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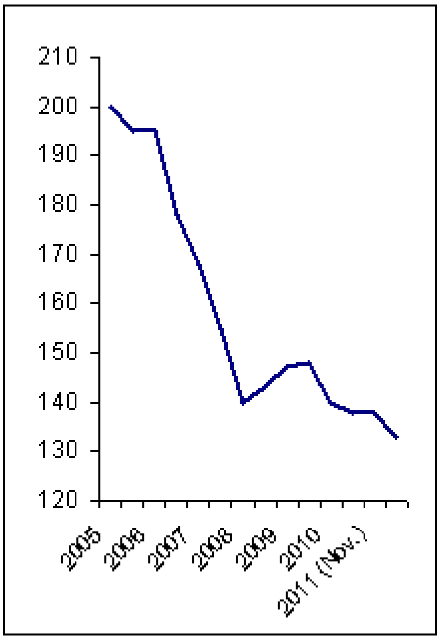
Leading Economies: Continued Response to Crisis

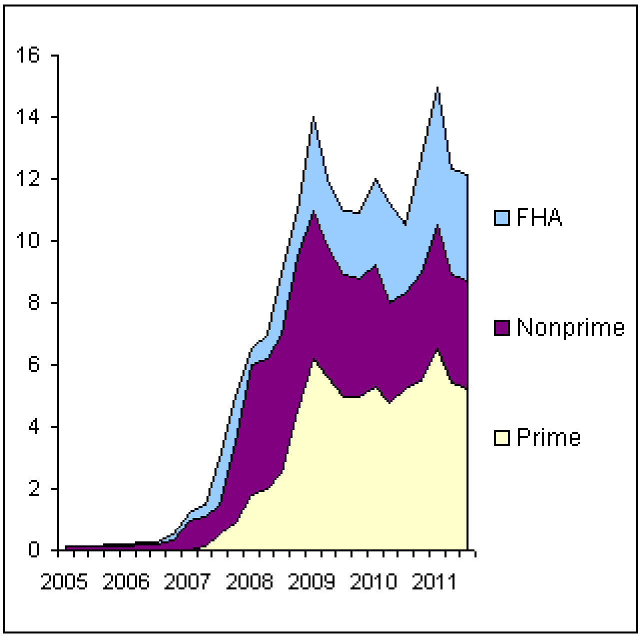
In late January 2012 Ben Bernanke, the chairman of the US Federal Reserve, said that the economic recovery has been disappointing[2]. Moreover, the factors crucial for pulling the economy out of depression – consumer demand and mortgage lending, remain in a difficult condition. Decline in home prices by almost 1/3 since the pre-recession peak of the housing boom (Fig. 1A) resulted in more than a US$7 trillion loss of household wealth and lead to continuous growth of mortgages with negative equity (Fig. 1B), thereby impeding mortgage refinancing and sales of houses. Reduced household wealth consequently decreases their spending (by some estimates, the elasticity is about 5%, that means a potential decline in spending by US$350 billion or 2.3% of GDP) and further slowdown of economic growth.

Fig. 1.

A) Home prices (January 2000 = 100)



B) The number of "underwater" mortgages (million)



Source: FRS, January 2012.

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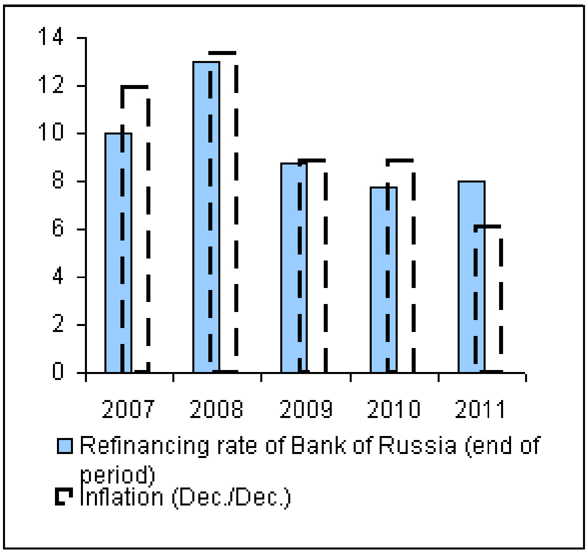
[2] B.S. Bernanke "Housing Markets in Transition", 10 February 2012.

To revive the economy the Federal Reserve will continue using serious measures of support. In particular, the federal funds rates will remain at the current minimum level of 0 – 0.25% till the end of 2014. The present actual rate is about 0.1% that is significantly lower than the inflation rate (Fig. 2).

Fig. 2. Refinancing and inflation rates in the US and Russia (%)

US **Russia**

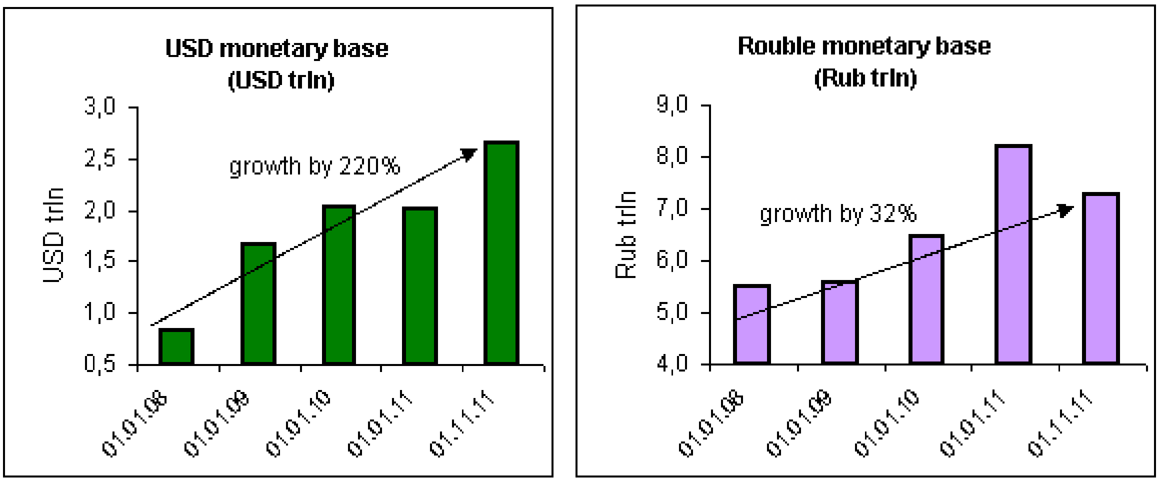


Source: US Fed, Bureau of Labor Statistics, Central Bank of the Russian Federation, Federal State Statistics Service (Rosstat).

Apart from the fact that such approaches are far more liberal than in a number of other countries (e.g. in Russia), it also gives rise to some more related comments and issues. The federal funds rates, as mentioned above, will be kept this low for three (!) more years. Is the current economic situation in the US so difficult, that it requires provision of cheap funding within such a long period of time to stimulate the economic growth? Besides, market players have usually learnt about changes in rates after such decisions were made, rather than before. The mere fact that this kind of decision is made public in advance and for a long period of time, which has no precedent in itself, may indicate significant lack of confidence of market participants, their unfavorable condition and regulators' desire to bring greater clarity with regard to their future steps, thereby facilitating solving financial issues by companies and banks.

In addition to making financial resources cheaper, to mitigate the consequences of the recession many countries (the US in the first place) used large-scale liquidity "injection" into their economies. It resulted in more than a three-fold increase in dollar emission (monetary base) (Fig. 3).

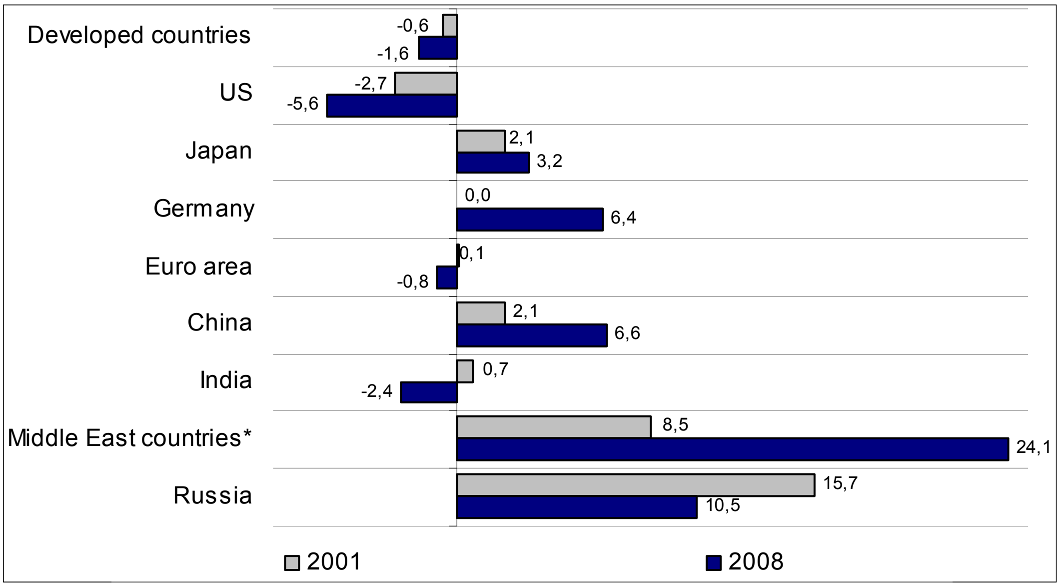
Fig. 3. Monetary bases of the US and Russia



Source: the US Federal Reserve, the Central Bank of the Russian Federation

Concerns of US regulators are certainly caused by a great number of current as well as institutional problems that existed even before the crisis. One of them is the so-called "global disbalances", i.e. when countries with excess savings and budget surplus fund shortage economies, where the consumption level (level of investments) is higher than the savings level.

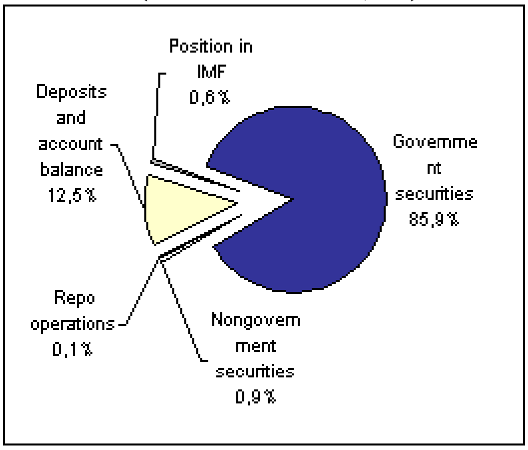
Fig. 4. Difference between savings and investments (% of GDP)

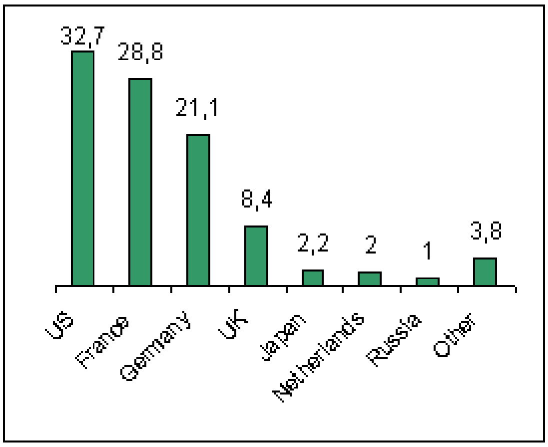


* Iran, Kuwait, Libya, Oman, Qatar, Saudi Arabia, Yemen.
Source: BIS data, 2009.

Creditor countries of the global economy include Russia with its accumulated financial resources, sufficient enough to invest these resources in financial instruments and economies of other countries. Resources of stabilization funds, gold and foreign exchange reserves are often invested in treasury bonds or mortgage instruments of other countries (Fig. 5), thereby increasing risks of losses as a result of falling stock prices (it is what happened with securities of the US mortgage agencies).

Fig. 5. Breakdown of foreign exchange assets of the Bank of Russia by instruments and by countries (as of 30.06.2011, %)





a) by types of instruments **b) by countries**

Source: Central Bank of the Russian Federation

In this respect, relevance of such approaches, necessity and possibility of using a part of these resources inside the country (the reference is to stabilization funds in the first place) are once again on the agenda.

As for a more balanced creation of gold and foreign currency resources, we raised this issue even before the recession.

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**)[3]

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.

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.

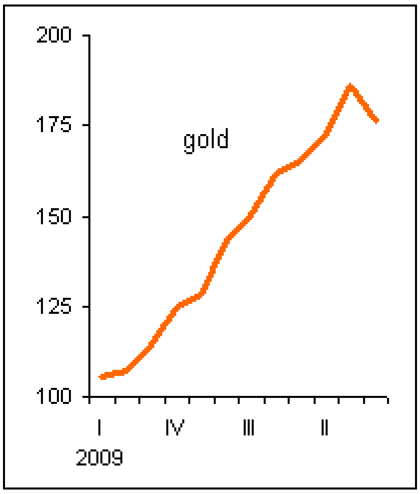
[3] M. V. Ershov. Materials for the Meeting of the Banking Committee of the Russian Union of Industrialists and Entrepreneurs, 7 February 2008.

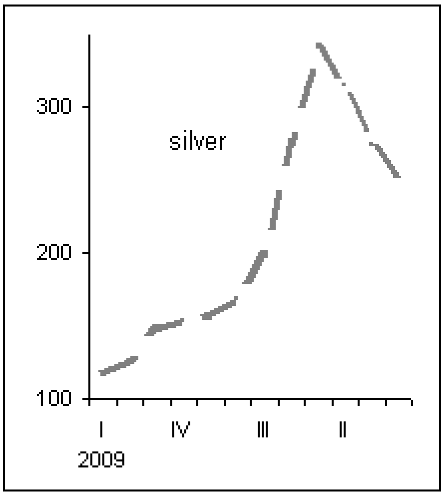
2. We also need to bear in mind the steady decline of the US dollar exchange rate against a number of currencies (Euro, Swiss franc, pound sterling, renminbi, rouble) over more than the last two years. Moreover, international organizations estimate that the US dollar still remains overvaluated (which 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.

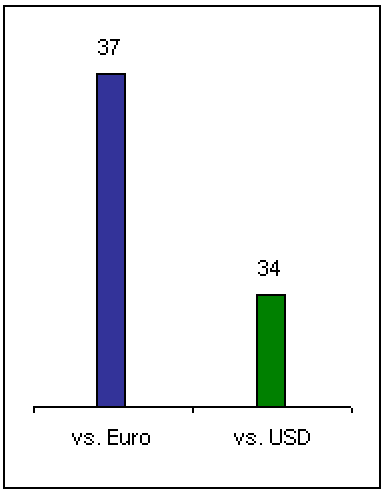
Given the above, it would be reasonable to consider gradual diversification of the currency portfolio of international reserves (and the currency structure of the foreign trade turnover) by increasing the share of other currencies.

Much of the above said has occurred in the course of crisis, and should such tendencies have been taken into account well in advance, it might have had a far more positive impact for the Russian regulators. In future it would be advisable to thoroughly evaluate possible ways of further optimization of gold and foreign currency reserves formation, particularly in view of potential aggravation of recession.

Fig. 6. Swiss franc, gold and silver rise in price







Silver and gold price (USD/troy oz., 01.01.2009=100)

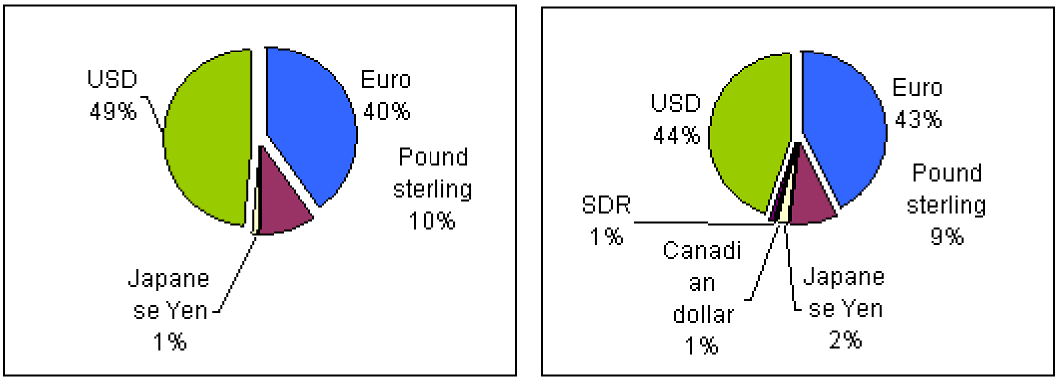
Strengthening of Swiss franc vs. Euro and USD (June 2007-Feb. 2012, %)

Source: calculation is based on data at kitco.com

Although approaches to creation of reserves were somewhat modified after the recession (Fig. 7), those changes were not comprehensive.

Fig. 7. Distribution of Bank of Russia foreign currency assets (%)

end of 2006 **as of 30.06.2011**



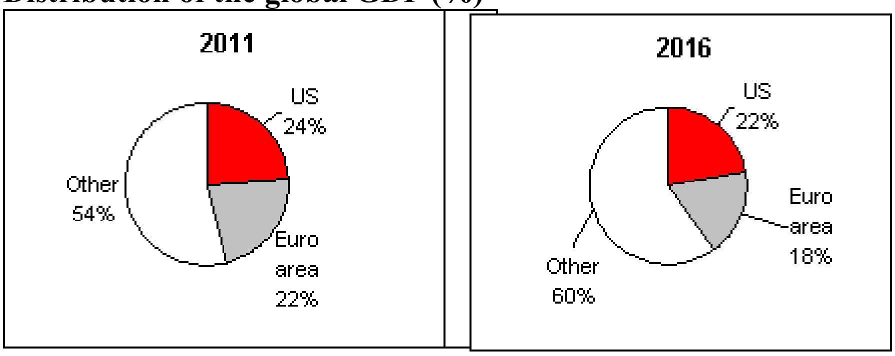
Source: Central Bank of the Russian Federation

Paying attention to external risks is all the more important in view of both - the Eurozone crisis and further growth of debt burden in the US themselves. According to the Federal Reserve chairman, B. Bernanke, "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].

In reality, it is expected, however, that while the share of the US in the global GDP is diminishing, their share in the global sovereign debt will be growing (Fig. 8).

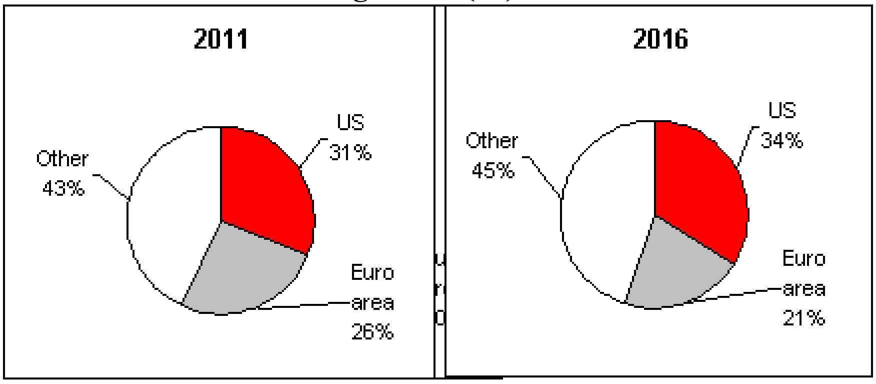
Fig. 8. Some countries' shares in the global GDP and global sovereign debt.

Distribution of the global GDP (%)



[4] Chairman of US FRS B.S. Bernanke. Speech at the Federal Reserve Bank of Kansas City Economic Symposium, Jackson Hole, Wyoming, August 26, 2011.

Distribution of the sovereign debt (%)



Source: IMF's Fiscal Monitor, International Financial Statistics and World Economic Outlook; Prasad E.S. Role Reversal in Global Finance, Aug. 2, 2011.

Continuing budget deficits will imply continuing tasks of their financing, as well as the preservation of institutional and long-term nature of the problem as a whole, that may take many years to be resolved. According to international experts, if no radical steps are taken to rectify the situation, "the government debt will grow to dangerous levels in most advanced and in many emerging economies over the next 25 years"[5].

All this makes the global situation extremely volatile, thereby increasing the risk of the "second wave". Under these circumstances economic authorities and business should take into account potential risks, while developing required mechanisms to enable recovery from the global volatility (if such occurs) with minimum losses and preserve potential for further development of the Russian economy.

[5] Peterson Institute for International Economics.