact on the destiny of *euro* since the situation is fairly dynamic and changing rapidly. However, it appears that the future situation is likely to be similar to conditions when euro was created - when political rather than economic factors had a crucial role to play. Indeed in the late 1990s the integration processes in Europe reached certain level of development, still major differences between the countries were in place (for example, Germany and France, on the one hand; Greece and Portugal, on the other hand). These countries still had a long way to go before the real "unification" of their economies (important for efficient integration) could be achieved. However, the differences were not a barrier to unification since the adopted **political decisions** put the participants before the 'happened reality' and forced them restructure all of their economic mechanisms and approaches to make the new financial architecture possible. In this regard, it appears that if the single currency faces a question "to be, or not to be" which, in essence, would mean whether to "dismantle" the financial architecture which took shape during the recent decade with all associated geoeconomic and geopolitical risks and global systemic changes which may follow as a result, political factors are very likely to dominate again. Such high level of decision-making will be required and then should be supported by economic mechanisms and leverages to make such decision possible. If global destabilization is not on the agenda, it is then obvious that the decisions of international participants should be aimed at maintaining the euro positions in the international monetary system.

Political factor will be decisive in determining future existence of the single European currency.

If global destabilization is not on the agenda, it is then obvious that the decisions of international participants should be aimed at maintaining the euro positions in the international monetary system.

All of these issues, obviously, aggravate global imbalances. Moreover, the existing deficits will inevitably create the situation in which countries with excessive liquidity (and often high savings rate) will finance "deficit" countries, as before the crisis, thus causing financial resources necessary to finance their deficits to flow into these troubled countries.

Resource inflow can be a factor putting downward pressure on the level of interest rates (which are already low). As a result, the profitability of financial operations will decline, necessitating more aggressive banking policy for the purpose of raising profits. When yields are

low, banks will be less skeptical about asset quality and become more interested in higher-yield and simultaneously riskier areas of investment.[98] This trend again became visible during 2010, which saw, first, the growth of issues and demand for junk bonds and, second, reduction in the spread between government securities and high-risk bonds.

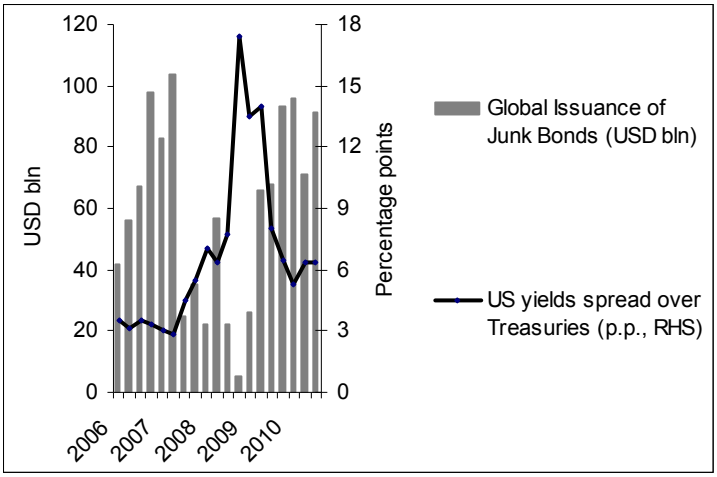


Fig. 6.7. Junk Bonds Worldwide

Source: The Economist, September 30, 2010

Obviously, despite regulatory and restrictive measures, the world's banks will witness again growing leverage and unreasonably overblown balance sheets. In other words, the risks preceding the recent crisis are beginning to reemerge again.

The risks preceding the recent crisis are beginning to reemerge again.

Naturally, this will be a large-scale and systemic phenomenon. As the head of the Bank of Japan fairly stated, "most financial institutions will find it hard to resist pressures from equity holders to raise the return on equity under severe competition"[99].

These circumstances show how fragile the achieved stabilization is and how high the risks faced by the world economy and individual countries are – up to possible country defaults in the future with growing risks for possible geopolitical crisis.

These circumstances show how fragile the achieved stabilization is and how high the risks faced by the world economy and individual countries are – up to

[98] Specifically, we pointed out in 2009 that these trends can emerge again. For details, see NSMA Conference. Panel Discussion of Macroeconomists "Russia's Financial Market Prospects" (December 10-11, 2009). May 2010 Brochure. www.ershovm.ru

[99] Shirakawa M., Some thoughts on incentives at micro and macro level for crisis prevention. BIS, Papers No53, June 2009. P. 25-26.

possible country defaults in the future with growing risks for possible geopolitical crisis.

Another important circumstance giving rise to future risks is the excess of global liquidity (we mentioned large-scale increment in USD monetary base, among other things, which has already exceeded USD 2 trln and can soon exceed USD 2.5 trln, i.e. demonstrate virtually 300% growth rate against the pre-crisis level).

The resulting growth of the leading economies' money supply considerably outpaced their GDP growth rates (Fig. 6.8).

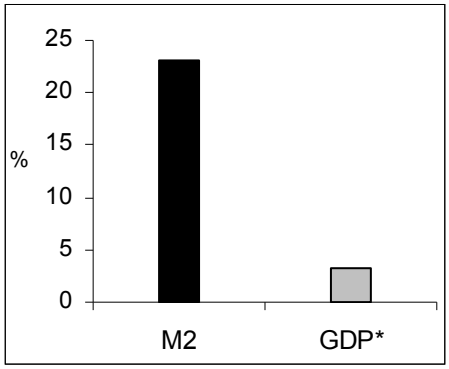


Fig. 6.8. Increment in the Money Supply (M2) and GDP of Major Economies in 2007-2009 (Dec./Dec., %)**

* Growth of nominal GDP
** Euro area, US, UK, Japan, China, Russia

Source: calculated using data from Eurostat, US Fed, BEA, Bank of England, Bank of Japan, National Bureau of Statistics of China, Rosstat. CBR.

These trends will become more distinct since new QE and dollar emissions are planned in the US (Fig. 6.16).

The above-mentioned resources, obviously, will search for its niches first by flowing into the markets and warming them up as a result and then leaving the markets, thus creating the risk of collapse. In an environment of free capital flow, this will aggravate the risks of new regional crises and the volatility of both - financial markets and the entire world economy.

As was fairly said in the international reviews, "developed countries too quickly poured large resources into developing countries. This created an asset bubble in the mortgage and stock market as well as currency price growth"[100].

Obviously, developing markets will take measures aimed at restricting capital operations and neutralizing the adverse effects of speculative short money inflow. These steps have already

[100] Gallagher K.P. "Losing Control: Policy Space to Prevent and Mitigate Financial Crises in Trade and Investment Agreements", UN report, No 58, May 2010.

been taken by a number of countries (such as Brazil and South Korea) and such approaches are likely to become more widely-used.

> A number of countries have already started to limit their capital transactions and reduce negative effect of speculative money inflows.

In developed countries, primarily the US, with a view to mitigate negative impact on the financial sector, an attempt can be made first to transform the financial bubble into a general economic bubble by pushing it out from financial sphere, to the greatest extent possible, into the real economy. Since the prime recipient of aid is the financial sector, it is also the first sector to experience positive effects of rendered support. Obviously, in this case it will strengthen due to relative weakening of the real sector. This will allow allocating risks "more evenly" across the economy: the financial sector (which remains the main supporting point) will face lower risks, unlike other participants, resulting in all possible implications for the economy in general such as sectoral, inflation-related, currency-related, etc.

Then, given the shaping conditions, the bubble can be pushed into the external environment, which will also allow solving the task of efficient placement of additional liquidity (especially if external assets are undervalued) and thus pre-empting future devaluation of the dollar.

> It is desirable that the issuer of the leading reserve currency pushes the bubble out into the external sphere, accomplishing simultaneously the objective of efficient placement of additional liquidity (especially if external assets are undervalued) and pre-empting possible major devaluation of the USD in future.

Developing economies are an important and receptive segment for such "absorbing" of funds. If these countries realize destabilizing risks associated with global liquidity excess and take action to restrict short money flow from countries with excessive emission, this will significantly complicate the achievement of "new post-crisis alignment." For this particular reason, the G-20 London declaration, speaking about the need for opposing protectionism (recently, similar documents have almost always mentioned this issue), **emphasizes the prevention of financial protectionism, particularly measures that constrain worldwide capital flows, especially to developing countries.**[101]

[101] G-20, "The Global Plan for Recovery and Reform", 2 April 2009.

The worst-case scenario does not rule out the full range of economic and geopolitical tools which can be applied for shifting the center of gravity of the crisis to other places, with ensuing global destabilization. (Simultaneously, this can contribute to solving pending debt issues.)

Excessive liquidity will also mean that aggravated US dollar risks can emerge.

About New and Old Risks of USD

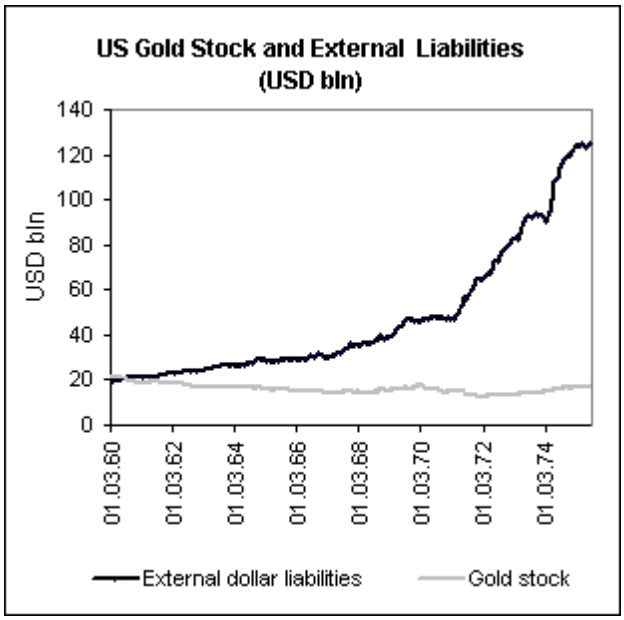
As crucial element of the current financial system, and as a centerpiece of strong strategic interest of the leading centers of power, the US dollar has historically held leading positions. Interests in maintaining the status of the dollar were so high that, in the past, even the large-scale "reputation shock" did not damage its positions: when in 1971 the US unilaterally announced default on their obligations to exchange USD for gold, leading to collapse of the Bretton Woods system.

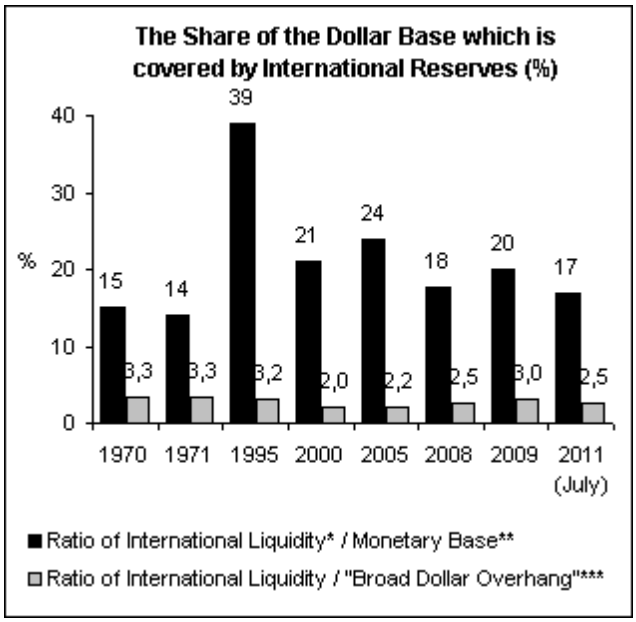
Interests in maintaining the status of the dollar were so high that, in the past, even the large-scale "reputation shock" did not damage its positions: when in 1971 the United States unilaterally announced default on their obligations to exchange USD for gold, leading to collapse of the Bretton Woods system.

Although, in principle, these events can be perceived as "the remote past," the market, however, is sensitive to new risks of the US dollar, bearing in mind its imperfect "credit history." Currency market participants were nervous about the adopted decisions on additional USD creation by US Fed, believing that the US dollar will incur significant damage. According to international experts, "in the grand sweep of history we are witnessing the end of 'Rome' on the Potomac "[102]. "This is a historic moment of the start of debasement of the world's reserve currency"[103].

Indeed, the US dollar can enter the same phase of risks as before the Bretton Woods system collapse in the early 1970s, when it lost the necessary gold backing (Fig. 6.9).

[102] Bloomberg. March 23, 2009.
[103] Idem.





* Incl. foreign currency reserves, reserve position in IMF, SDR, gold stock. Gold value is calculated based on market value.
** Incl. currency in circulation (excluding currency in the depositaries of the money authorities), reserve funds of commercial banks with US Feds.
*** Incl. monetary base, debt of monetary authorities minus Treasury securities at US Fed balance sheet.

Fig. 6.9.

Source: IMF; calculated using data from US Fed, IMF.

For a number of other currencies, gold and foreign exchange reserves support looks far more satisfactory.

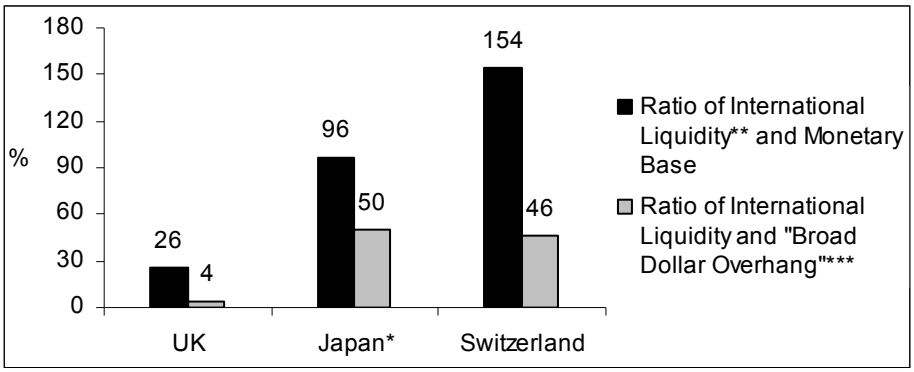


Fig. 6.10. Monetary Base to Gold and Foreign Currency Reserves (Ratio) (2009, %)

* As of September 2010
** Includes currency reserves, reserve position in IMF, SDR, official gold reserves.
*** Includes monetary base and government debt.

Source: central banks of the countries concerned, IMF.

We have emphasized these risk faced by the US dollar before.

About Forecasts:

M. Ershov[104] (**2000**): "Perspectives of US dollar and the world monetary system as a whole at present look problematic".

P. Volcker[105] (**2003**): "There is 75% chance of currency crisis in the US within 5 years".

In general, recently, the US dollar, indeed, has entered the phase of long systemic depreciation (Fig. 6.11).

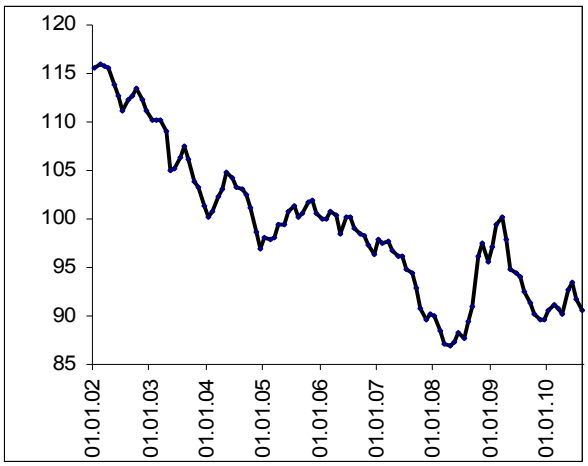


Fig. 6.11. Real Effective USD Rate (2005=100)

Source: BIS.

Moreover, following the declared measures, its rate devalued versus many currencies (Fig. 6.12).

It is becoming obvious that following the declared growth of emission its backing by necessary reserves, at least for calming down the markets, is getting very weak (especially given the factor of domestic debt).

[104] M.V. Ershov. Monetary and Financial Mechanisms in the Modern World (Crisis Experience of the Late 90s). – M.: Ekonomika, 2000.
[105] P. Volcker, Chairman of FRS in 1979-1987. The Economist. – 2004. – November, 13th. – P. 88.

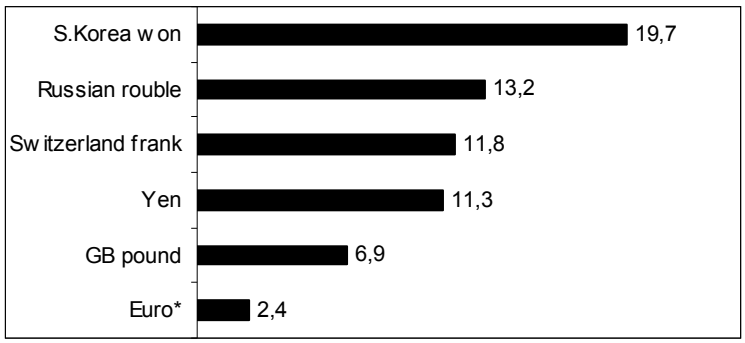


Fig. 6.12. USD Devaluation (March 2009 – September 2010, %)

* March 2009 – October 2010.

It is also obvious that any new economic deterioration in the United States as well as its "dollar infusion" as part of anti-crisis measures will complicate the US currency positions.

Possible loss by the US dollar of its 'stability anchor' position, obviously, will raise the question of what the currency system will have to rely on. Various options are currently being considered up to the possibilities of getting back to the Bretton Woods 2 targets (to varying degrees) and strengthening the role of gold. According to R. Zoellick, President of the World Bank, "the system should also consider employing gold as an international reference point of market expectations about inflation, deflation and future currency values"[106]

We emphasized the feasibility of strengthening the role of other currencies and the role of gold in the shaping of gold and foreign currency reserves in an environment of global instability during the initial crisis phases.

Regarding Some Issues of Forming International Reserves in Russia

(For the meeting of the Banking Committee of the Russian Union of Industrialists and Entrepreneurs (Unites Big Business) of **07.02.2008**)[107]

1. The high risks and turmoil in the international financial sector in 2007-2008, and related foreign exchange fluctuations brought forward the issue of a 'stability anchor' in the international currency system as well as the need to find least risk-exposed assets. In this connection, the attention was once again focused on gold, firstly, as an asset that is traditionally viewed as the most reliable asset in crisis times, and, secondly, as an asset whose price has been steadily growing over the last 3 years.

[106] R. Zoellick, FT, November 8, 2010.

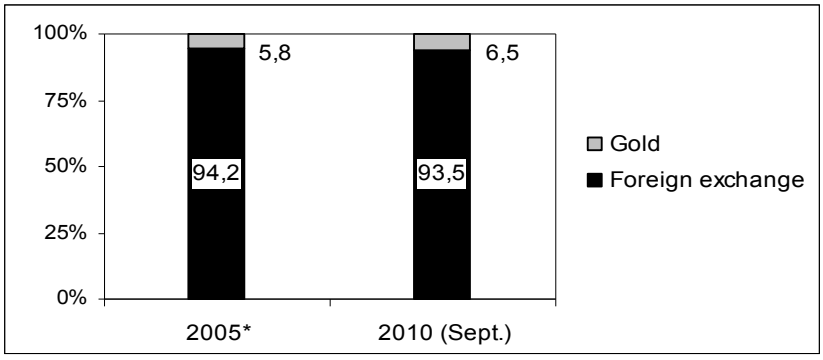
[107] M. V. Ershov. Materials for the Meeting of the Banking Committee of the Russian Union of Industrialists and Entrepreneurs, 7 February 2008.

Given that the crisis trends in the global economy may deepen in the coming year, which might result in foreign exchange losses, we need to consider potential measures to diversify national gold and foreign exchange reserves by increasing the share of the gold component.

2. We also need to bear in mind the steady decline of the US dollar exchange rate against a number of currencies (Euro, Swiss franc, pound sterling, renminbi, rouble) over more than the last two years. Moreover, international organizations estimate that the US dollar still remains overvaluated (which means the existing potential for its further decline).
Crisis trends in the US economy and lower interest rates may also contribute to the dollar depreciation by making investments in US dollars less attractive.

Given the above, it would be reasonable to consider gradual diversification of the currency portfolio of international reserves (and the currency structure of the foreign trade turnover) by increasing the share of other currencies.

Indeed some changes in the above could be seen during crisis. However such changes still remain quite small (Fig. 6.13).



a) Structure of International Reserves of the Russian Federation (%)

* gold reassessed at the market price

b) Structure of foreign exchange reserves of the Bank of Russia (%)

Fig. 6.13. International Reserves of Russia

Source: Central Bank of Russia.

The markets' concerns and the overall uncertainty brought about once more the questions about new reserve currencies.

We have already mentioned that the process of adequate replacement of the US dollar with other currencies can not be quick and, obviously, will face strong opposition at geopolitical and geoeconomic levels alike.

Furthermore, global development prospects will depend, in many respects, on the direction of reforms to be undertaken by the leading Western markets and their major regulators. The US Fed deserves special attention. Due to both - objective and subjective circumstances, it became the world's leading central bank and its actions often have a large-scale impact on the rest of economic world.

New Views on FRS and Its Future Role

Crisis deterioration forced the regulators to try to change certain fundamental principals of the institutional nature of the functioning of the system, which are of paramount importance.

In June 2009, a reform of financial regulation was announced. At first US President B. Obama and then US Treasury Secretary T. Geithner presented a broad program of new approaches[108]. The program provides for substantial changes in the "weight categories" of the regulators, where the Department of the Treasury, not FRS, will often have the dominant role. This immediately gave rise to talks about the decrease in the prior longstanding independence of FRS pointing that these measures may in some cases transform it into a functional unit of the Treasury.

Specifically, it is provided as follows:

- to create the Financial Services Oversight Council (chaired by Treasury and including the heads of the principal federal financial regulators as members);

- to create the National Bank Supervisor (as a single agency with separate status in Treasury), which will be responsible for federally chartered depository institutions. [mimeo: Let us point out that these functions should have rather been the prerogative of FRS, and therefore these innovations may be regarded as a transfer of the center of balance in regulation toward the Treasury];

- new authority for the FRS to supervise not only banks, but also all firms that may pose a threat to financial stability. One should suppose that such extensive functions may

[108] "Financial Regulatory Reform. A New Foundation: Rebuilding Financial Supervision and Regulation". US Department of the Treasury. 2009.

substantially complicate FRS's work, making it in fact responsible for financial failures of the entire corporate sector;

- limitation of FRS's capacity in the matters of providing of emergency loans and receiving prior written approval for these actions from the Secretary of the Treasury.

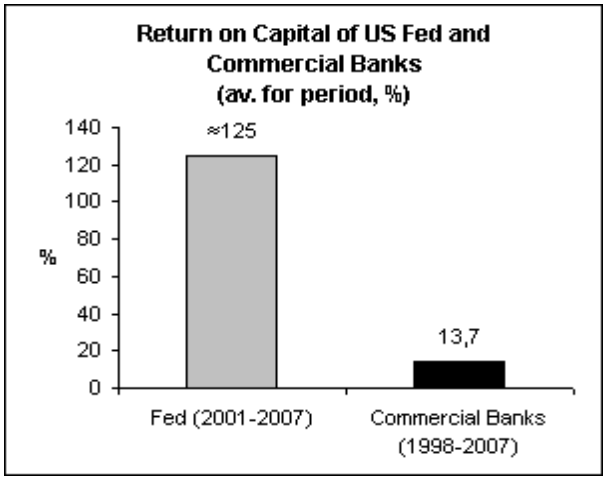
In the context of recent discussion of these and other initiatives, the features of US Fed performance have often started to attract attention. We would like to remind you that FRS comprises 12 Federal Reserve Banks (FRBs), whose degree of independence, at least de jure, may be regarded as quite high. Each of the FRB's shareholders bear responsibility under the individual obligations of the relevant bank (but not of other federal banks)[109]. In this connection, one can, for example, recall such precedents where the Federal Reserve Bank of Chicago refused to conduct operations aimed at supporting the Federal Reserve Bank of New York in the pre-war period[110].

Therefore, the consolidated balance sheet of FRS may be regarded as such with certain reservations. (Although the shareholders of the regional commercial banks may be the same entities that are the shareholders of their mother banks at the same time thus making such collisions unlikely in modern times.) However, these circumstances should be taken into account in assessing the risks associated with the US Fed balance and status.

Finally, more and more often questions are raised about the necessity for differentiating between the independence of the monetary policy, on the one hand, and the independence of FRS itself, on the other. Particularly since the shareholders of regional FRBs are commercial banks that are having quite concrete commercial interests and interests of their shareholders.

Recently, there has been more attention paid to the efficiency of FRS activities (Fig. 6.14).

[109] Federal Reserve Act (December 23, 1913). Sec. 2, partly incorporated in 12 USC 222 and 223. As amend by act of July 7, 1958 (72 Stat. 350); March 18, 1959 (73 Stat. 12); 12 USC 502.
[110] Meltzer, Allan H. A History of the Federal Reserve, Volume 1: 1913-1951. University of Chicago Press, 2003.



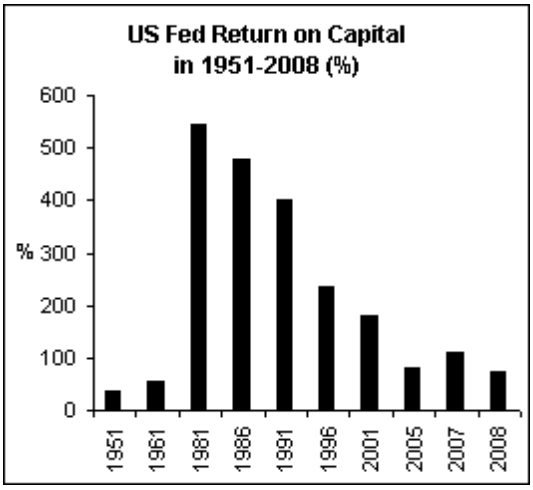


Fig.6.14. Return on Equity of the US Fed and commercial banks

* for the period from 2001 to 2007
** for the period from 1998 to 2007
Source: IMF; calculated using data from IMF.

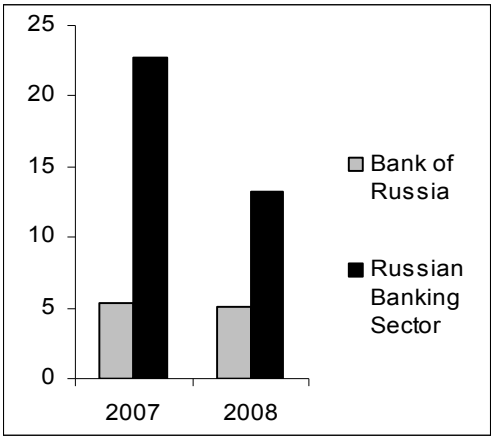


Fig. 6.15. Return on Equity of the Central Bank of Russia and the russian banking Sector (%)

Source: Central Bank of the Russian Federation; calculated using data from Central Bank of the Russian Federation.

Moreover, the US Congress is currently considering the bill providing for the US Fed audit.[111] The crisis situation forced legislators to obtain the fullest possible information about the US Fed activities. Until recently, audits have not yet covered crucial areas of its activity such as monetary operations, including discount window loans (which give the opportunity of direct lending to financial market participants); open market operations; operations with foreign governments and foreign central banks.[112]

[111] Federal Reserve Transparency Act, HR 1207, February 2009.
[112] US General Accounting Office, Federal Reserve System Audit, October 27, 1993.

The fact that such crucial (in essence major) functions of central bank, such as monetary policy, are not subject to control by taxpayers, is at least strange.

The fact that such crucial (in essence major) functions of central bank, such as monetary policy, are not subject to control by taxpayers, is at least strange.

The regulator turns out to be so closed that it makes it impossible to assess its actions in all necessary detail. In this regard, it is not clear at all how in principal such modern economic system, which declares itself open and transparent and which requires openness from others, remains so non-transparent in its key operational spheres.

How in principal such modern economic system, which declares itself open and transparent and which requires openness from others, remains so non-transparent in its key operational spheres?

And why did the system which is considered "democratic" fail to consider this issue immediately (moreover, this should have been done many decades ago!) and to resolve it positively right-away? Can the taxpayer be so indifferent (or powerless?) in the environment of the so called "developed democracy" so as to ignore such important issues? And is it so that all that this major deep crisis could do was to simply make possible just an attempt to simply raise the voice about the problem ?

Finally, in November 2010, a number of the US Congress members initiated the law which provides for reducing the areas of responsible of the US Fed down to price stability and inflation prevention issues. Virtually, it is proposed that the US Fed be deprived of its major functions for maintaining employment and, consequently, economic growth. If the law is adopted, the US Fed can lose its critical systemic functions and will be unable to influence the progress of national and international economic processes as before. These events appear to be unlikely as the centers of interests opting for the preservation of previous approaches are too powerful. However, until post-crisis issues are solved, the advocates of rebalance of forces are likely to continue their attempts. If their action is consistent, it is possible that the current crisis situation can be an impetus for drastic systemic changes in the shaping of the fundamentals affecting the level of involvement of the centers of economic power in the functioning of the existing financial system.[113] Such "cross-departmental optimization" and related reshuffling of

[113] Certain attempts to shift partly the center of gravity from the US Fed to the Treasuryy (in crucial matters such as national currency emission) were last made by the John F. Kennedy Administration, when the President planned to authorize the Department of the Treasury with powers of emission. The tragic events of the President's death,

the spheres of influence at regulatory as well as at corporate levels can give rise to creating of a different geoeconomic and geopolitical configuration of the modern processes and mechanisms.

In the document proposed in the summer of 2010, a whole range of the above-mentioned issues as well as a number of new issues are supported by the legislators to varying degrees.

A whole range of issues are still to be discussed and adopted.

The important adopted initiatives include the imposition of restrictions on the use of client funds for the risky investments of banks ("proprietary trading"). This is critical, all the mores so as many of these funds (deposits) are guaranteed by the government (for protecting the interests of depositors) whereas banks can use them for their, often fairly risky, investments. This restriction was conventionally titled the "Rule of Walker" (former head of the US Fed, who was the author of the above-mentioned measure). Derivatives will have to be traded through special affiliates to be established by banks. To decrease the role of the New York Fed, its head will be appointed by the presidents of country rather than the Board of Directors of the US Fed.

For the purpose of protecting consumer interests, the Consumer Protection Agency will be established. Virtually, it is planned to function as part of the Federal Reserve System.

The Financial Stability Oversight Council will be established. It will be chaired by the head of the Department of the Treasury and composed of managers of the leading economic agencies. It is planned to track thoroughly "leverage" indicators and off-balance-sheet operations; in case of large companies (bank holding companies whose asset value exceeds USD 50 bln and non-banking financial companies supervised by the US Fed), to restrict (in case of stability risks) merger and acquisition operations and the possibility of product offer. It is expected to be recommended that these companies sell a part of their balance-sheet and off-balance-sheet assets to third parties (non-affiliates).

It is planned that the US Fed will control all largest and inter-related financial institutions (yet not all economically important entities, crucial to financial stability in the economy, as was the case suggested by the initial proposals).

It has been obvious from the beginning that the originally tough proposals of regulators would face strong opposition from the banking lobby. It was also clear that the "institutional resource" represented by chief executives and regulators would try to make the best of the situation. It should also be taken into account that the situation as such gave a historically unique chance to change the balance of forces from the dominant leadership of the financial sector to possibly different "centers of attraction."

---

apparently, prevented these plans from being implemented. Later, for some reason, these plans have never been reactivated.

It should also be taken into account that the situation as such gave a historically unique chance to change the balance of forces from the dominant leadership of the financial sector to possibly different "centers of attraction."

For example, it is quite possible that the representatives of the real sector capital (which in the cotemporary history somehow gave up their leading positions, ceding them, to a certain degree, to the representatives of financial capital) will try to strengthen their positions again in the new post-crisis environment and will try to shape more favorable "rules of the game" for themselves[114]. All the more so as the supportive measures which have already been taken are expected to support the so far shaky positions of the financial sector in first place. However, this is likely not to be the final picture in this changing environment. The trade-off attained so far may be viewed as temporary and is likely to be revised in the future with allowance for new regrouping of forces and evolution of the economic situation.

In this regard, it should be noted that a number of high-ranking officials from the administration resigned after a relatively short term of office. Apparently, this can show either stronger "intra-apparatus" and "intra-system" counter-action (which is true of any system) or it shows more significant matters which relate to the perception of economic prospects and reluctance to be responsible for new phases of crisis aggravation[115]. It appears that near future will make the real reason more clear.

Once Again About Russian Risks

Possible risks necessitate even more to shape a stable financial system in Russia, which would have strong internal basis for its development and would not depend on global economic fluctuations. Systemic risks remain and thus we would like to remind that the lack of necessary funding before crisis (at an affordable price and of affordable duration) in the domestic market forced Russian industrial companies and banks to enter external markets and rely on the external sources of finance. (In the 4-5 years preceding the crisis, their corporate debt grew from virtually minimal values to more than USD 500 bln.) Ultimately, this issue has not been solved

[114] Naturally, in the present situation, the property of financial and real sectors is highly intertwined and many entities representing the real sector hold an interest and participate in the financial sector. At the same time, many traditional "real and industrial houses," which were the originators of national economic fundamentals are likely to be willing to regain their original leading systemic roles which they lost.

[115] In the second half of 2010, the following officials left the administration: Christina Romer, Chair of the Council of Economic Advisers; Peter R. Orszag, Director of the Office of Management and Budget; Lawrence H. Summers, Director of the National Economic Council and Assistant to the President for Economic Policy.

and unless the systemic solution is found, the Russian market will remain essentially dependent on external sources of finance.

Unless the systemic solution of the problem is found, the Russian market will remain essentially dependent on external sources of finance.

Once, for a short period of time, monetary authorities, affected by crisis risks, declared their intention to reverse the situation. We would like to remind you that in 2008-2009 the Bank of Russia, for the first time in many years, switched in its monetary policy to fundamentally new approaches to money supply creation, where domestic (rather than external) sources had a leading role to play.

This should have implied weakening external risks, higher role of interest rates, bigger role of the interest rate transmission mechanism, which was supposed to allow these resources to reach not only export but also the remaining branches of the economy, i.e. to ensure the funding for all economic participants, thus contributing to structural transformations. The market perceived the above-mentioned attempts as a correct step driven by new realities.

However, as soon as the crisis became less acute, previous approaches related to the domination of currency sources of monetization (money supply, emission) regained their dominant role.

This means return to pre-crisis monetary policy approaches, which, in many respects, strengthened our dependence on the external sector and aggravated the crisis. This also implies that we should be ready that, if monetary approaches remain basically the same, many risks faced by the Russian economy in the pre-crisis period can come back again.

If monetary approaches remain basically the same, many risks faced by the Russian economy in the pre-crisis period can come back again.

It is especially important to consider these facts in the current global situation. Inevitable restructuring of bank balances in Western economies (deleverage, reduction of troubled assets) will be associated with weaker financial activity and economic activity in general. The measures being taken will increase the risk of renewed growth of government debt (since commercial debt will often have to be transformed into public debt) in most developed countries, thus aggravating the threat of country defaults for some of them. Excessive US dollar liquidity and new plans of its further growth (Fig. 6.16), obviously, increase the destabilizing risks faced by countries to which this liquidity inflows (and then outflows) as well as increase risks of the US

dollar as such. The use of these large-scale measures also shows that the situation in the US remains complicated and its stabilization still requires vast supportive measures.

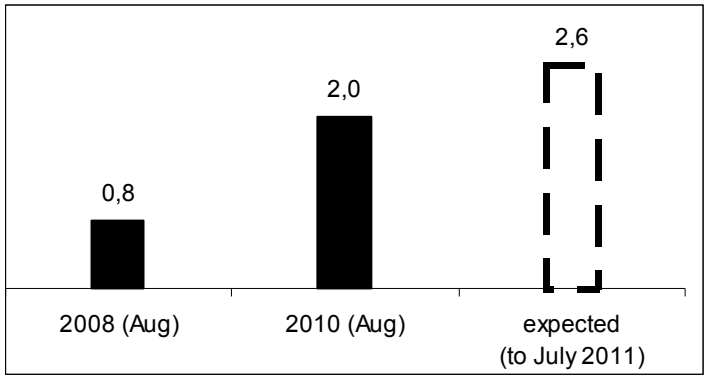


Fig. 6.16. Monetary Base of the US Dollar (USD trln)

Source: US Fed.

All that complicates prospects of sustainable development in the world and requires from Russian participants an adequate degree of alertness to be able to oppose new global risks and to ensure strong anti-crisis basis to of strengthen the Russian economy.

INSTEAD OF AN EPILOGUE

(OR WHAT NEEDS TO BE DONE)

The scope of global risks forced major countries to revise their economic approaches dramatically. "Reasonable pragmatism" became the center-piece of such approaches. Everything that was in line with the common sense and had to be done to ease the course of crisis - was done indeed. Ideological dogmas about "government non-intervention", "free market" and many other things previously presented as indisputable axioms were forgotten. Now, even "apologetes" such as IMF talk about the possibility of budget deficits for encouraging economic growth and the "free market" defenders such as the United States emphasize the need for "industrial policy" and, if necessary, even render large-scale government support to the economy, including nationalization (when required). Other countries (for example, Great Britain) are beginning to discuss in full the necessity of controlling "short" speculative money flows and a number of other countries are introducing measures to restrict capital flows. In general, the strengthening of protectionism has become a clear threat to the world economy.

It is obvious that if new risks increase as a result of possible second wave of the crisis or due to the threats of global liquidity flows (caused by "anti-crisis measures") or for other reasons, protectionist trends will only grow and will simultaneously confront severe opposition from developed economies. The behavior of both sides is quite clear. Developed economies experiencing (or having experienced) a crisis do benefit from having multiple points of support to maneuver. They need channels to move and push out their liquidity they need external assets (preferable undervalued) in which such liquidity can be invested as well as other external opportunities. Therefore, they naturally, oppose any action trying to limit these opportunities. The behavior of developing countries (and not only them) is also understandable: when "epidemics" brake out there is always a desire to introduce "quarantine" measures in order to protect oneself against negative effects.

Since in the present situation restrictive measures alone are unlikely to solve the problem (in principle, it is worth using them only if risks grow further), the strengthening of domestic economic position should be a key priority which will enable to have stable positions even in an

environment of turbulence. Simultaneously, the coordination of cross-country approaches should be improved by making them more consistent and at the same time mitigating the risks of cross-country economic conflicts, trade and currency "wars," which are becoming more likely again.

At the same time, it is important that use of anti-crisis and other measures do not block the "systemic horizon" when resolving the problems. Regulators and market participants should have a clear idea (to the extent such clarity is possible in principle when the environment is so dynamic) of the post-crisis economy, specific ways out of the crisis and significance of new risks.

In the situation of new global challenges associated with further integration of Russia into the world economy, a number of crucial systemic questions should be answered clearly. Will Russia be among the leaders in the future integration or will its role be secondary and subordinate?

In the situation of new global challenges associated with further integration of Russia into the world economy, a number of crucial systemic questions should be answered clearly. Will Russia be among the leaders in the future integration or will its role be secondary and subordinate?

In other words, will we be used by others to satisfy their needs or, on the contrary, will we take advantage of the benefits inherent in the international system for our own development?

Are we willing to stop at last "going with the flow", which was shaped without our active involvement (during the formation of domestic market mechanisms) and, instead, to start playing new roles in the new post-crisis environment? – When will our integration into the world economy be no longer equivalent to broadening our role as raw materials supplier to other countries but rather will lead to expansion of our positions in this world as a systemic participant entering the external markets as investor and buyer of their industrial and other assets?

We should consider more aggressive entering the world financial system without spraying our investments into "common graves" like to mortgage giants Freddie Mac and Fannie Mae, where investors are already abundant and our voice will get absolutely lost (and whose shares, in addition, have devalued considerably). Instead, we should consider purchasing significant stakes in some top-tier Western banks which need investment (as was the case with Citi Group and Mitsubishi or could have

been the case with the purchase of bankrupt Lehman Brothers, if there had been a purchaser).

Will we manage to keep our economic sovereignty, which will allow Russian regulators and national businesses to have decisive weight in the shaping and implementation of Russia's development priorities and to have a decisive voice in the adoption of fundamental decisions concerning the future of national economy? Or will such decisions be made elsewhere and Russia will simply become an "economic territory", a kind of a "cross-border, transnational area" supplying resources to the entire world?

Obviously, the struggle over natural resources in the post-crisis world will only get stronger.

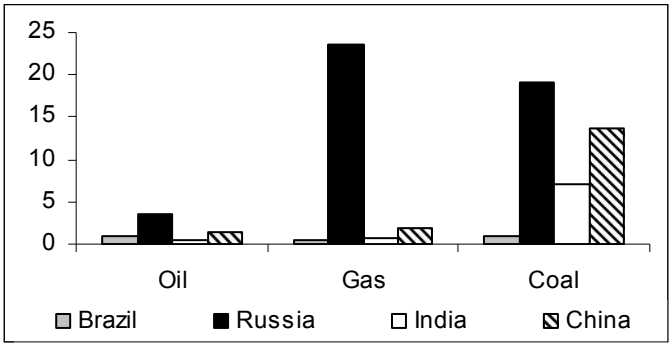


Fig. 1. Natural Reserves (% of Global Volume)

Source: BP, Troika Dialog.

Moreover, Russia, with less than 3% of the world's population, accounts for more than 30% of global raw material reserves, there is an obvious risk that the aggravation of struggle for resources and new crises, sooner or later, will raise the issue of "fairer allocation" of such resources in the global context. This situation will require stable geoeconomic and geopolitical foundations necessary for an adequate dialog allowing us to maintain the existing status quo.

This situation will require stable geoeconomic and geopolitical foundations necessary for an adequate dialog allowing us to maintain the existing status quo.

All of these risks necessitate laying stable domestic foundations for the Russian economy. To improve its competitive positions and to neutralize possible external and domestic risks, Russia needs to develop a set of measures aimed at ensuring sustainable development of national economy even in the environment of global instability and giving the opportunity to strengthen the positions of the country amid growing global competition.

We suggest that special attention be paid to the approaches which could contribute to the accomplishment of these objectives in a new competitive environment.

These measures concern a broad range of issues related to financial, foreign exchange and fiscal policy, foreign economic activities and should be viewed in their interconnection as an important part of common economic policy of the country. Although some of them are beginning to be taken, obviously, much work still has to be done to create an integrated system of measures and crisis management mechanisms.

Certain Post-Crisis Development Measures

1. There is a need to formulate clear economic priorities of national development in the post-crisis world, which will ensure sustainable economic growth and development of Russia despite possible external risks. This should be accompanied by more active budget policy so that the budget becomes a powerful systemic mechanism fostering progressive structural transformations, the improvement of quality of growth and the strengthening of country's positions in general.

2. It should be taken into account that progressive changes coupled with maintaining economic growth are hard to achieve simultaneously. Normally, the implementation of significant structural changes slows down the growth rate (to use a sports analogy, it is difficult to keep the pace while putting on more modern running shoes, which will later allow running faster).

However, it does not mean that this is an absolutely unattainable objective. There are a whole range of financial and monetary policy tools that can contribute to their simultaneous accomplishment.

Note

Possible "double-action" tools include the lowering of Value Added Tax (VAT). As any tax cut, it will ensure additional demand and the resulting economic growth. Moreover, high-added-value industries will benefit most from VAT reduction in the first place, thus becoming the "driving forces" behind such growth, shifting the center of gravity from raw materials industries to industries with higher degree of manufacturing component.

Similarly, there is an option of 'task-refinancing' backed by securities of top-priority progressive industries, which will ensure the inflow of necessary financial resources into the "new economy" industries, whose growth will increase both - their share in GDP and GDP as such.

3. There is a need for special systemic policy to shape and manage monetary resources in the economy in post-crisis environment. It should rely on a broad range of mechanisms and

tools allowing to neutralize "external shocks" and creation of adequate financial resources in line with the objectives of post-crisis recovery and resumption economic growth. It should simultaneously contribute to efficient cash flow to the necessary segments. It is also important that mechanisms and effective tools be in place for setting and regulating the price of financial resources, which would reflect the real money demand from the economy and market participants.

This policy should primarily rely on domestic sources and mechanisms for creating funds, which is especially important amid global instability. Domestic sources of funding should gradually replace the international financing.

4. Integrated approaches of money supply creation should be worked out to link the policy of the Central Bank of Russia with the objectives of budget, industrial and structural policy.

National monetary authorities should lay basis for the above-mentioned approaches, providing for sustainable development of the Russian economy and national business in a highly dynamic global environment, strengthening the necessary mechanisms of internal development and minimizing external risks. It is important to create domestic conditions and incentives to work with the ruble which could smoothen the effects of "financial openness", discouraging the outflow of newly created liquidity to the currency market, which could hamper financial stability.

5. Rate of refinancing and refinancing mechanisms should play an important role allowing the Central Bank of Russia to affect considerably not only credit markets and financial markets but the entire economy as a hole (as is the case in leading countries). Refinancing should be both - short-term and longer-term (for example, up to one year, as was the case during the last crisis).

To make the refinancing rate an effective mechanism which shapes the pricing parameters of the financial market, the monetary base should be created not as a result of currency revenue inflows (as is the case nowadays); instead, "domestic" component should play a more important role. This implies money supply creation primarily based on domestic mechanisms and tools, reflecting, to a greater extent, domestic demand for money.

Moreover, the above-mentioned approaches, in principle, will, first, ensure the creation of monetary resources in line with the objectives of structural policy and, second, broaden the basis for ‘long’ resources. This will result in the necessary diversification of the economy and financial market alike, increasing its liquidity and the investment potential of financial

resources. Given that even in far more mature financial markets the basis for long resources is formed by national monetary authorities (using the above-mentioned approaches), such practice deserves closer attention as applied to the Russian situation since it can secure the creation of the necessary long resources needed for the Russian economy.

6. When the abundance of the global liquidity exists, not only outflows but inflows of capital into the economy should be carefully monitored. The latter should not be assessed by formal principals such as “any investment is good” or “the more investments - the better”. In the current situation, with excessive global liquidity, which is seeking where to go, it is important that attention be paid to the quality of capital, duration of stay, directions of use, terms of repatriation, ensuring that the above-mentioned parameters conform to economic priorities.

7. In an environment of excessive global liquidity, reasonable level of foreign exchange rate becomes even more important. The possibility of setting the rate at a higher level is, among other tools, sort of a buffer neutralizing the undesirable inflows of hot speculative money, making the cost of ruble-denominated assets and, consequently, the overall cost of "entrance" to the Russian economy higher. Foreign trade implications of such measures can be offset by customs and tariff policy leverages as well as measures aimed at supporting the exporters.

It is also necessary to consider using simultaneously (or prior to such rate increase) leverages preventing the destabilizing effects of the inflow and outflow of speculative funds.

This simultaneously broadens the potential of Russian business in terms of entering the markets of other countries (since asset purchases in these markets will become less costly). As a result, this will imply gradual expansion of the Russian business presence in foreign markets not as raw materials supplier (due to currency devaluation) but as systemic investors purchasing assets in Western countries.

8. This necessitates a more active entering into global financial system, for example by purchasing significant stakes in top-tier Western banks and through other mechanisms.

9. Economic liberalization requires crisis management mechanisms capable of offsetting the effects of external shocks. These measures should concern, to a great extent, the stock market and the banking sector as most rapidly responding to the crisis and the entire economy alike. Possible measures aimed at restricting speculative pressure on the market (“short” operations, leverage, etc.), buy-backs and the establishment of special institutes and special funds whose money can be used for the purposes of stabilizing crisis events.

10. If currency reserves go down to the limits jeopardizing the financial stability of national economy and speculative pressure on the ruble remains, there is an option to reintroduce for some time the practice of mandatory sale of currency revenues; as well as the use currency position limits and other measures reducing speculative demand in the currency market. When the situation stabilizes, these requirements can be eased again.

11. There is a need to strengthen the banking sector as the pillar of national financial system and to contribute to its capitalization growth. It is important to increase the role of refinancing mechanisms, which can provide both - instant and systemic liquidity, and to expand domestic base for money supply creation. To maintain the financial market stability, it is feasible to ease access to refinancing, including access for the stock market participants.

12. It is important to have clear control of the development of asset and liability operations of financial institutions, of the use of balance-sheet and off-balance-sheet tools, the maintenance of adequate quality of assets and liabilities. It is important to track thoroughly the size of "leverage" for the purpose of mitigating the risks associated with asset transactions given the level of equity/capital.

13. It is necessary to use the standards regulating more strictly the value of corporate external borrowings. Simultaneously, there is a need to shape domestic market conditions and mechanisms creating adequate domestic financial resources.

14. The stock market needs to be diversified and transformed into an effective mechanism of resource allocation, which should be closer "integrated" into the real economy. (This will also be supported by the above-listed measures aimed at increasing the role of interest rates and broadening money supply creation channels).

Obviously, the diversification of the stock market tools should strengthen its base and simultaneously broaden the opportunities of cash flow among the instruments (and sectors). The above-mentioned diversification should, in its turn, result from measures aimed at the overall economic diversification and the shaping of more focused structural policy approaches.

15. Monetary policy tools should also be used for stabilizing stock market (since global mechanisms of financial interdependence necessitate strengthening common base for the integrated development of the entire financial system).

16. Foreign participation in the stock market appears to be inevitable in the global economy. However, it is important that in the mature and developed market its basis, first, be formed by national participants, and, second, non-speculative resources have to play a leading role.

This is a complicated multi-level objective, which includes monetary and financial matters, currency regulation issues, etc.

However, even now, if we start creating an adequate domestic basis for financial resources and simultaneously shaping incentives for Russian participants to operate domestically, the domination of foreign participation and the associated risks can gradually decrease. This should be accompanied by the use of leverages aimed at discouraging speculative funds (for example, by setting taxes for repatriation depending on the duration of stay in the market) and at the same time encouraging the inflow of longer resources. Possible action for mitigating the undermining effects on the market includes marginal trade regulation, "leverage" control, the use of insurance deposits, etc. ‘Futures’ transactions should also be considered.

17. It is important that the fundamental role be played by the Central Bank forming the basis for financial market and having in place crisis management tools.

The Central Bank should become a real creditor of the last resort, the timeliness and correctness of whose action will affect the financial sector stability and the overall economic development. The market should know that in an extreme situation it can rely on the mechanisms of immediate liquidity injection and other forms of anti-crisis support (like in August 2007 and later, as the crisis evolved, when quick response of the Central Bank of the Russian Federation to the lack of liquidity and the provision of necessary resources through refinancing smoothed the situation and was fairly justified).

18. The objective of improving quality of growth, maintaining its rates and diversifying the market requires that the broadening of the Central Bank’s roles be considered (as is the case in leading countries where they serve the goals of supporting economic growth and employment in addition to foreign exchange rate and prices).

19. For shaping new points of support for the world economy and ensuring its monetary and financial stability, work should continue with a view to create economic and legal conditions for establishing an international financial center in Moscow.

20. It is necessary to start exploring the possibilities of using the ruble as the currency of price and the currency of settlements for Russian export supplies, forming the basis for transforming the ruble into an international currency for international foreign trade transactions (during the first phase, within the scope of CIS).

21. The financial sector in general should be viewed as a common object of regulation on the part of monetary authorities. There is a need for close coordination between the actions of the Central Bank and other regulators of the financial market (the Ministry of Finance, the Federal Service of Financial Markets, etc.). If to oppose global financial risks simply by actions of isolated regulators in certain market segments, it is unlikely to attain success.

22. With a view to ensure coordinated development of global crisis management steps and also in terms of systemic positioning of Russia when such positioning reckons the grown role of the country in the world economy, there is a necessity of getting fully involved in the work of international regulating mechanisms (within the framework of G-8, G-20, etc.). Furthermore, the above-mentioned approaches (as any other measures of cross-country coordination) should consider to maximum capacity, the national interests of Russia and meet the objectives of strengthening its domestic and external positions.

*****

The global events of recent years have given a strong impetus to the processes of shaping of fundamentally different geoeconomic and geopolitical foundations of the global financial system. The balance of forces in the economic world is changing; previously powerful financial institutions are disappearing, new sources and mechanisms of financial resources are emerging. In response to the crisis challenges, regulatory methods and mechanisms which should ensure stability in the new environment are being revised drastically.

The crisis is not only “Judgment”. Indeed, throughout the history (especially contemporary history), there have been many reasons to be liable for. Yet the crisis is also a “Turning Point”, which gives the opportunity to comprehend what has been done, to wipe away the accumulated problems and to outline new solutions.

Nowadays, unique opportunities (in historic sense) are emerging to create principally new approaches and mechanisms which can lay the foundations for Russia's sustainable development for many years ahead, strengthening its international positions and turning it into a significant center of economic and political influence in the world.

These opportunities should be used.

About the author

Mikhail V. Ershov graduated from Moscow Institute of Finance (now - Moscow Financial University with the Government of Russia), faculty of International Economics (with honors).

Received Ph.D. from Institute of World Economy and International Relations (IMEMO) of the Academy of Sciences of the USSR - thesis on foreign exchange problems.

In 1998 received degree of full Doctor of Economics from Institute of Europe, Academy of Sciences - thesis on Russian and international monetary problems.

He worked in major international and Russian financial companies and banks. For several years he was head of management consulting (MC) at Deloitte and Touches CIS.

Mr. Ershov was invited to take part in various committees and work groups; banking associations. He took part in Russian-American Banking Dialog (reported to the Presidents during the US-Russian Summits).
He is a member of the Banking Council within the framework of the Council of Federation; member of expert council in the Russian Industrial Union - RSPP (unites big business); member of expert council on anti-crisis policy of the Analytical Department of the State Duma.

Mr. Ershov was a member in the workgroup of the Presidium of the State Council of Russian Federation:

- on the questions of state industrial policy (2003);
- on the questions of the banking sector (2006);
- on the questions of investment attractiveness of regions (2010).

M. Ershov was the member of the official delegation of Russia to some of the G-7 Presidential and Ministerial meetings.

He is the author of numerous articles on financial, foreign exchange and banking issues and author of 3 books.

At present M. Ershov is a senior vice-president of ROSBANK.