

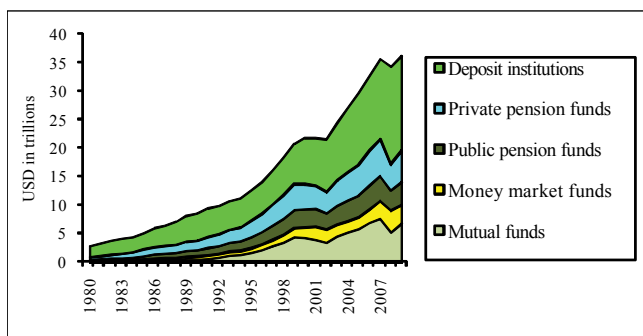
World in the Post-Crisis Environment: New Challenges¹

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Mervyn King, Governor of the Bank of England, when asked about the problems, which the world economy faces, said: "None of the underlying causes of the current crisis have been removed."²

An important cause has been large imbalances suffered by banks in terms of their debt to equity ratio (leverage). The problem was further aggravated by the fact that most market participants had functioned in a "milder" regulatory environment than banks. The G-20 meeting in November 2011 re-emphasized that "the shadow banking system," "causing the build-up of systemic risk outside the scope of the regulated banking sector,"³ was one of the major reasons behind the crisis.

Indeed, more loyal regulation compared with traditional commercial banks allowed financial companies, hedge funds, investment banks and money market funds to act as financial intermediaries at lower cost than the traditional commercial banking system.



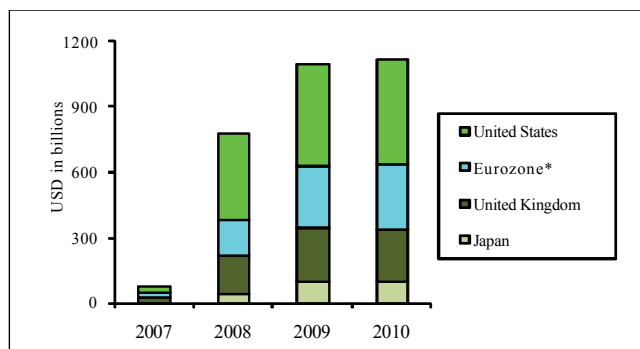
Source: Financial Crisis Inquiry Commission. May. 2010.

Fig. 1. United States: Assets of Some Financial Institutions

Furthermore, in the 1980s, the traditional banking system accounted for about 70% of assets of the entire financial sector, whereas by the 2000s their share went under 50% despite significant asset growth demonstrated by other financial institutions.

In combination with low cost of money and its easy availability from the market (or central banks), loose regulation led to system imbalances in the financial sector and inadequate equity to assets ratio, ultimately aggravating the ongoing crisis.

Although capitals have somewhat increased, the problem of accumulated debt still remains (Fig. 2, Table).



* Belgium, France, Germany, Italy, Luxembourg, the Netherlands.

Source: BIS. Rescue Packages and Bank Lending. WP № 357. Nov. 2011. P. 3.

Fig. 2. Accumulated Borrowed Capital

Table

**Debt: Government, Corporate, Households
(% of Nominal GDP)**

	2000	2010
United States	198	268
Japan	410	456
Germany	226	241
United Kingdom	223	322
France	243	321
Italy	252	310

Source: BIS. The Real Effects of Debt. WP № 352. Sept. 2011. P. 7.

In general, the problem of asset quality on the balance sheets of leading banks is still severe. According to estimates, the shares of Bank of America, Morgan Stanley, Citigroup are valued by the market at a discount of 43-46% (relative to the book value of tangible assets),⁴ a symptom of extremely cautious market attitude to their asset quality.

To secure themselves against possible market aggravations, participants prefer to increase liquidity amount on their balance sheets.

It is noteworthy that the growth of cash on balance sheets since the crisis panic continues although the situation appears to be normalizing.

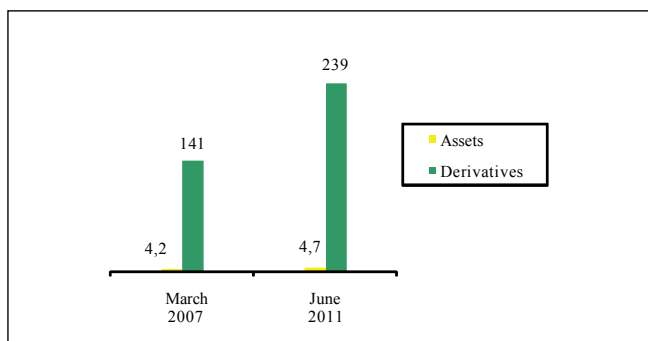
¹ The article reflects the personal opinion of the author, www.ershovm.ru

² King M. Do we need an International Monetary System? Speech at the 2011 Economic Summit at the Stanford Institute for Economic Policy Research. 2011. March 11.

³ G-20 Cannes Summit Final Declaration. 2011. 4 Nov.

⁴ CNBC. 2011. Sept. 22.

Generally, another disquieting fact is continued large-scale multiplication of derivative instruments based on “underlying” assets. We remember a negative role of derivatives in crisis unfolding in 2007. The current level of derivatives of the U.S. banks is much higher than before the crisis (Fig. 3).



* 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. 3. United States TO-5 banks: Assets and Derivatives (USD in Trillions)

We hear again that this is the consequences of restructuring of portfolios, and attempts to decrease risks and disperse risks, but the same arguments we heard before the crisis.

Although the leverage problem is gradually normalizing, it still receives close attention.

About leverage. As a result of unreasonable imbalances of the leading financial institutions, the assets relative to their proprietary funds (equity) were many times higher than these banks used to work with.

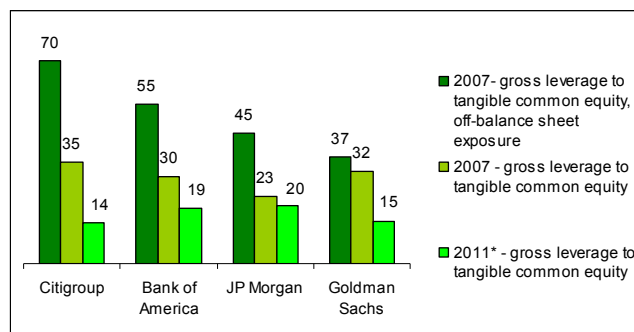
Different groups of financial institutions before crisis had the level of leverage (assets/equity ratio) in the range of 7-10 (depending on the types of transactions and business area), often reaching 20 and sometimes 30 in the case of hedge funds and investment banks.¹

Subject to off-balance operations, leverages of most financial institutions were significantly higher and in some cases reached 50x to 70x (Fig. 4). Moreover, the amount of off-balance operations sometimes exceeded the balance sheet total. For instance, according to estimates, in 2006, off-balance operations of Citigroup reached about USD 2 trln, while the balance sheet total was only USD 1.8 trln².

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.

¹ 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).

² IMF.



* As of June 30, 2011

Sources: calculated based on data from the US National Information Center; US Fed, SNL Financial and 10-Ks; FCIC, Hearing on the financial crisis. 2010. Jan. 13, etc.

Fig. 4. 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"³. 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.’⁴

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 capital⁵.

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.⁶

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

³ B.T.Moynihan, Chief Executive Officer and President, Bank of America. Testimony to FCIC, Washington, D.C. January 13, 2010. P. 10.

⁴ FCIC. 2011. Jan.

⁵ B.Born. “Regulatory Responses to risks in the OTC derivatives market”, November 13, 1998, p. 3.

⁶ IMF.

allowed a small group of investors to actually set prices for assets, making these investors capable of getting hold of enormous assets¹.

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..

Unsatisfactory prospects for the leading U.S. banks lowered their credit ratings in September 2011. Moody's lowered the ratings of the Bank of America, Citigroup, Wells Fargo.

Given that the above-mentioned banks are major participants in the financial market, accounting for about 30% of total deposits and 30% of the overall assets of the U.S. banking system, the large problems faced by the financial system in general can persist and the situation becomes very unfavorable.

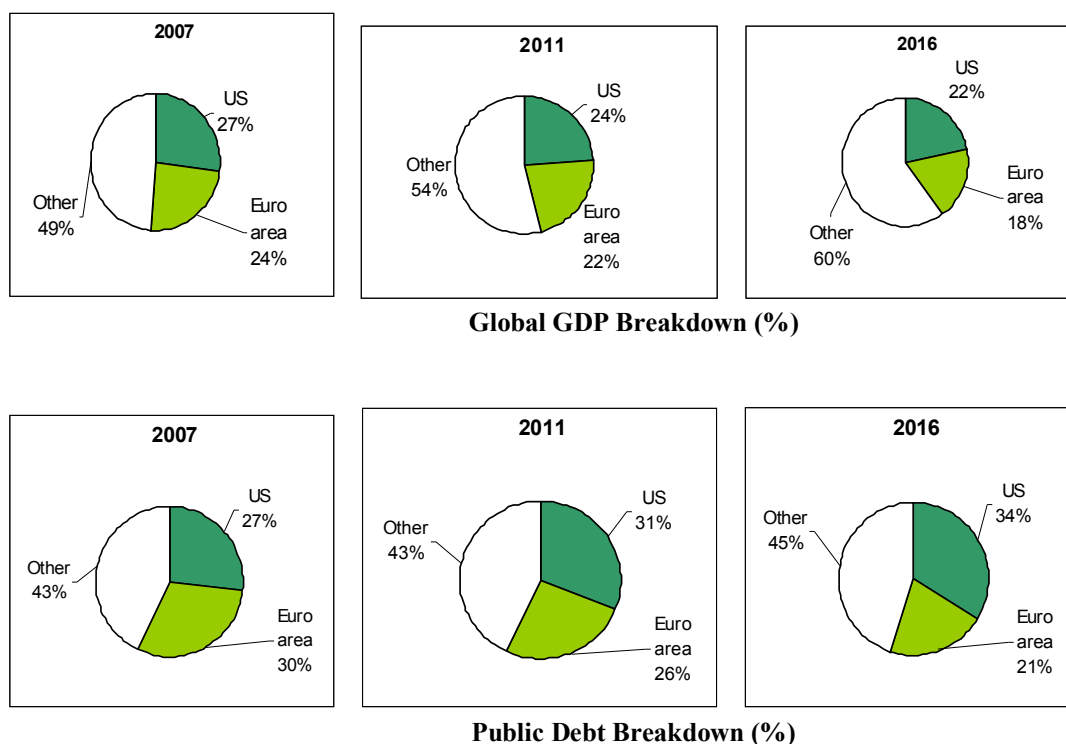
Let us note that the other side of the deleverage process is a whole range of adverse implications. In particular, a lower private debt translates into a higher public debt when the government bails out affected players. Due to the scale of the problems, the arising debt burden may considerably destabilize 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.’²

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 owners³. Such trend may impair balance sheets and create new risk sources.

Consequently, many of the previous problems are still here, some of them have transformed into new sources of risks and a group of new destabilizing factors have emerged during the crisis management efforts.

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.’⁴

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. 5).



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

Sources: IMF's Fiscal Monitor, International Financial Statistics and World Economic Outlook; Prasad E. S. Role Reversal in Global Finance. Aug., 2011.

¹ FCIC Hearings.

² *El-Erian M.* Bloomberg. 2011. 22 Sept.

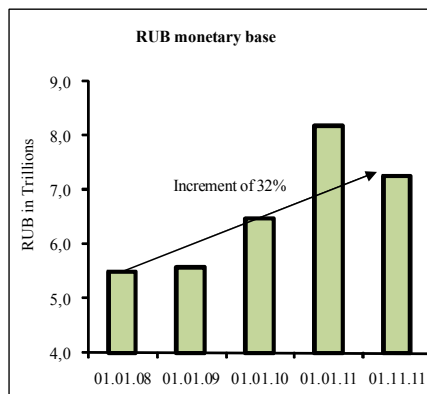
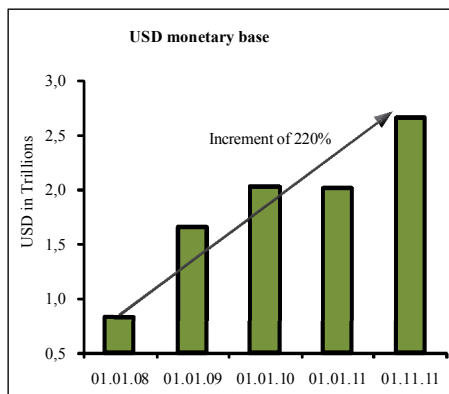
³ We pointed out such processes back in 2010 (see M. Ershov. *New Risks of the Post-Crisis World // Voprosy ekonomiki.* 2010. No. 12. P. 7-8)

⁴ B. S. Bernanke. Speech at the Federal Reserve Bank of Kansas City Economic Symposium. Jackson Hole, Wyoming, Aug. 26, 2011.

If deficits remain, it will mean, first, that they still need to be financed and, second, the problem in general will have systemic and long-lasting nature and it may take many years to solve it. International experts state that unless radical steps are taken to improve the situation, “government debt will grow to dangerous and unsustainable levels in most advanced and in many emerging economies over the next 25 years.”¹

About “hot” money in the post-crisis environment. 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%.

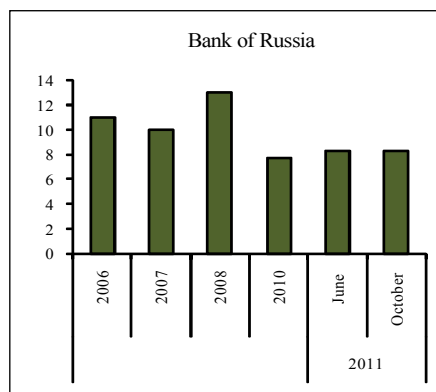
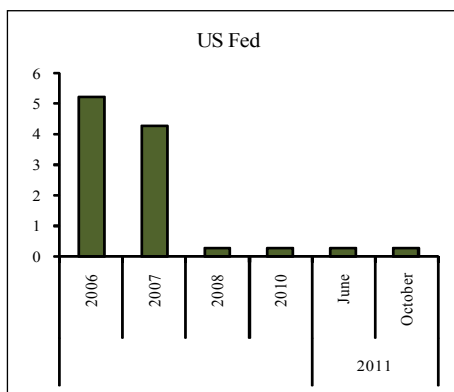


Sources: US Fed, the Bank of Russia.

Fig. 6. Monetary Base in the United States and Russia

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). However, the other side of these efforts was a significant narrowing of opportunities for running a crisis

management policy going forward. In a number of countries, interest rates are approaching zero 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).



Sources: New York Fed; Bank of Russia.

Fig. 7. Refinancing Rates of USD Fed and the Bank of Russia (%)

In Russia, the monetary base growth was followed by a slight contraction: a significant part of liquidity drawn to the market was sterilized with various instruments.

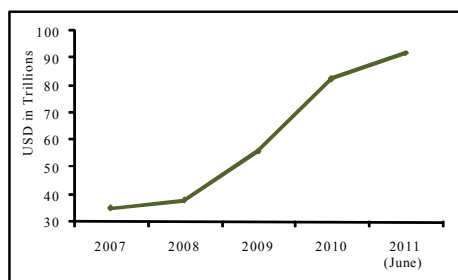
All post-crisis risks need to be assessed against the backdrop of a large-scale growth of global liquidity.

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 the steady growth of the money supply in question, with its value considerably exceeding pre-crisis levels (Fig. 8). (Global GDP data is provided for comparison purposes.)

Moreover, in general the amount of many financial assets exceeded pre-crisis levels (Fig. 9).

¹ Gagnon J. E. with Hinterschweiger M. The Global Outlook for Government Debt over the Next 25 Years: Implications for the Economy and Public Policy. Peterson Institute for International Economics. 2011. P. 2.

Aggregated liquidity* in the United States



* Including M3, all loans, state and local government debt, net derivatives (no double count).

Sources: nowandfutures.com; World Bank.

Global GDP (USD in Trillions)

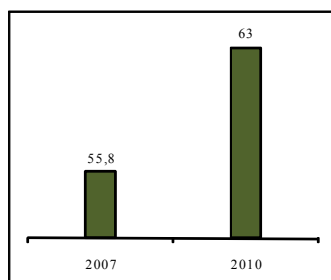
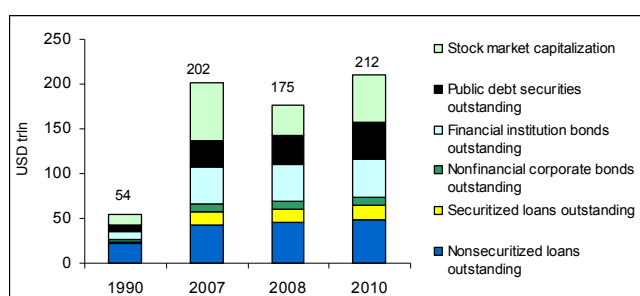


Fig. 8. Liquidity and GDP



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

Fig. 9. Some Basic Components of Financial Market (Calculated for 79 countries, as of the period end, at a flat rate of 2010)

As far as additional liquidity is concerned, it resulted in the risk of intensified migration of free capital and all destabilizing market effects it implies, forcing a number of countries to resort to restrictive steps in respect of 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..."¹ Repatriation conditions matter too.

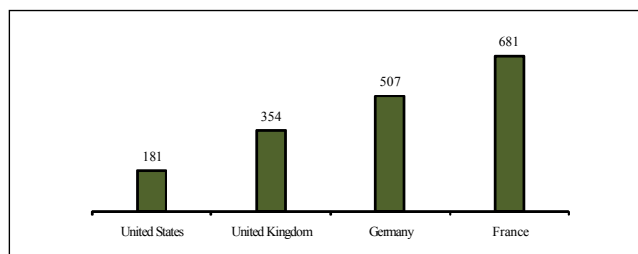
Now, even IMF writes almost the same thing: "Capital controls may be useful in addressing both macroeconomic and financial-stability concerns *in the face of inflow surges* (italics mine)."²

Major international investors estimate that another bubble, fraught with all relevant risks, is being formed in the market of long-term Treasury bonds.³ 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.

In general, crisis management action (including liquidity injection, the lowering of interest rates, etc.) eased the problems only to a limited extent. As early as 2011, in our new book, *World Financial Crisis. What's Next?*, we pointed out that "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."⁴ The events of August 2011 are illustrative of the market participants' moods regarding future prospects.

In the environment of the global interdependence, the European problems that emerge reinforce the risks of the leading banks (U.S. banks included). As of September 30, 2011, the six biggest banks invested a total of USD 50 billion in the troubled Eurozone countries (Greece, Spain, Portugal, Ireland and Italy). As a consequence of vast penetration of the U.S. banks into many segments of the world economy, that are sensitive to their position, Fitch (an international rating agency) stated that "unless the euro zone debt crisis is resolved in a timely and orderly manner, the broad credit outlook for the U.S. banking industry could worsen" and that "further contagion poses a serious risk"⁵ (although the investments of American banks in the stressed European countries are lower than those of other nations' banks (Fig. 10)).



Source: BIS.

Fig. 10. Investment of Banks of Some Countries in the Troubled Eurozone Countries (Greece, Spain, Portugal, Ireland, Italy) as of the End of June 2011, USD in Billions

In this regard, what matters is the steps undertaken by a number of European countries to stabilize the position of the European economies.

For example, the recent decisions of Germany and some other nations inspire a somewhat optimistic outlook on the easing of euro problems. As is known, in September 2011 the German Parliament approved the measures aimed at strengthening Germany's role in

¹ See M. Ershov. Crisis of 2008: The 'Moment of Truth' for the Global Economy and New Opportunities for Russia // Voprosy ekonomiki [Economic Issues]. 2008. No. 12. P. 24.

² See IMF. Managing Capital Inflows: What Tools to Use? Staff Discussion Note. 2011. April 5.

³ Bloomberg. 2011. Aug. 25.

⁴ M. Ershov. World Financial Crisis. What Is Next?. M.: Ekonomika, 2011. P. 11.

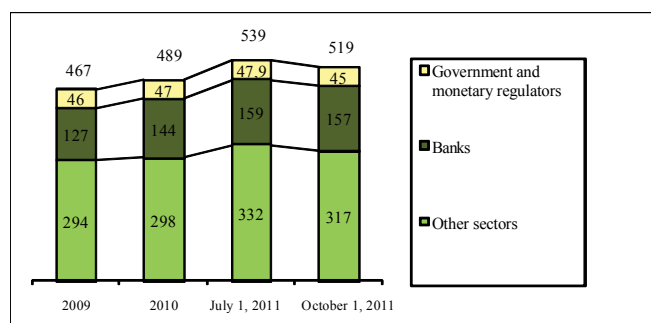
⁵ Bloomberg. 2011. Nov. 17. (US Banks Face Contagion Risks From European Debt: Fitch).

stabilizing the situation in Europe and supporting the European currency. Germany will widen its presence in the extension of guarantees to secure loans to EUR 211 billion against the previously agreed participation level of EUR 123 billion.¹ If other countries decide positively, an influential mechanism will be established and stabilize the situation in the Eurozone.

However, it should be noted that 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 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"²

Russian economy: old risks are here again. After a brief pause caused by crisis, the Russian corporate external debt owed by industrial companies and banks resumed its growth (although there has been some decline in the third quarter – see Fig. 11). 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. 11. Foreign Debt of the Russian Federation (USD in Billions)

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 risk.³ Hence, from systemic standpoint, we are forced to rely on energy sectors, thus turning into the major commodity supplier.

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.

As we see it, the need to create additional support points for the leading economies in an unstable global environment, has accelerated the possibility of a positive decision on Russia's accession to the WTO. Moreover, apparently, the firm position of Russia on the accession principles during the final phases of negotiations in recent years can finally allow our country to be admitted to the organization to a great extent upon the terms that Russia has stood up for in the past few years.

On November 10, 2011, the WTO working group approved Russia's accession to the WTO. According to mass media, Russia will become a member of the organization on its own terms: support for agriculture will remain almost unreduced, domestic gas prices will be subject to regulation, foreign banks will still have no permission to open branches in Russia.

It has been clear for many years that if Russia sticks to a consistent and persistent approach, it would be admitted to the WTO on its terms. The WTO member states are unable to ignore the enormous potential and vast opportunities the organization members will get as a result of full integration and openness of the Russian economy. Ultimately, the WTO is interested in Russia no less than Russia is interested in the WTO, although it is, naturally, a reciprocal process which is beneficial to both sides if correctly organized and balanced. It is desirable that Russia defends its positions not only during the current stage but in the future as well.

World development in the post-crisis period looks unstable. Prior risks remain unresolved and new ones are becoming more intense. The emerging instability appears fragile and puts a strong focus on the willingness to use anti-crisis stabilization mechanisms if necessary. And the latter, it seems, will not be long in coming. ■

¹ New York Times. 2011. 29 Sept.

² M. Ershov. World Financial Crisis. What's Next?. M.: Ekonomika, 2011. Pp. 247-248.

³ We have repeatedly written about it before (see, for example, M. Ershov. World Financial Crisis: a Year Later // Voprosy ekonomiki [Economic Issues]. 2009. No. 12; M. Ershov. New Risks of the Post-Crisis World // Voprosy ekonomiki [Economic Issues]. 2010. No. 12.