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TWO YEARS AFTER THE CRISIS: DO RISKS OF A 'SECOND WAVE' BECOME STRONGER? [1]

Situation at the Global Financial Markets

Despite the growth resumption, the overall global economic situation looks complicated. The developments of the second half of 2011 are just another proof of that.

On 31 July 2011, the U.S. government announced that a consensus had been reached on the increase of the federal debt limit. Its level is now allowed to reach USD 14.3 trln. The likelihood of a 'technical default' in the country decreased, but the market tension remained and even got stronger when, in August, S&P's decided to downgrade the U.S. credit rating. Financial markets reacted by an abrupt downfall: for the next three days alone, the Dow Jones Index dropped by more than 700 bp while the overall stock market volatility considerably grew (see Fig. 1).

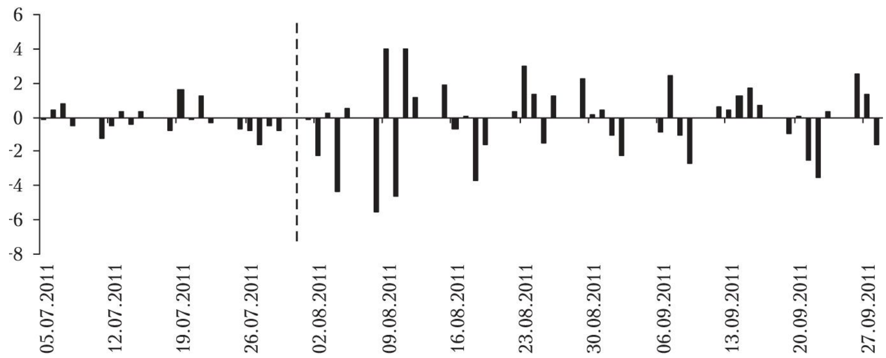


Fig. 1
DJIA Dynamics (day-on-day, %)

Nervous market sentiments reappeared when the Fed took new crisis management decisions in September 2011 to restructure its public debt portfolio and announced its plans to sell short-term Treasury papers for USD 400 bln in the market and buy back longer-term papers for the same amount. This measure will clearly enhance the long-term component of the USD (money base) creation. At the same time, the regulators may rely on lower long-term interest rates to revive long-term demand. This primarily concerns mortgages that could become a growth driver, but still face important challenges. In average, the cost of 30% mortgage facilities is lower than the cost of respective mortgage-based loans (see Fig. 2).

[1] *This article reflects personal views of the author.

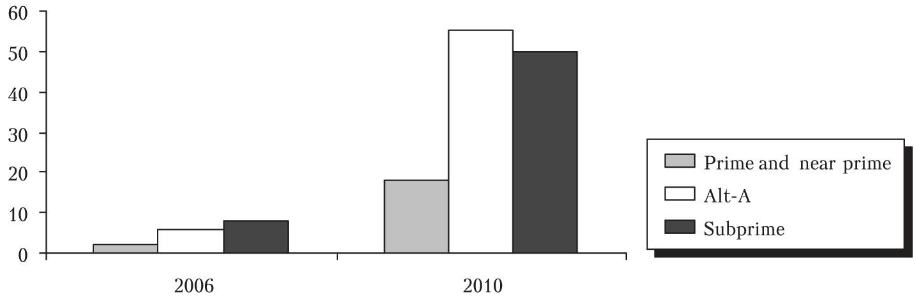


Fig. 2

Underwater (Negative Pledge) Mortgage Loans (%)

Note: Alt-A: satisfactory mortgage loans between prime and subprime

Source: FSOC, Annual Report, 2011.

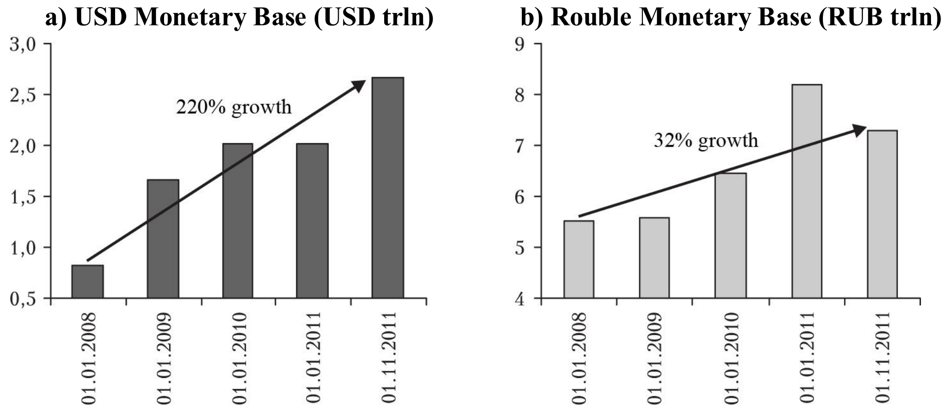
Over the year mortgage prices have gone down by 5-7%, which complicates loan repayment. At the same time, almost 20 million houses remain unoccupied and are not solicited by market players who, confronted with market uncertainty, prefer keeping demand down. This factor noticeably reduces the mortgage market capabilities to bolster economic growth. In general, 'over 90% of market operations rely on government assistance and without considerable return of private capital'.[2]

As in previous periods of uncertainty, metal prices are rapidly growing (gold prices are breaking records once again by exceeding USD 1,900 per troy ounce in a number of cases, and, although the prices somewhat decreased later on, general estimates of future trends indicate further growth expectations). The Swiss franc was steadily appreciating (approximately by 20% against major currencies from early in the year until mid-August). Moreover, the OECD estimates that, subject to the Purchasing Power Parity (PPP), the Swiss currency is overvalued by more than 40%[3] against Euro, which underlines the 'hedging' nature of such appreciation. Swiss regulators even had to take measures to limit the appreciation.

Indeed, to neutralize consequences of the crisis, many countries (primarily the U.S.) had to 'stuff' their economies with liquidity on a large scale and cut down their interest rates (refinancing rates). As a result, the USD creation (monetary base) grew by more than threefold (see Fig. 3a), and interest rates were reduced to below 1%.

[2] FCOC, Annual Report. 2011. P. 14

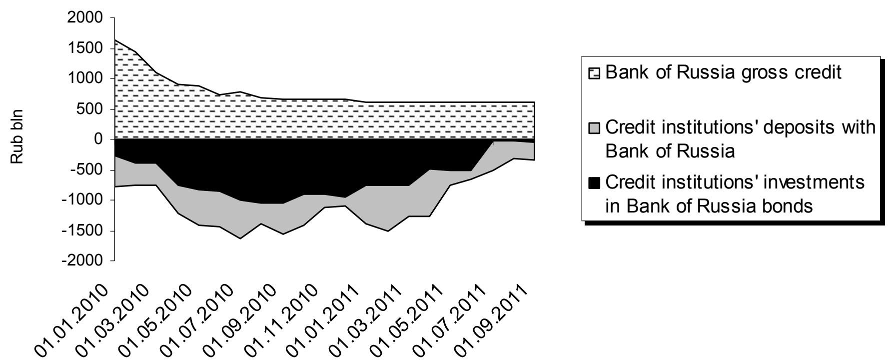
[3] RBC. 2011. 7 September.



Source: U.S. Fed, Bank of Russia

Fig. 3

In Russia, the monetary base growth was followed by a slight contraction (see Fig. 36). On the whole, a significant part of liquidity drawn to the market was sterilized with various instruments (see Fig. 4).



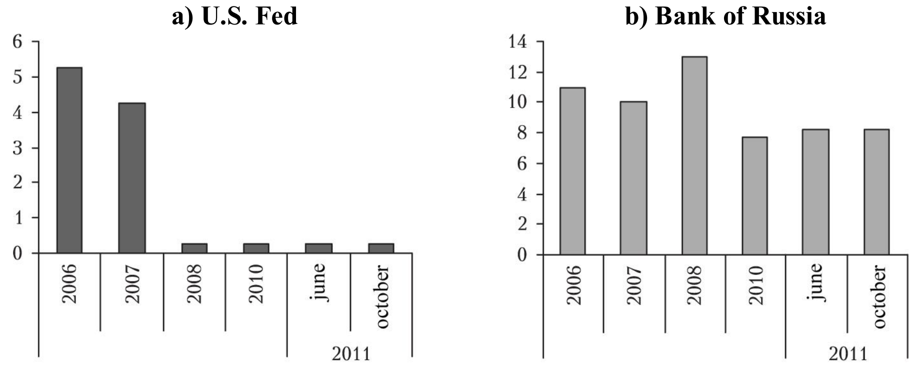
Source: Bank of Russia

Fig. 4

Bank of Russia Gross credit to credit institutions and Bank of Russia obligations on Absorption Operations (RUB bln)

Note the 'aggressiveness' of stabilization measures taken in the U.S.: both in terms of providing the economy with financial resources and in terms of making them cheaper (e.g. as compared to the Russian economy). These measures, however, considerably narrowed the range of opportunities for running a crisis management policy going forward. In a number of countries, interest rates are approaching zero (see Fig. 5) and cannot be reduced any further. (On the whole, the situation is an actual example of the 'liquidity trap' and in certain cases countries have to use negative interest rates, as in Sweden whose central bank set negative rates for commercial banks' deposits with the central bank in summer 2009). Extra liquidity generated risks of free capital migration, which would destabilize the markets. As a consequence, a number of countries imposed restrictions on capital transactions.

In 2008, we wrote: 'We need a thorough monitoring of capital flows, both outgoing from and, which is equally important, incoming to the country. No formal principles, such as 'any investment is good' or 'the more, the better', should be used. In a modern context, we need to focus on the capital quality, maturities, nature and scope of application'.[4] IMF experts are now supporting similar views: '... capital controls may be useful in addressing both macroeconomic and financial-stability concerns in the face of inflow surges.'[5]



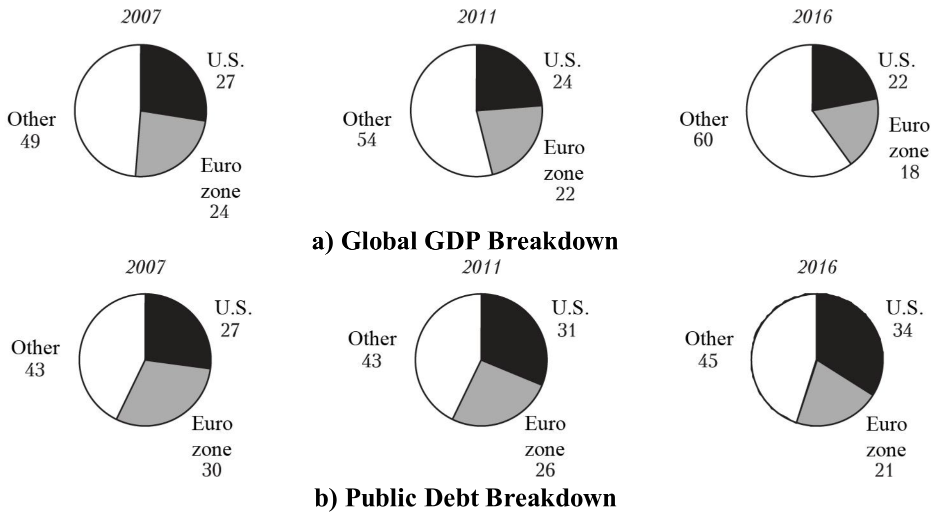
Sources: New York Fed; Bank of Russia.

Fig. 5
U.S. and Russian Refinancing Rates (%)

The above crisis management measures only partially masked the gravity of the issues. Earlier in the year, we pointed out that 'crisis management measures have only stabilized the situation for a while, without eradicating fundamental causes of the recession. As a result, the market tension persists regardless any growth resumption, while a 'second wave' of the crisis remains highly likely'.[6] The August 2011events are representative in terms of the market sentiments towards further outlooks of the overall situation.

At a Fed conference, Fed Governor B. Bernanke said that 'To achieve economic and financial stability, U.S. fiscal policy must be placed on a sustainable path that ensures that debt relative to national income is at least stable or, preferably, declining over time.' [7] However, the U.S. share in global public debt is actually expected to grow while the specific weight of the U.S. in the global GDP is diminishing (see Fig. 6).

[4] See: M. Ershov. 2008 Crisis: The Moment of Truth for the Global Economy and New Opportunities for Russia//Voprosy ekonomiki. 2008. No. 12. P. 24.
[5] See: Managing Capital Inflows: What Tools to Use? // IMF Staff Discussion Note. 2011. Apr. 5
[6] M. Ershov. World Financial Crisis: What's Next? - M.: Ekonomika, 2011. P. 11.
[7] B. S. Bernanke. Speech at the Federal Reserve Bank of Kansas City Economic Symposium. Jackson Hole, Wyoming, Aug. 26, 2011.



Sources: IMF's Fiscal Monitor, International Financial Statistics and World Economic Outlook; Prasad E. S. Role Reversal in Global Finance // NBER Working Paper Series. 2011. No. w17497.

Fig. 6
U.S. Input in the Global GDP and Global Public Debt (%)

As such, the persistence of global deficits means that their funding remains an issue and reveals the systemic and long-term nature of the problem whose solution might take multiple years.

Solution to Euro Issues: Driven by Political Decisions

Despite the existing problems in the Euro zone, the debt burden in the region is forecast to reduce in the future. Recent decisions made by a number of countries are rather encouraging. As we know, in September 2011, the German parliament approved measures designed to enhance the role of Germany in stabilizing the situation in the E.U. and supporting the Euro. Germany will expand its loan guarantee commitment to EUR 211 bln (against the former EUR 123 bln).[8] The European Financial Stability Facility has been approved to be increased to EUR 1 trln. At the same time, we would point out unilateral initiatives by the Greek government that in late October decided to hold a referendum on the terms of financial assistance by the E.U. to Greece. The market response to this news was extremely negative. Under tough pressure, the incumbent Prime Minister of Greece G. Papandreou cancelled the decision.

However, back at the early stages of aggravation of currency issues it was clear that the situation would be thoroughly controlled from systemic standpoint, and nothing would happen to Euro (naturally, except for the current market volatility). Half a year ago we wrote: 'It seems that the political rather than economic factor would be decisive in the future as was the case during the launching of Euro. Given that in the late 1990s the development of integration processes in Europe reached a sufficient level, this, however, did not remove essential differences between countries (for example, between Germany and France, on the one hand, and Greece and Portugal, on the other hand). These countries had yet to come a long way to achieve actual 'unification' of their economies (which would be instrumental for efficient integration).

Nevertheless, the differences did not impede the unification as the adopted *political decisions* confronted the Member States with an accomplished fact and made them align all their economic facilities and approaches with the

[8] New York Times. 2011. Sept. 29.

new financial infrastructure. In this connection, it seems that if Euro has to answer 'to be or not to be' and potential 'disassembly' of the existing financial architecture of the last decade is placed on the agenda, with ensuing geo-economic and geopolitical systemic changes, the political factor will be very likely to prevail once again. Respective decisions should be taken at this very level and from this standpoint and then supported with economic mechanisms and levers.

Unless global destabilization is at issue, it is obvious that decisions of international players must be aimed at maintaining Euro positions in the global monetary system'.[9]

About Global Imbalances

The issue of global imbalances will be a permanent source of global destabilization, while its solution will require important efforts by major global economy players for a long while. We would note that in general the evolution of the issue of deficits in some countries and surpluses in other countries was linked to the ratio between consumption and savings in different countries (see the table below).

Table

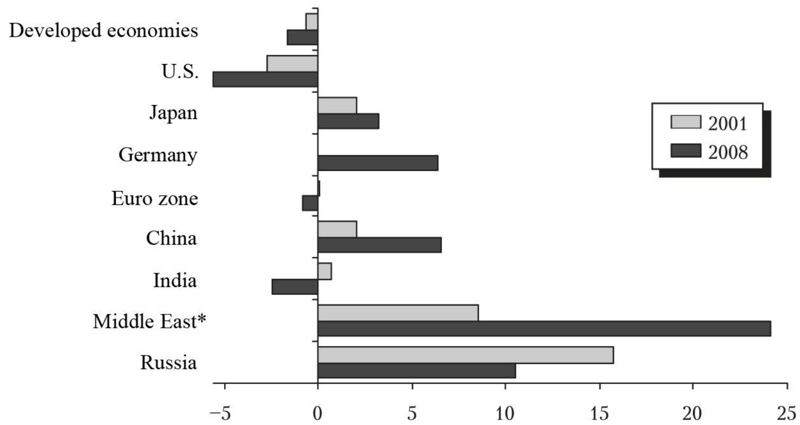
Gross Savings and Investments (% of GDP)

	Savings		Investment	
	2001	2008	2001	2008
Developed economies	20.0	18.8	20.6	20.4
U.S.	16.4	11.9	19.1	17.5
U.K.	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
Emerging economies	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

Source: BIS, 2009.

As a consequence, a number of countries ended up with a free cash surplus, while other countries had to look for funding sources required to finance their deficits (see Fig. 7).

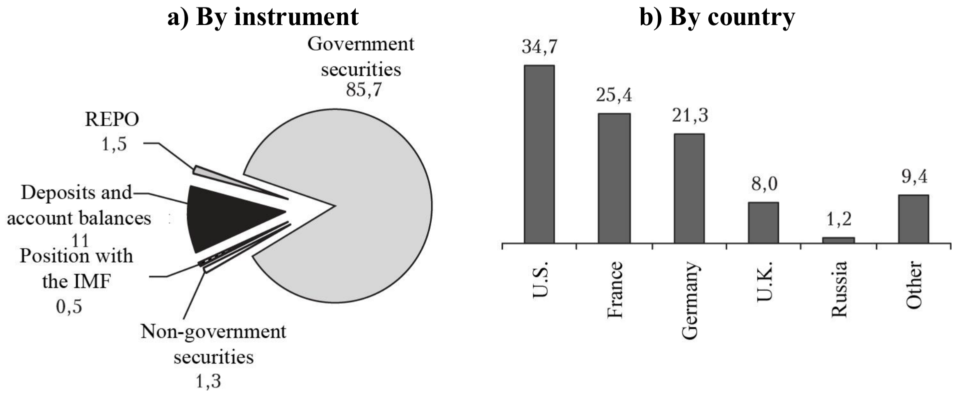
[9] M. Ershov. World Financial Crisis: What's Next? - M.: Ekonomika, 2011. P. 247.



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

Fig. 7
Difference between Savings and Investments (% to GDP)

Russia is among the countries where the level of savings is higher than the level of investment, which makes it a potential liquidity source for countries suffering from liquidity shortages. As we know, in practice, a portion of our financial savings held in specialized government funds (Reserve, National Welfare, and other funds) and in foreign exchange reserves is invested in U.S. Treasury bonds and instruments of other countries, thereby financing their deficits (see Fig. 8).



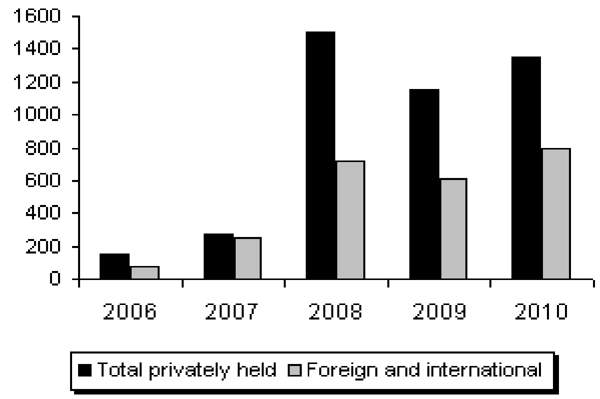
Source: Overview of Foreign Exchange Asset Management by the Bank of Russia, Bank of Russia, 2011.

Fig. 8
Breakdown of Foreign Exchange Assets of the Bank of Russia by Instrument and by Country (as of 31.03.2011, %)

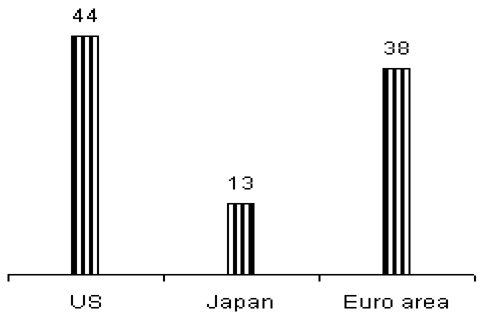
Since spring 2010, the share of the U.S. in the Bank of Russia's portfolio of foreign exchange assets has slightly decreased over the year from 38% to 35%, and that of Russia in the same portfolio decreased from 3% to 1.2%. Government securities still retain a high share: about 86%.

On the back of instability, many are forced to go into liquidity and public debt instruments. In particular, the share of foreign investors in the U.S. government papers started growing during the crisis as investors, seeking where to apply liquidity surplus, consider investment in government securities as one of such opportunities (see Fig. 9). The fact that investors committed to treasury bonds during the crisis on a large scale and still maintain their investments in them witnesses their uncertainty, which is comparable to their sentiment at the start of the crisis. In general, strong exposure of the U.S. to foreign investors makes the country highly sensitive to their preferences.

a) U.S.: Treasury Bond Volume Growth
(including private and foreign holders, USD bln)



b) The Share of Foreign Public Debt Holders (%)



Sources: Treasury Bulletin/U.S. Treasury. June 2011; Prasad E. S. Op. cit.

Fig. 9

Since the U.S. is a major debtor, the country cares extremely about financing its deficit. The related financial inflows from countries with a surplus in savings suppress interest rates that have been extremely low as it is for a number of years. This situation reduces yields on operations of financial market players who have, first, to switch to higher-yield but, consequently, riskier instruments, and second, to use levers that unreasonably expand their balance sheets thereby increasing their leverage, which makes them less stable and increases the risk of deleverage on the whole. High leverage of the financial sector has been accompanied by a large-scale growth of public and private debt, especially in the 2000s. Despite the issues in the U.S. economy, investors' appetite for assets resulted in large-scale investment in U.S. Treasury bonds, which triggered their price growth and yield minimization (see Fig. 10).

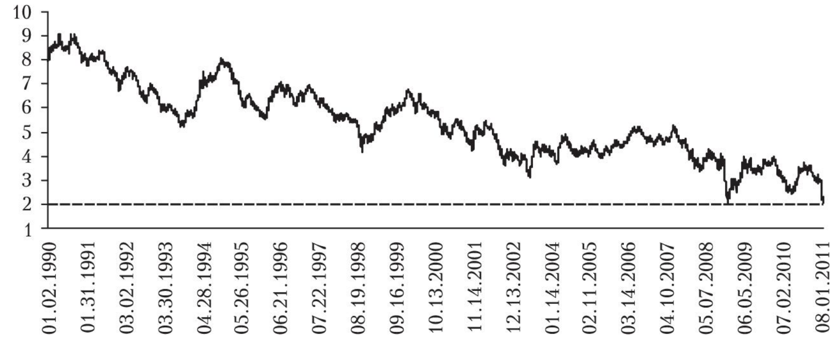
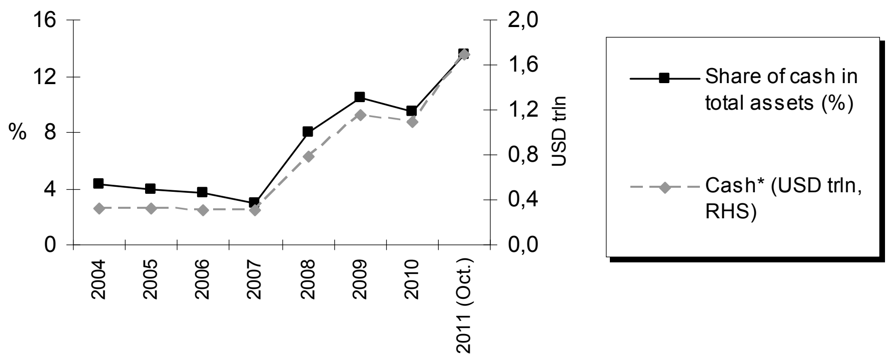


Fig. 10
Dynamics of 10-Year U.S. Bond Yield (%)

Major international investors estimate that another bubble, fraught with all relevant risks, is being formed in the market of long-term Treasury bonds.[10] The loss of confidence by investors and disposal of such papers will release a considerable amount of liquidity to the market, which would clearly destabilize the market situation. The remaining balance sheet imbalances of financial institutions, aggravation of debt issues, uncertainty of the housing market outlooks and other problems (including excessive global liquidity) make the overall situation extremely unstable. To protect themselves against potential risks, market players prefer increasing the liquidity share in their balance sheets (see Fig. 11). The growth of cash in balance sheets started in the turmoil of the crisis is still continuing, although the situation seems to start stabilizing.



* Including: cash in vaults; cash in collection; balances with other depositary institutions; cash with the Fed.

Source: U.S. Fed.

Fig. 11

Cash in U.S. Banks

Leverage and Stock Market Challenges

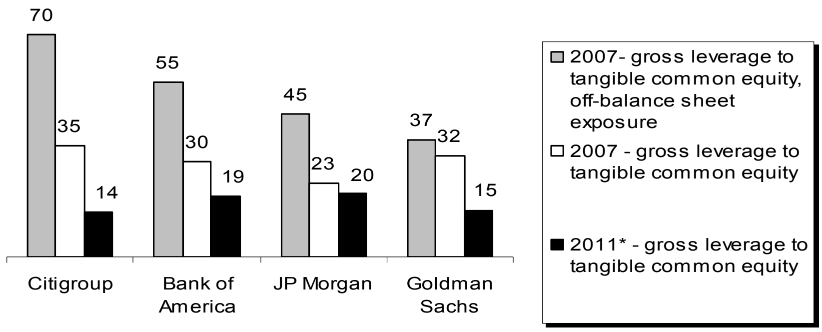
Unjustified imbalances in the balance sheets of major financial institutions results in a multiple increase of the ratio of assets operated by such banks to their own equity (capital). In different groups of financial institutions, the average pre-crisis leverage (assets to equity ratio) was 7x-10x (depending on the type of operations and industry), while it was close to 20x and even 30x for hedge funds and investment banks.[11]

Subject to off-balance operations, leverages of most financial institutions were significantly higher and in some cases reached 50x to 70x (see Fig. 12). Moreover, the amount of off-balance operations sometimes exceeded the balance sheet total. E.g. IMF estimates that, in 2006, off-balance operations of Citigroup reached about USD 2 trln, while the balance sheet total was only USD 1.8 trln.

[10] Bloomberg. 2011. Aug. 25.

[11] At least, such definition is given in the materials of the hearing on the bankruptcy of Lehman Brothers (US Bankruptcy Court. N.Y., 2010, March 11). Sometimes leverage is viewed as an equity to assets ratio, which makes it virtually identical to N1 ratio used in the Russian banking practice and relying on Basel principles (see U.S. financial reform legislation HR 4173).

The regulators seemed to 'missed the point' in this case, since, in the environment of a protracted economic growth which considerably expanded profit-making opportunities for market players, the regulators failed to limit lust of the participants in a due way, even despite the emerging future risks.



* as of 30 June

Sources: calculated based on data of U.S. National Information Center; U.S. Fed; SNL Financial Form 10-Ks; Hearing on the Financial Crisis / FCIC. 2010. Jan. 13; etc.

Fig. 12
Leverage of Major U.S. Banks in Late 2007 and at Present

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"[12]. A year later, in summing up opinions of regulators and market players, the Commission concluded that 'this financial crisis was avoidable. The crisis was the result of human action and inaction... Widespread failures in financial regulation and supervision proved devastating to the stability of the nation's financial markets.'[13]

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 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 capital14.

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) 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.

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.

[12] B.T.Moynihan, Chief Executive Officer and President, Bank of America. Testimony to FCIC, Washington, D.C. January 13, 2010. P. 10.
[13] FCIC. 2011. Jan.
[14] B.Born. "Regulatory Responses to risks in the OTC derivatives market", November 13, 1998, p. 3.

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. At present, the respective situation has somewhat stabilized on the whole (see Fig. 12), but the issue of quality of assets in balance sheets remains on the front burner.

Experts estimate that shares in the Bank of America, Morgan Stanley and Citigroup are traded in the market at a 43-46% discount (against the book value of material assets), which witnesses the very prudent attitude of the market to the quality of their assets. [15] In September 2001, Moody's downgraded ratings of the Bank of America, Citigroup and Wells Fargo. Given that the above banks are the major players of the financial market and their overall share accounts for about 30% of all deposits and 30% of total assets in the U.S. banking system, it is clear that the overall financial system is still haunted by large-scale issues.

Deleveraging also has other adverse implications. In particular, a lower private debt translates into a higher public debt when the government bails out affected players. Due to the scale of the problems, the arising debt burden may considerably destabilize the situation and provoke a new crisis, all the more so due to the market instability, unsolved issues and strong unrest among market players. Some experts believe that 'the world is on the eve of the next financial crisis, with sovereign debt its epicentre.'[16]

Furthermore, while banks are turning towards a more prudent lending policy in general, which is surely justified, in case of excessive conservatism that has replaced excessive activity, such policy might lead to a slowdown in economic processes and growth overall. Also note the already emerging trend of investing in lower quality and higher yield instruments to achieve performance required by bank owners.[17] Such trend may impair balance sheets and create new risk sources.

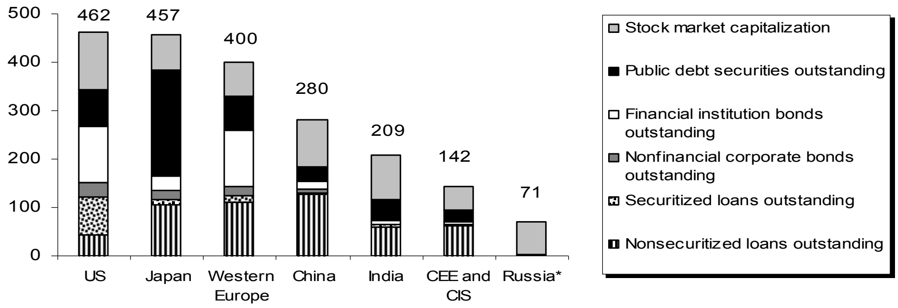
Experts estimate that 'in the process of deleveraging, advanced country banks started drastically reducing their exposure to emerging markets, closing credit lines and repatriating funds.'[18] These measures immediately affect the stock market. It is clear that the deeper a market is, the more stable it is, and the lower its exposure to capital inflows and outflows (see Fig. 13). It was particularly noticeable on the back of global instability when international investors had to withdraw from external markets and consolidate their capital.

[15] CNBC. 2011. Sept. 22.

[16] El-Erian: World Is on Eve of Next Financial Crisis over Sovereign Debt // Bloomberg. 2011. Sept. 22.

[17] We pointed out such processes back in 2010 (see M. Ershov. New Risks of the Post-Crisis World // Voprosy ekonomiki. 2010. No. 12. P. 7-8)

[18] O. Blanchard. The Crisis: Basic Mechanisms , and Appropriate Policies // IMF Working Paper. 2009. WP/09/80. P. 19.



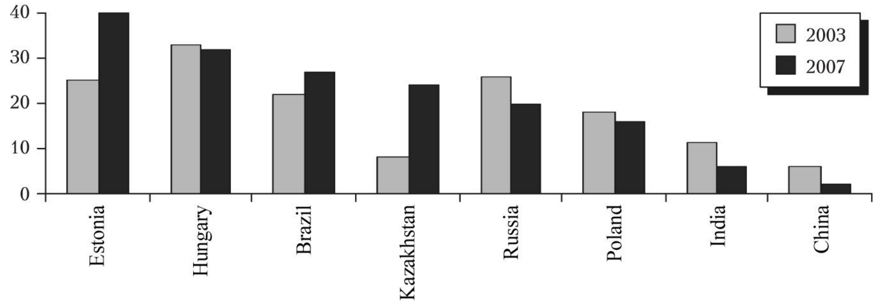
* Net of bonds issued by non-financial corporations and securitized loans.

Sources: BIS; Dealogic; SIFMA; S&P; McKinsey Global Banking Pools; McKinsey Global Institute analysis.

Fig. 13

Financial Depth of Certain Markets (% of regional GDP as of the end of 2010)

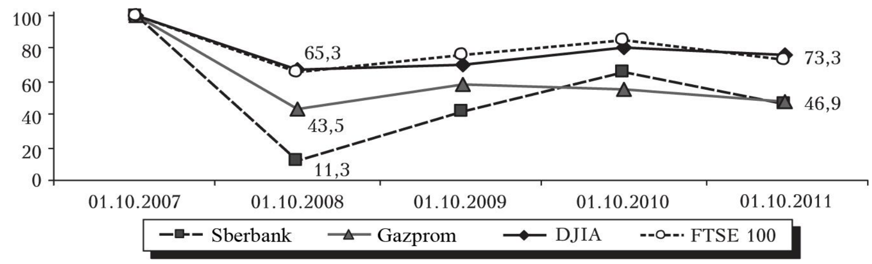
The Russian stock market is heavily exposed to non-residents (see Fig. 14), which naturally resulted in a significant downfall.



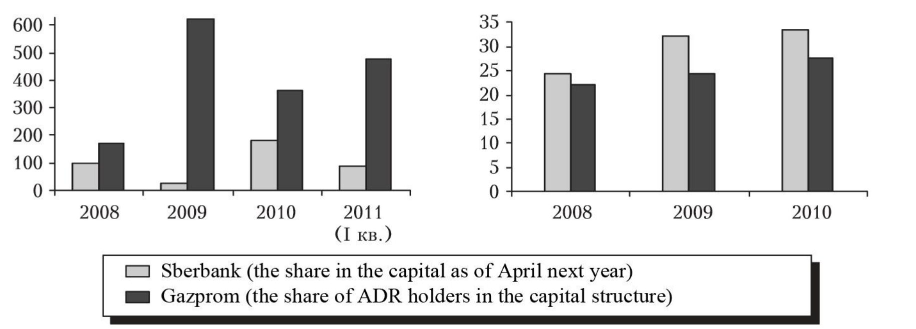
Source: World Bank, 2010.

Fig. 14

Foreign Participation at the Stock Market (% of market capitalization)



a) Stock and Stock Exchange Indices Performance (1 October 2007 = 100)



b) Net profit (RUB bln) **c) Non-resident share in the capital (%)**

Sources: information from web-sites sbrf.ru, gazprom.ru and finam.ru.

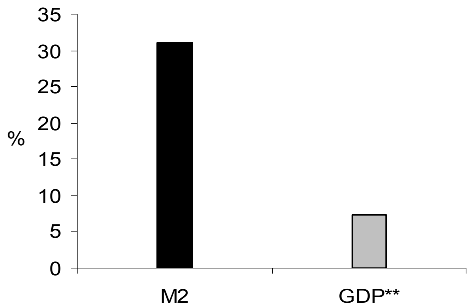
Fig. 15

The aggravation of the stock market situation in autumn 2011 demonstrated that Russian majors that still have stable positions in the market and consistently accumulate profits (Gazprom, Sberbank, etc.), with foreign investors, accordingly, having great appetite for their instruments when they are short of liquidity, suffered more (i.e. their stock prices fell deeper) than crisis-affected markets and companies (see Fig. 15). This situation occurred as, among other things, investors (banks) were forced to sell their assets and consolidate cash, which resulted in lower price performance and in rouble depreciation. Moreover, funds and other investors began purchasing stocks at a lower price level, thus retaining foreign participants in total (with lower costs incurred due to lower price). The resulting rouble proceeds are then converted into foreign currencies and repatriated, which simultaneously leads to rouble depreciation.[19]

We have previously underlined the need to mitigate such risks: '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.'[20]

About Global Liquidity Growth

All post-crisis risks need to be assessed against the backdrop of a large-scale growth of global liquidity. As a result of crisis management measures, the increase of global resources in the economy exceeded GDP growth (see Fig. 16).



* Euro zone, U.S., U.K., Japan, China, Russia.

Sources: calculated based on data of Eurostat, U.S. Fed, BEA, Bank of England, Bank of Japan, National Bureau of Statistics of China, Bank of Russia, Russian Federal State Statistics Service.

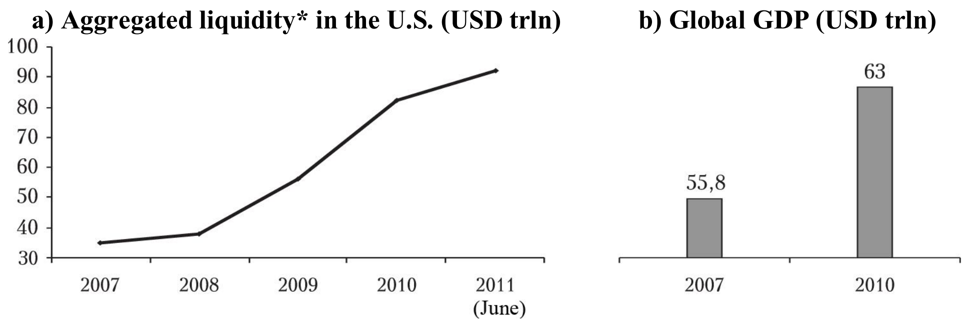
Fig. 16

Money Base (M2) and GDP Growth in Major Economies* in 207-2010 (December on December, %)

If other forms of money aggregates are considered (as sometimes done by experts to provide a larger picture of the problem scale), then these figures would reach tremendous levels for the U.S. We would underline once again the steady growth of the money supply in question, with its value considerably exceeding pre-crisis levels (see Fig. 17).

[19] For example, A. Ulyukayev, First Deputy Chairman of the Bank of Russia, estimates that in September 2011 the Bank of Russia sold USD 8 bln in the FX market, USD 1.15 bln on 4 October and USD 400 mln on 5 October in the scope of FX interventions run to offset abrupt rouble depreciation (RBC. 2011. 7 October). Despite these measures, in September the rouble depreciated by approximately 10%.

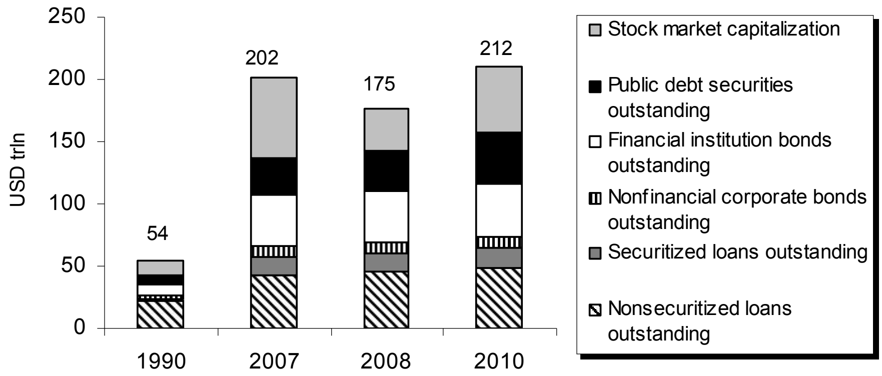
[20] M. Ershov. World Financial Crisis. What's Next? - M.: Economica. 2011. P. 228.



*Including M3, all loans, federal, state and local government debt, net derivatives (no double count).
Sources: nowandfutures.com; World Bank.

Fig. 17

Additionally, the amount of many financial assets exceeded pre-crisis levels (see Fig. 18).

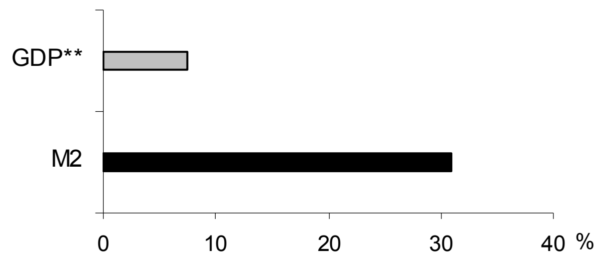


* Calculated for 79 countries, as of the period end, at a flat rate of 2010.
Sources: see Fig. 13.

Fig. 18

Some Basic Components of the Financial Market* (USD trln)

At the same time, the market continues its large-scale multiplication of derivatives based on 'underlying' assets. We remember that derivatives played a negative role in the development of the global crisis of 2007-2009. At present, their ratio to assets in U.S. banks considerably exceeds the pre-crisis level (see Fig. 19).



* 2007: JP Morgan Chase Bank NA, Citibank National ASSN, Bank of America NA, HSBC Bank USA National ASSN, Wachovia Bank National ASSN; 2011: JP Morgan Chase Bank NA, Citibank National ASSN, Bank of America NA, Goldman Sachs Bank USA, HSBC Bank USA National ASSN.
Source: US Comptroller of the Currency.

Fig. 19

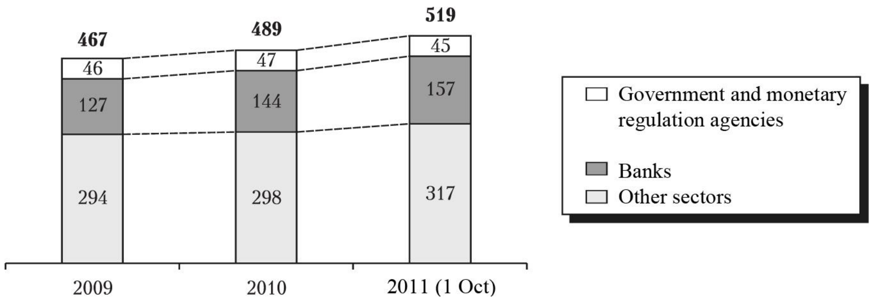
Amounts of Assets and Derivatives in 5 Major U.S. Banks* (USD trln)

Thus, many issues have yet to be solved, with a part of them transformed into new risk sources, and a whole group of destabilizing factors generated at the stage of implementing crisis management measures. In March, M. King, Governor of the Bank of England, pointed out: 'None of the underlying causes of the current crisis have been removed.'[21]

The difficult situation might become a reason for resigning of a number of high-level experts and significant staff reshuffling. Early in the year, we pointed out 'that a number of high-ranking officials from the administration resigned after a relatively short term of office'[22], which may be related to their understanding of economic outlooks and unwillingness to bear responsibility for new crisis upsurge. First (in the second half of 2010), the U.S. administration was left by C. Romer, Chair of the President's Council of Economic Advisers, P. Orszag, Director of the Office of Management and Budget, L. Summers, Director of the National Economic Council and Assistant to the President for Economic Policy, J. Bernstein, Chief Economist and Economic Policy Adviser to Vice President J. Biden. Then the 'exodus' continued. Later on, in mid-2011, A. Goolsbee, the new chairman of the Council of Economic Advisers for President Barak Obama, left his post. Even T. Geithner, Secretary of the Treasury, announced his intention to leave in 2011 (with this decision cancelled later).

Russian Economy: Return of Old Risks

After a brief pause caused by crisis, the Russian corporate external debt owed by industrial companies and banks resumed its growth (see Fig. 20). Such growth brings about undesirable risks, when capabilities for financing domestic economic processes become contingent on the external juncture and decisions of foreign lenders and investors.



Source: Bank of Russia

Fig. 20

Russian External Debt (USD bln)

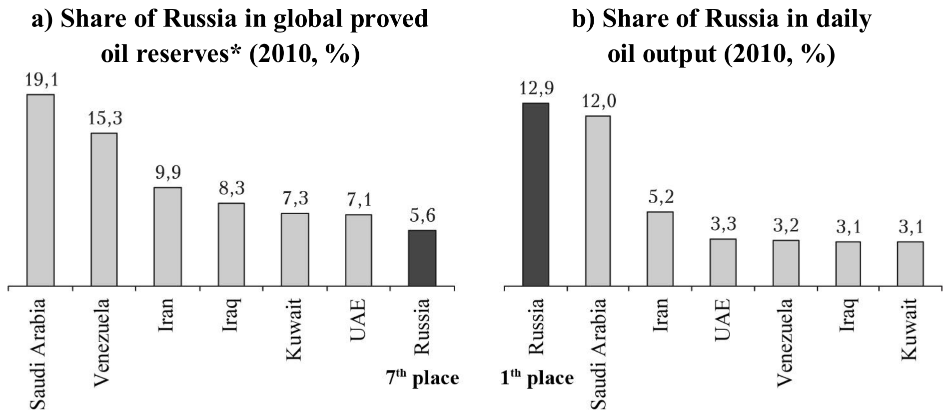
To make things worse, there are almost no appropriate mechanisms in place to substitute external sources with domestic ones. The main money creator, the Central Bank, returned to its money creation approach based on external sources when rouble liquidity is generated based on an inflow of foreign exchange exports receivables and by taking loans in foreign currencies from international markets. The reliance on domestic factors in creating the rouble monetary base, which became instrumental during the crisis, began to play secondary role once again. As a result, the Russian monetary sector becomes increasingly exposed to the global juncture, and its entailing risks[23]. Hence, from systemic standpoint, we are forced to rely on energy sectors, thus

[21] M. King. Do We Need an International Monetary System? / Speech at the 2011 Economic Summit at the Stanford Institute for Economic Policy Research, March 11, 2011.

[22] M. Ershov. World Financial Crisis. What's Next? – M.: Economy. 2011. P. 271.

[23] We have repeatedly mentioned this (e.g. see M. Ershov. The Global Financial Crisis: One Year Later // Voprosy ekonomiki. 2009. No. 12; M. Ershov. New Risks of the Post-Crisis World // Voprosy ekonomiki. 2010. No. 12).

turning into the major commodity supplier whose share in the global production considerably exceeds its share in reserves (see Fig. 21).



* Figure 21 shows the top seven countries in terms of proved oil reserves.
Source: BP, 2011.

Fig. 21

It is obvious that if the above trends persist, it would be increasingly hard for us to achieve economic diversification and modernization and dependence on the domestic energy exporting sectors. Moreover, we risk losing the status of a commodity exporter as the resources deplete.

* * *

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 (from Ancient Greek κρίσις) s 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 [24].

[24] www.ershovm.ru