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Condoning the Crisis

Regulators of developed countries have to continue the policy of liquidity injection to mitigate the second wave of the crisis. Thus they only postpone the solution of acute structural problems.

The 2011 statistics look encouraging to the U.S. economy: U.S. GDP rose by 1.7%, and industry, by 4%. In February 2012, unemployment fell to 8.3%. The situation, however, seems to raise concerns among regulators.

In his recent estimate of the U.S. economic position (February 2012), Federal Reserve Chairman Ben Bernanke said that 'the economic recovery has been disappointing'[2]. Major drivers that could pull the economy out of depression – such as consumer demand and mortgages – still seem to be in trouble. The collapse of housing prices by almost 1/3 of their pre-crisis highs caused a more than USD 7 trln contraction of household wealth and a further surge in underwater mortgages to further aggravate the issues in mortgage refinancing and home sales. In its turn, lower household wealth translates to lower household expenditure (the elasticity is estimated at 5%, meaning a potential USD 350 bln cutback of expenditures or 2.3% of GDP) and further growth slowdown.

To spur on recovery, regulators have announced that until the end of 2014 federal funds rates will stay at their current lows, i.e. between 0% to 0.25% (currently at 0.10%). Note that this is much lower than U.S inflation rates. Moreover, this is the first time regulators **announce their rates beforehand** for such a long time horizon. Such a long-range signal to the market might imply that their sentiment is really troublesome, and to improve the actual economic situation it requires such low rates for another three (!) years to stay. By way of comparison, Russian approaches appear to be much tighter (Fig. 1).

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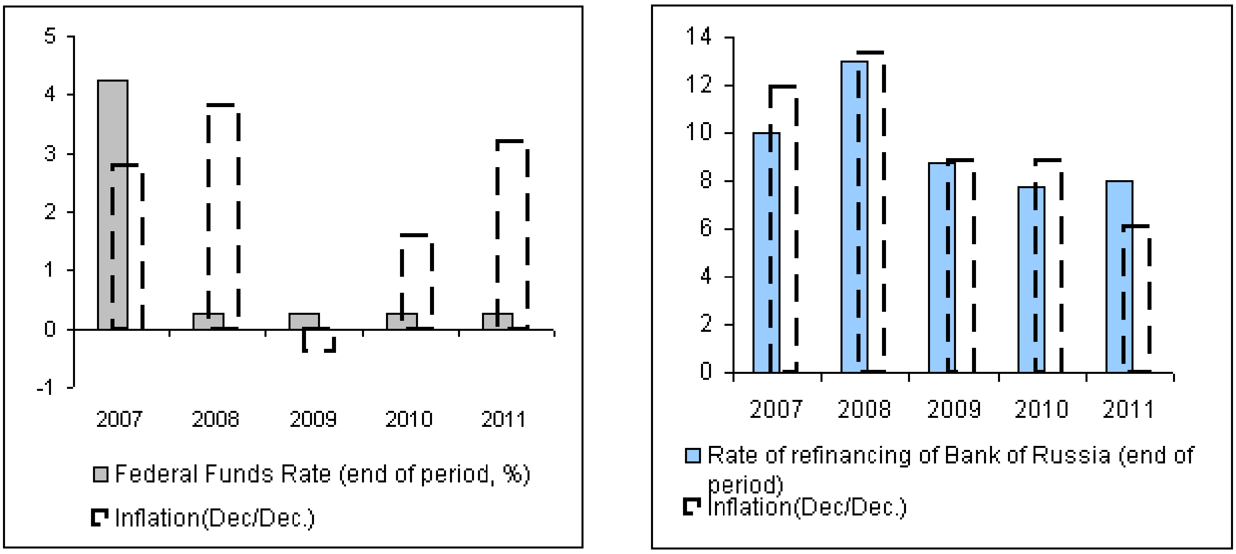
[2] B. S. Bernanke 'Housing Markets in Transition', 10 February 2012.

Fig. 1. Refinancing rates and inflation in the U.S. and Russia (%)

U.S. **Russia**



Source: US Fed, Bureau of Labor Statistics, Bank of Russia, Russian Federal State Statistics Service.

The same is also true for the overall liquidity growth fuelled by anti crisis measures (Fig. 2). It is noteworthy that, despite such a lavish USD injection, inflation rates in the U.S. economy look quite decent (Fig. 3).

Fig. 2. Monetary base growth in major economies, 1 February 2012 (late 2007 = 100)

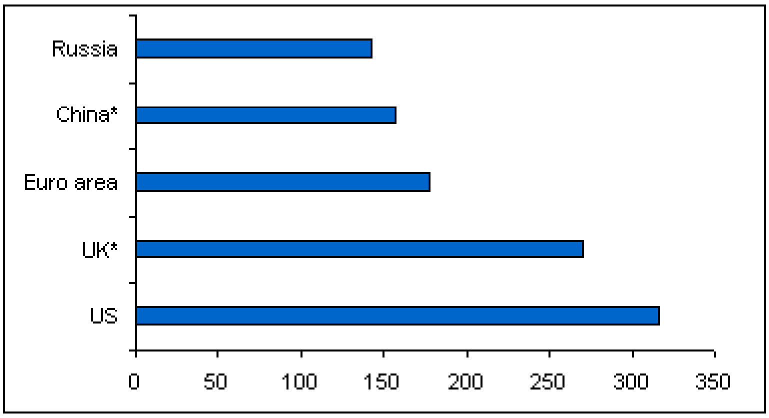
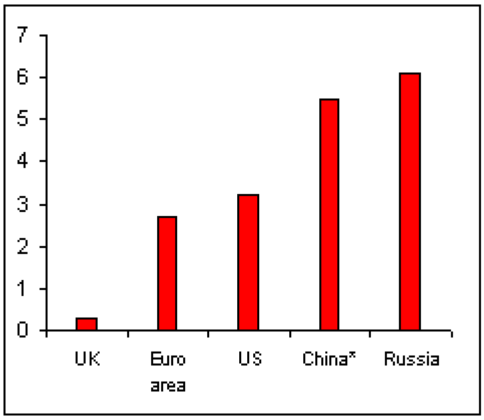


Fig. 3. Inflation in 2011 (%)

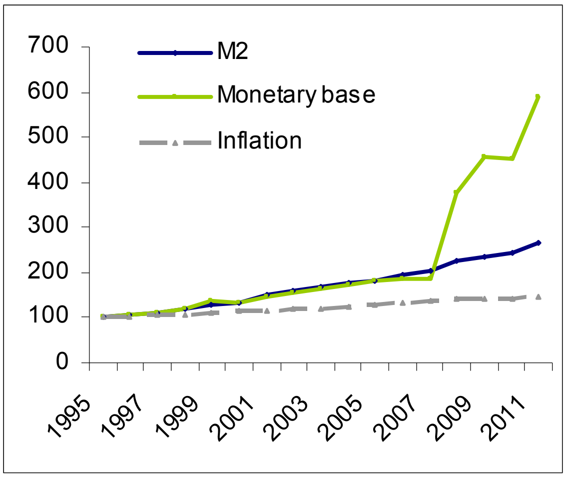


* 1H2011

Source: central banks of respective countries.

One of the reasons for this is that the Fed holds reserves of U.S. banks. Such practice impedes the flow of new dollars in the economy and decreases effect of multiplier which transforms the money base into a respective monetary aggregate (back in October 2008, the Fed set the interest rates on banks' reserve requirements deposited with the Fed, the rate currently being 0.25%). The U.S. major banks accumulating cash as a sort of 'reserves' has the same effect. All this adds up to a curious situation where the monetary base grows substantially faster than the growth of money supply (Fig. 4).

Fig. 4. U.S. Monetary base, money supply (M2) and inflation (1995 =100)



Source: data by U.S. Fed, U.S. Department of Labor Statistics

The bulk of money creation is of long-term (i.e. less inflationary) nature. There is also a strong outflow of U.S. dollars to third country markets. Given the above as well as subdued consumer demand which is still in place, the Fed may inject money in the economy on a large scale with the least inflationary repercussions.

The USD exchange rate might actually prove to be another risk area. There were expectations of its potential collapse at the very outset of the crisis in the U.S. To make things worse, the U.S. dollar formally has the least coverage with monetary base/gold and foreign exchange reserves among all major currencies. Its coverage stands at 21% (with potential sovereign debt monetization reducing it to below 4%). So, injecting more cash just makes it worse.

Indeed, the dollar has entered a systemic depreciation path in the last decade. But at some stages the demand for dollars from other nations (which increased during the crisis) turned into its appreciation rather than depreciation (Fig. 5).

Some steps suggested by the Federal Reserve also contribute to its appreciation. In March 2012, Ben Bernanke said that, in late 2011, the Fed extended to 2013 the 'currency swap' facilities with the ECB and central banks of Canada, Japan, Switzerland and the U.K. (these facilities were initially launched during the crisis and then re-launched in May 2010). These actions pushed the volumes of USD dealings between central banks up to record-breaking highs, with the USD 100 bln threshold crossed in mid-February 2012.

Fig. 5. USD real effective exchange rate (2010 = 100)

Source: BIS.

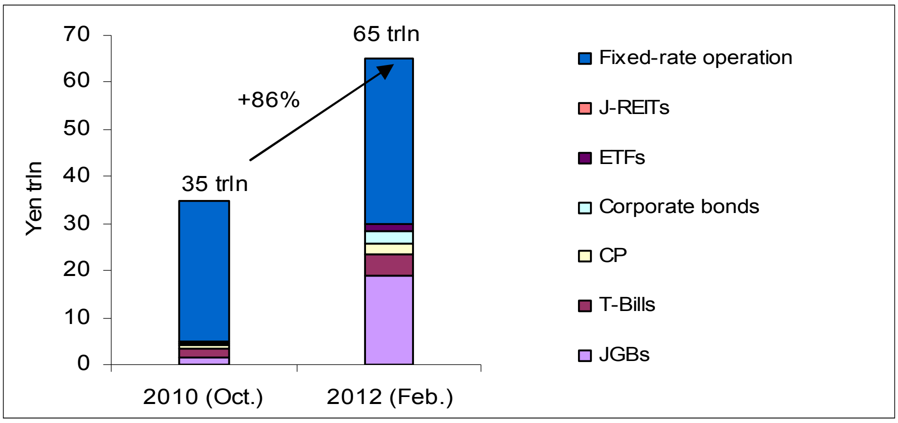
Regulators continue to rely on long and cheap money

After crisis, all developed countries expand long resources for their economies. As such, the Federal Reserve continues its asset swap program (announced in September 2011) which implies the purchase by the Fed of long-term US treasuries and sales of short-term treasury securities. Long instruments currently account for almost 90% of the total accumulated dollar base. This is apparently intended to make long money cheaper and mortgages more affordable.

The Bank of Japan announced similar approaches in February 2012. Its Governor Masaaki Shirakawa said that the Bank will continue pursuing powerful monetary easing by conducting its virtually zero interest policy and will buy more assets, including not only Japanese treasuries, but also risky private sector instruments (corporate bonds, etc.), which is an 'exceptionally unusual practice for a central bank'[3] (Fig. 6). (For more detail visit www.ershovm.ru)

[3] M. Shirakawa, 17 February, 2012.

Fig. 6. Asset Purchase Program of the Bank of Japan (JPY trln)



Source: M. Shirakawa 'The Bank of Japan's efforts Toward Overcoming Deflation', 17.02.2012.

The ECB is also implementing a longer-term policy through its LTRO programme. It will issue 3-year fixed-rate loans at 1% (we would remind that inflation in the E.U. is 3%). The loans may be paid-off in full or partially after one year. The ECB is also substantially expanding its list of collateral. In late February, the ECB ran another 3-year loan auction for more than EUR 500 bln. The appetite of European banks for such loans has hiked as compared to the first auction (run in December 2011), while the number of participants rose to 800 (50% growth over two months).

For information: During the crisis Russia used 1-year refinancing loans, but the duration is currently reduced to 6 months. Still, this March the Bank of Russia has announced (although only as an intent) that the Lombard List would be expanded for refinancing purposes and that maturities could be extended up to 1 year[4].

Regulators clearly believe that long and cheap money must at least somehow help clean up the mess of systemic imbalances built up in major economies.

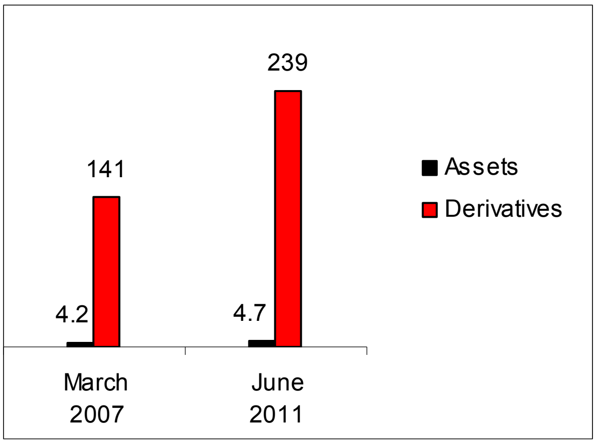
Global economic risks are still there

As pointed out by Mervyn King, Governor of the Bank of England, 'none of the underlying causes of the current crisis have been removed'[5]. Indeed, apart from the above-mentioned impediments in the mortgage industry (which, as a consequence, is unable to play the role of economic driver), and subdued consumer demand, by and large we are still speaking of unsolved debt issues piled up in developed economies, continuing deficits and 'global imbalances'. All this substantially constrains growth opportunities.

[4] RBC daily, 20 March 2012.
[5] M. King, 11 March 2011.

Moreover, the growth of derivatives issued by major, mostly U.S., banks raises concerns as well. We all remember the negative role derivatives played in the unwinding of the crisis of 2007. Today their level in top U.S. banks considerably exceeds even pre-crisis volumes (Fig. 7).

Fig. 7. Top five U.S. 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 for respective quarters.

While we hear again that this is all due to portfolio 'restructuring' and attempts to minimize and diversify risks, we should also bear in mind that we had already witnessed such arguments before the crisis.

The aftermath of the E.U. sovereign debt crisis is also of concern to U.S. regulators, as it can affect the U.S., due to the interconnectedness between U.S. and E.U. banks in particular (especially when it comes to CDS derivatives which reach USD 1 trln, i.e. about 7% of assets). In this regard, the OECD estimates that 'the EU crisis could quickly return to the United States in the event of insolvencies within Europe'[6].

[6] OECD journal: Financial Market Trends, January 2012.