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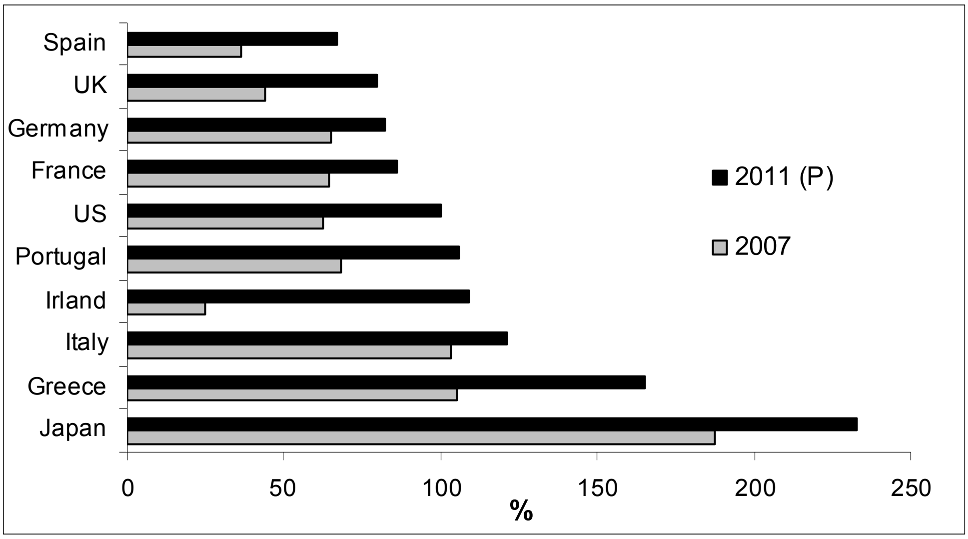
About Some Economic Risks After Crisis[1]

"The world is on the eve of the next financial crisis, with sovereign debt as its epicenter", say some reputable experts[2]. Indeed, anti-crisis measures and private sector bailouts transformed corporate debt into government debt, which has aggravated the latter and left many economies faced with a threat of default. The 'Euro crisis' that burst out in 2011 affected a number of countries and cast strong doubts over the viability of existing integration mechanisms. Stricter measures of budget policy are expected to be used in addition to monetary (foreign exchange) integration of member-countries.

Fig. 1. Public debt in 2007 and forecast for 2011
(for the end of period, % of GDP)



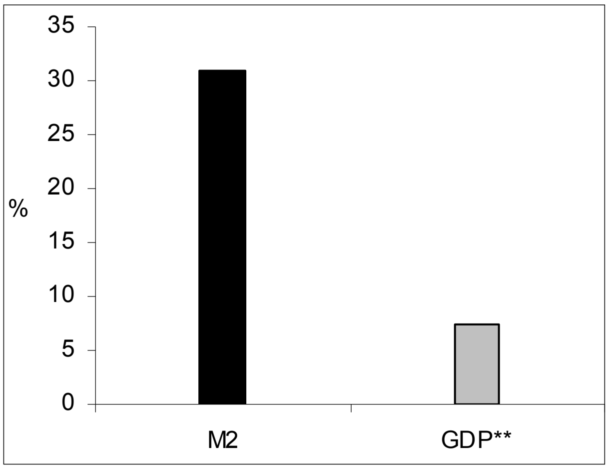
Source: IMF, September 2011

The above negative trends come hand in hand with stronger destabilization risks due to a large-scale increase in global liquidity that has considerably surpassed GDP growth (Fig. 2).

[1] This article reflects personal views of the author. www.ershovm.ru

[2] El Erian, World Is on Eve of Next Financial Crisis over Sovereign Debt. Bloomberg. 2011. Sept. 22.

Fig. 2. Growth of money supply (M2) and GDP in major economies* in 2007-2010 (December/December, %)



* Euro zone, US, UK, Japan, China, Russia
** Nominal GDP growth
Source: based on data by Eurostat, US Fed, BEA, Bank of England, Bank of Japan, National Bureau of Statistics of China, Bank of Russia, and Russian Federal State Statistics Service.

These resources will evidently seek spheres where to be used initially coming in overheating markets and then leaving them increasing the risk of their collapse. In the context of free capital flow, this will reinforce the risks of new regional crises and volatility in both financial markets and the overall global 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”[3].

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 been taken by a number of countries (such as Brazil and South Korea) and such approaches are likely to become more widely-used.

Back in 2008, and in our new book “Global Financial Crisis. What Is Next? (March 2011)[4], 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

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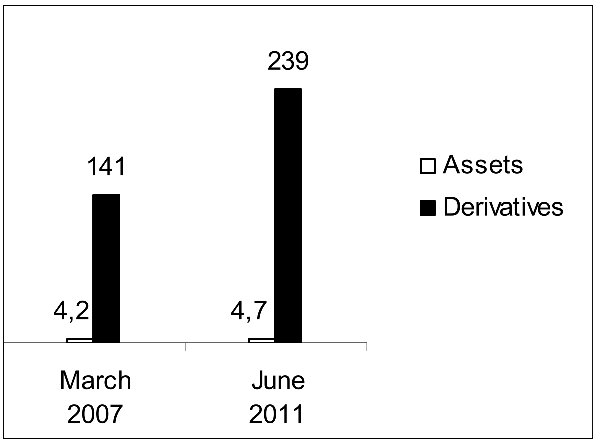
[3] Gallagher K.P. "Losing Control: Policy Space to Prevent and Mitigate Financial Crises in Trade and Investment Agreements", UN report, No 58, May 2010.
[4] M. V. Ershov “Global Financial Crisis. What’s Next?” - M.: Ekonomika, 2011. 295 P.

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..."[5].

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"[6].

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).

Fig. 3. Top 5 US banks: assets and derivatives (USD trln)



* 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

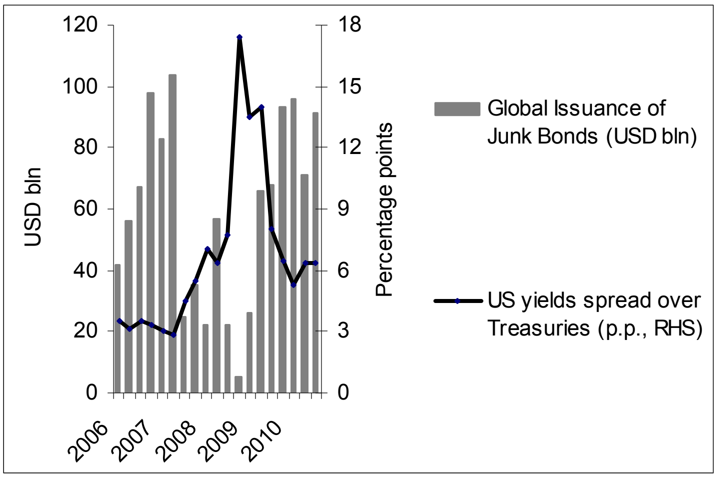
Furthermore, in a context of low interest rates and, accordingly, low yields, market players resume the intensive use of various risky tools that also offer higher returns. In particular, the issue of 'junk' bonds, considerably depressed during the crisis, is on a rise again.[7] (Fig. 4).

[5] 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.

[6] IMF, Staff Discussion Note "Managing Capital Inflows: What Tools to Use?", April 5, 2011.

[7] We already pointed out, in particular in 2009, that such trends might come back. For more detail see: Conference of the National Securities Market Association. Discussion Panel of Macro Economists "Outlooks of the Russian Financial Market" (December 10-11, 2009). Brochure, May 2010. www.ershovm.ru

Fig. 4. 'Junk' Bonds in the World



Source: The Economist, Sept. 2010.

It is clear that even despite regulatory and restrictive measures banks worldwide will build up their leverage and unreasonably expand their balance sheets. In other words, the risks being the precursors of the last crisis are re-emerging again.

These trends will quite naturally be large-scale and systemic in nature. As rightfully indicated by the Governor of the Bank of Japan, "most financial institutions will find it hard to resist pressures from equity holders to raise the return on equity under severe competition."[8]

In general, "none of the underlying causes of the current crisis have been removed", said the Bank of England's Governor M. King some time ago.[9] This shows how fragile the achieved stabilization is and how high global and national economic risks are: including future country defaults with all pre-requisites for a strong global geopolitical crisis.

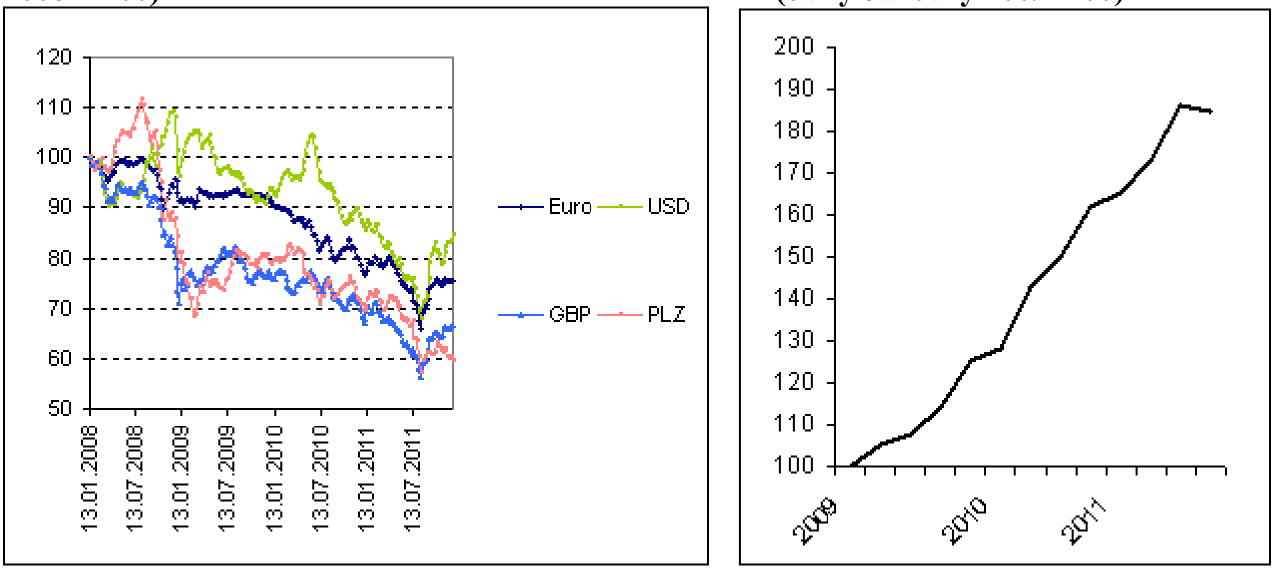
Lack of confidence of investors translates itself into continuous rise of Swiss franc (that has always been a 'refuge-currency' in crisis times) and gold prices (Fig. 5). The trend proved so stable that Swiss regulators were forced to announce that they were ready to intervene in the market should their national currency keep on appreciating, since in their view such a trend gave rise to problems for the national economy.

[8] Shirakawa M. Some thoughts on incentives at micro and macro level for crisis prevention. BIS, Papers No53, June 2009. P. 25-26.
[9] 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

Fig. 5.

A) Swiss franc exchange rate (January 2008 – November 2011, early January 2008 = 100)

B) Gold price growth (early January 2009=100)



Monetary Approaches: A Backward Advance

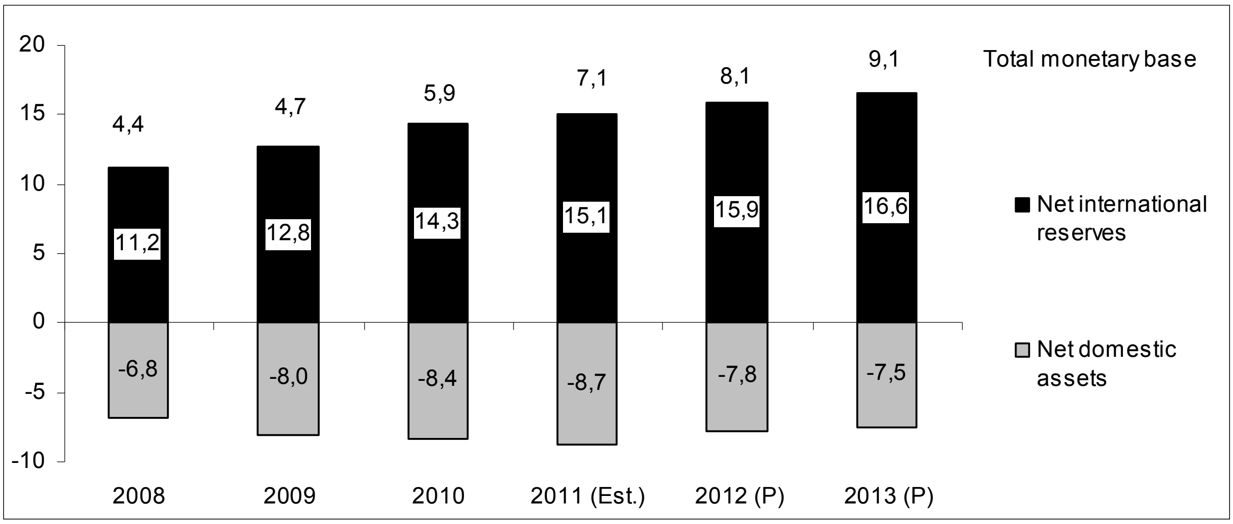
Initially, the crisis adjusted the approaches of the Bank of Russia to create money demand. As early as late 2007 (when the first signs of crisis process in the world were seen), virtually for the first time in many years, "Guidelines for the Single State Monetary Policy in 2008" provided for gradual 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. 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"[10]. 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"[11].

In fact, the role of external factor in 2008 weakened indeed and the role of domestic factor grew. However, the 2012 monetary program was presented assuming that the growth of net international reserves will be the principal source of monetary base expansion. In general, this

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

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. Now, external sources again become dominant in monetary base creation (Fig. 6).

Fig. 6. Sources of formation of the Ruble monetary base (RUB trln)



Source: "Guidelines for the Single State Monetary Policy in 2012 and for 2013 and 2014", baseline second version, Bank of Russia, 2011.

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.[12]

[12] 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).

Some Positive Trends in Russia

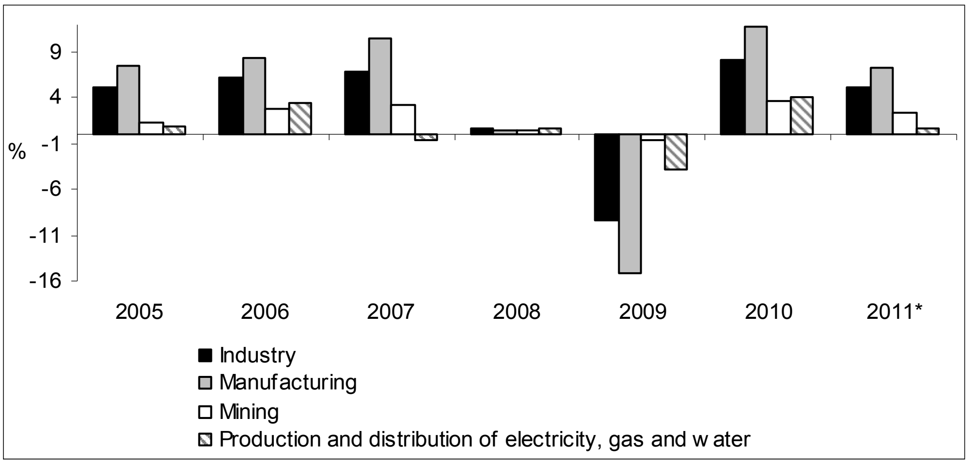
Before the crisis, as early as in 2005, changes were observed in the growth structure, when the growth rates in manufacturing notably exceeded the growth rates in mining operations[13].

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"[14]

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".'[15]

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**[16]**.** Indeed, both in 2010 and in 2011 the manufacturing growth rates exceeded growth rates of extraction industries (Fig. 7).

Fig. 7. Industry growth rates in 2005-2011, Russia (%, y-o-y)

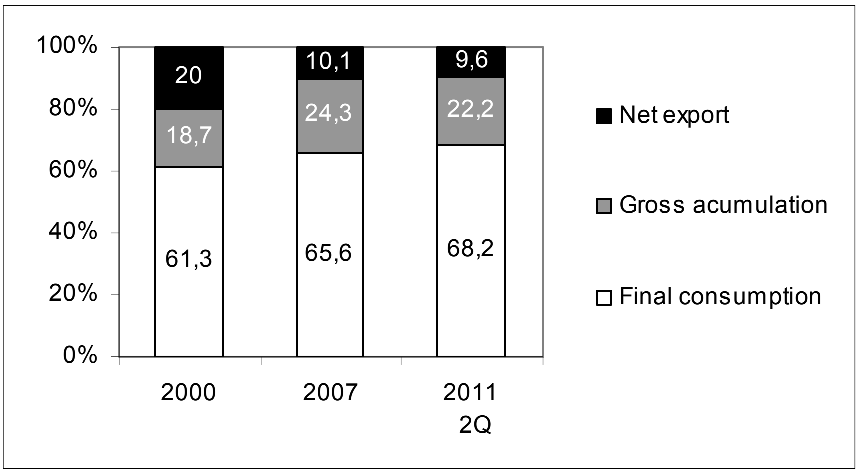


* January-September 2011/January-September 2010.
Source: Rosstat.

[13] "Principal Areas of the Unified State Monetary Policy for 2006". Bank of Russia. P. 5.
[14] World Bank. Russian Economic Report, November 2005. No. 11, P. 6.
[15] World Bank. Russian Economic Report, June 2007. No. 14, P.5.
[16] World Bank. Russian Economic Report, November 2010. No. 23, P. 5.

Additionally, exports are becoming less important, while domestic growth drivers are gaining weight (Fig. 8).

Fig. 8. Use of GDP (structure), Russia (%)



Calculated by the Center for Strategic Analysis of Rosbank based on data by the Rosstat.

All this is due in many respects to re-emerging post-crisis exchange rate trends that are to a larger extent driven by the existing situation in the foreign exchange market (which implies ruble appreciation) and aversion to unjustified currency depreciation. (We would remind that the World Bank mentioned the positive impact of exchange rates well before the crisis, in 2005).

In the aftermath of the crisis, both the global and Russian economies face multiple challenges and new risks. As such, successful growth in a turbulent post-crisis world hinges on how timely and balanced approaches by market players and regulators will be.