

M. Ershov

World Economy: Prospects and Barriers for Recovery*

According to the latest forecasts, it will take 10 years for the world economy to get back to “decent shape”. Some more critical estimates suggest that the whole western world will have a “colossal mess” within the next 5–10 years. Regulators of some major countries significantly and over a short time-period changed their forecast for the worse which means that uncertainty in the outlook for the future persists. Indeed, the intensive anti-crisis measures have reduced the severity of the past problems, however the problems themselves have not disappeared. Moreover, some of them became more intense – the euro-crisis, excessive debts, global liquidity glut against the backdrop of its deficit in some of market segments. As was the case prior to the crisis, derivatives and high-risk operations with “junk” bonds grow; budget problems – “fiscal cliff” in the US – and other problems worsen. All of the above forces the regulators to take unprecedented (in their scope and nature) steps. Will they be able to tackle the problems which emerge?

Keywords: anti-crisis measures, long money, monetary policy, liquidity.

JEL: E44, E51, E58, F34, G21.

The IMF estimates (October 2012) that “risks for a serious global slowdown are alarmingly high” (IMF, 2012). In early June, Robert Zoellick, the then President of the World Bank, was not-less emphatic: ‘The summer of 2012 offers an eerie echo of 2008. Markets are signalling anxieties about a major asset class. In this round, eurozone sovereign debt has replaced mortgages as the risky investment. Banks are under stress... collateral quality is declining’ (Zoellick, 2012). In this situation, the active stabilizing measures taken by regulators in major countries are quite natural.

New assessments of the economic situation require extra support measures

In late August 2012, Fed Chairman Ben Bernanke said that “the economic situation is obviously far from satisfactory”. He highlighted employment and mortgage lending issues,

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* The article reflects the private opinion of the author.

challenges in the fiscal policy and existing stresses in the lending and financial markets, which constrain the economic development (Bernanke, 2012a).

The U.S. economy shows a certain growth: within 2% over the first half of the year. However it looks surprising that April growth forecasts made by the Fed for 2012 were downgraded by 20% this summer! (see Table 1). Does this mean that over two months highly informed Fed experts managed to learn about the growth of their economy some facts that prompted them to make such a massive revision? Or had some new, so far unaccounted circumstances arisen that led to such large-scale revisions over such a short period of time?

Table 1

US GDP growth rate forecasts by the Fed, 2012 (%)

	2012	2013
June forecast	1,9–2,4	2,2–2,8
April forecast	2,4–2,9	2,7–3,1

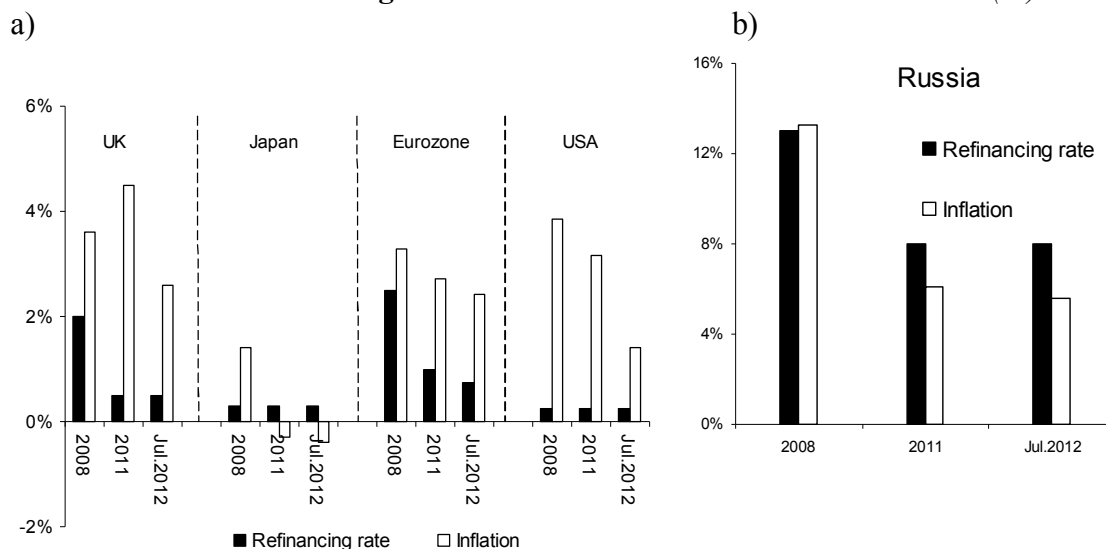
Source: US Fed, July 2012.

We should also highlight that regulators use unprecedented crisis management measures not seen before. In addition to liquidity injection and bringing interest rates even below the inflation level, they use ‘verbal’ interventions regarding their future policy which even contain specific numbers. E.g. the Federal Reserve announced *in advance* the federal funds rate which is made public *for a several-years-time-horizon*. First, it was stated that until mid-2014 the rates would stay flat, within the range between 0 and 0.25% (their current actual level is about 0.15%). Then this date was moved to mid-2015. Such a long-term message to the market might imply that the market sentiment is really bad, and, to recover, the market needs not only such a low price of financial resources – below inflation (actually recorded in some cases), but the funds rate level must be announced beforehand (which is extremely unusual for a central bank).

In response to the crisis, almost all developed countries made their financial resources considerably cheaper by cutting down interest rates that currently in most cases are below inflation rates (see Fig. 1a), thereby making the liquidity trap more visible. As a result, the need to encourage demand for the economy to recover becomes a priority.

Developing countries (and Russia) run much stricter monetary policy (see Fig. 1b, 2), with policy rates substantially above inflation rates.

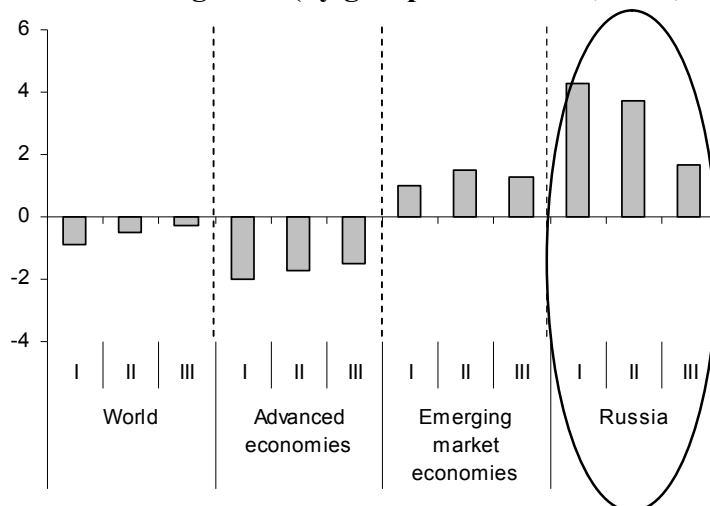
Refinancing and inflation rate in a number of countries (%)



Source: Bank of England, Bank of Japan, ECB, US Fed, Bank of Russia.

Fig. 1

Real refinancing rates (by group of countries, 2012, %)

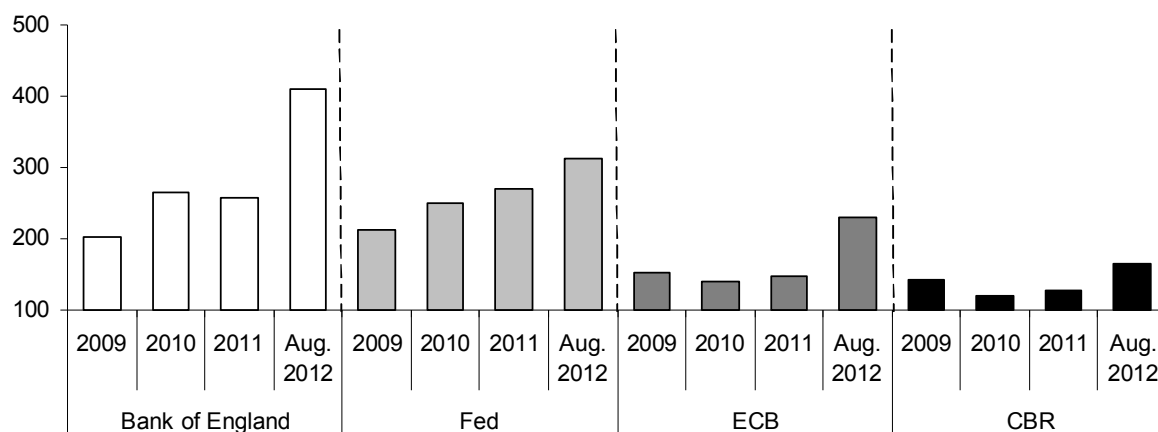


Sources: BIS, June 2012; Bank of Russia.

Fig. 2

As a result of all those measures the balance sheets of major money creation centres (i.e. national banks) have increased significantly (See Fig. 3). Given the leading role that they and ministries of finance of developed countries have played and continue playing in the post-crisis stabilization, the idea that the government starts playing an increasingly high role in the modern global economy becomes highly important from systemic standpoint.

Growth of balance sheets of some major central banks, 2008 – 2012 (*index, 2008 = 100*)



Sources: Bank of England, ECB, US Fed, Bank of Russia.

Fig. 3

This fact is most noticeable in developed countries where market mechanisms of the private sector and the free market in general earlier seemed to dominate.

The Bank for International Settlements estimates that total assets of all central banks are currently close to USD 18 trln (30% of global GDP). The ratio was twice as low ten years ago.¹

In such new circumstances, central banks not only provide cheap liquidity to their economies, but are increasingly compelled to support priority areas of the private sector. According to M. Shirakawa, Governor of the Bank of Japan, the bank will continue with 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 (Shirakawa, 2012) (see Table 2).

Table 2

Size of the Asset Purchase Program of the Bank of Japan (JPY trln)

Section	October 2010 (program launch)	End-December 2012	End-December 2013
Total size ^a	about 35	about 65	about 80
JGB ^b and T-Bills	3,5	33,5	48,5
Commercial papers and corporate bonds	1,0	5,0	5,0
Fixed rate funds-supplying operation against pooled collateral	30,0	25,0	25,0
Other	0,5	1,72	1,72

^a The total size of the program was JPY 60.2 trln as of 10 September 2012.

^b In addition to purchases under the Program, the Bank of Japan regularly purchases JGBs at a pace of JPY 21.6 trln per year.

^c Exchange-traded funds (ETFs) and Japan real estate investment trusts.

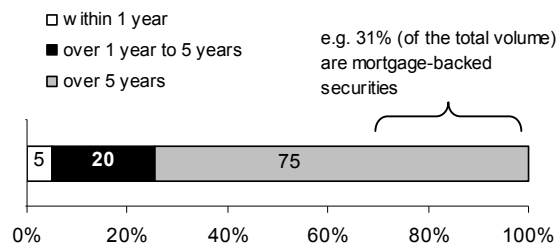
Source: Bank of Japan.

¹ BIS, June 24, 2012.

Similarly, the Fed creates most dollars by buying mortgage securities to bolster this crucial economic sector (see Fig. 4). As a result, interest rates in this market segment have considerably decreased; in late 2008 when the Fed announced its asset-purchase program, 30-year mortgage rates were above 6%, they went down to 3.5% by October 2012 (Bernanke, 2012b).

The implementation of the monetary policy in conjunction with crisis management measures in developed economies marked the birth of the mondustral policy that links monetary approaches to industrial priorities, i.e. its sectoral and corporate elements.²

Term structure of US monetary base, September 2012 (%)

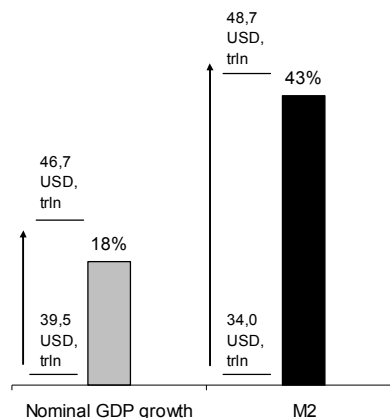


Source: US Fed.

Fig. 4

As a result of crisis management measures, the global money supply has considerably grown, way ahead of GDP growth rates (see Fig. 5). Thus destabilizing risks of excessive liquidity due to large-scale ‘capital migration’, primarily driven by ‘hot’ money, higher volatility of commodity markets, and unstable foreign exchange rates persist.

M2 and GDP growth in a number of major economies,* 2007 – 2011 (USD trln, %)



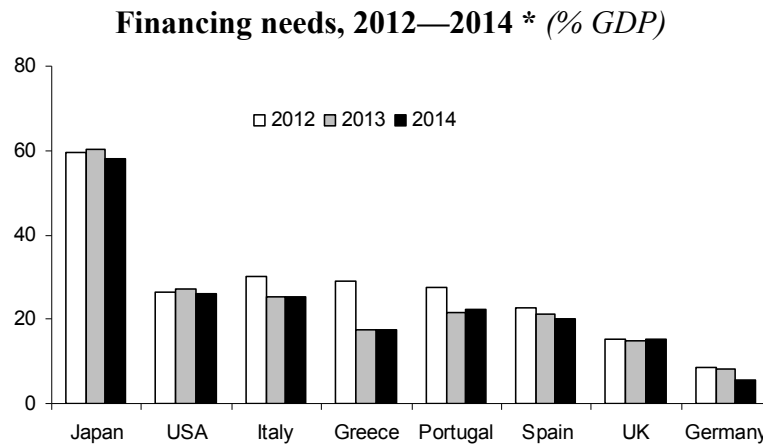
* Euro Area, US, UK, Japan, China, Russia.

Sources: calculated 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.

Fig. 5

² www.investopedia.com

Furthermore, given the need of major economies for extra funding in connection with forthcoming debt servicing money creation may grow by another USD 28 trln in the coming years (see Fig. 6). Greater liquidity may lead to a greater money supply.

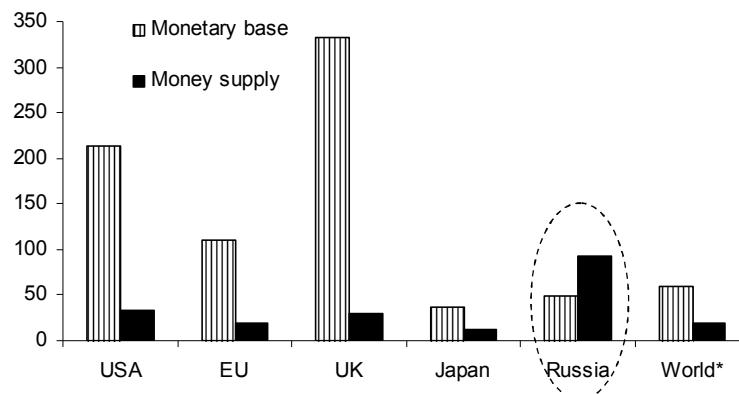


* Financing needs comprise the need to repay debt obligations (to a larger extent) and servicing the debt.
Source: IMF, Oct. 2012.

Fig. 6

We would note that in most developed countries the monetary base has been growing much faster than the money supply (see Fig. 7) as a result of both general economic causes (e.g. attempts by regulators, mainly in the US, to neutralize the inflation risk), and technical factors. The latter include the Fed keeping surplus reserves of US banks, which prevents new dollars from getting into the economy and decreases the multiplier that turns the monetary base into the relevant money supply aggregate (in October 2008, the Fed set the fees for the funds which banks keep on their reserve accounts with the Fed: standing at 0.25% at present). The policies of major US banks which keep large stocks of liquidity that actually serve as a sort of ‘reserve’ also contribute to lower growth of money supply (see Fig. 8).

Monetary base and money supply growth, 01.01.2008 – 01.08.2012 (%)

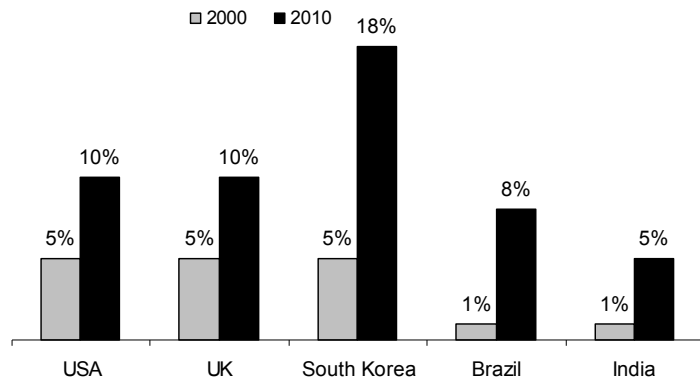


*Growth in 2008-2011

Sources: Bank of England, Bank of Canada, Bank of Japan, ECB, US Fed, Bank of Russia, Natixis.

Fig. 7

Corporate cash balances in 2000 and 2010 (% GDP)

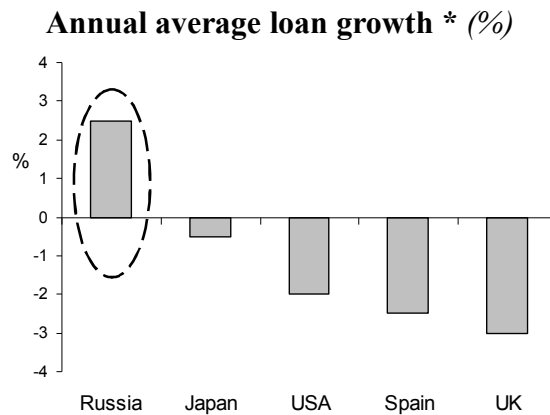


Source: McKinsey Global Institute, 2011.

Fig. 8

We would also note the ‘volume effect’ (a money supply much larger than ‘high-powered money’). This effect considerably smoothes the growth rates of large-scale indicators (money supply in this case) as compared to smaller parameters (monetary base).

Another important factor constraining the money supply growth at this stage is the lower volumes of lending by commercial banks (see Fig. 9). This factor constrains the inflow of liquidity to the economy and decelerates the money supply growth.



* In real terms, over three years, as of June 2012

Source: BIS, June 2012.

Fig. 9

‘Healthy banks, with an ability to lend, are critical to the global recovery’³ was stated by the G20 summit in summer 2012. On the whole, the credit crunch and large volumes of liquidity which is actually kept idle without getting into the economy reflect the persisting uncertainty of market players regarding their own stability and opportunities for growth (see Insert 1).

³ G20. Los Cabos, June 2012.

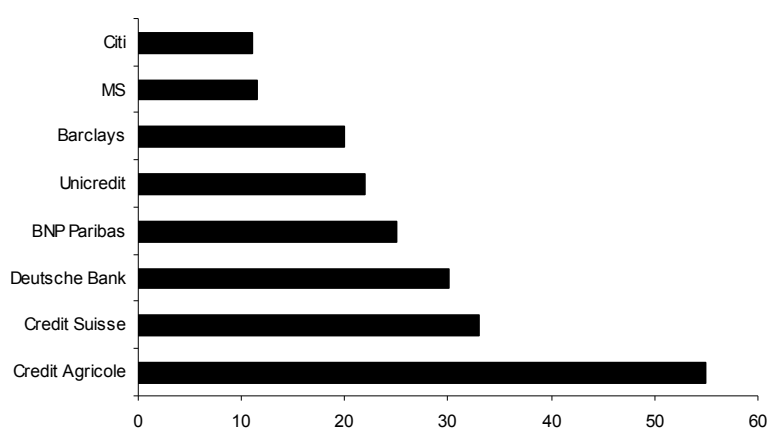
Combating the credit crunch

The credit crunch situation is so alarming that some countries start launching special programmes to revive lending. E.g. the Bank of England announced its funding for lending programme that will be run jointly with the Exchequer and implies providing of funds for commercial banks at a below-market-price to expand lending to the non-financial sector. The programme also provides for a sliding scale with interest rate charges rising for lower lending volumes, and vice versa. Other countries (such as the US) do not rule out similar approaches (see: Bernanke, 2012c).

As a result of the credit crunch and growth of banks' capitalization, bank leverage has slightly improved as compared to pre-crisis levels, although in a number of cases it still remains elevated (see Fig. 10). We would note that stabilization of banks' balance sheets is driven by their more conservative behaviour in the market and, as a consequence, less active participation in the economic life.

The exposure of major banks to short-term funding raises some concerns. According to the ECB, balance sheets of European banks record a significant rise in the share of short-term liabilities that exceed the respective growth of short-term assets, thereby aggravating the maturity mismatch. In general, short or even super-short (mostly overnight) instruments are also predominant in deposits (see Fig. 11 – 12).

US and EU banks with high leverage, 2011 (*times*)

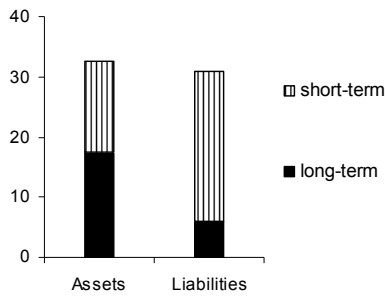


Note. The existing differences in recognition of financial operations distort the resulting picture (among other things, REPO transactions recognized on a net basis by US banks and on a gross basis by EU banks would naturally change the consolidated asset figures and increase the divergences when comparing the final values).

Source: JP Morgan, June 2012.

Fig. 10

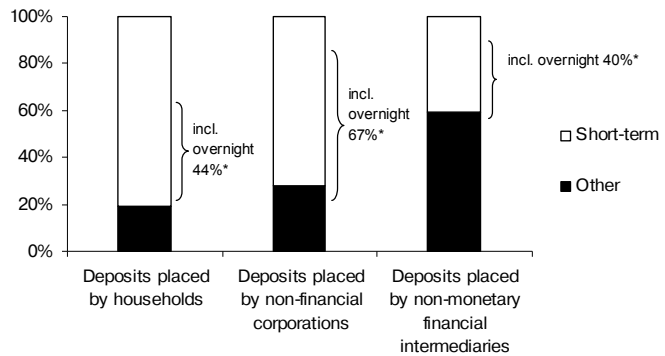
Balances of monetary financial intermediaries in the Euro Area, Q2 2011
(by maturity, EUR trln)



Source: ECB, April 2012.

Fig. 11

Euro Area M3 breakdown, July 2012 (by sector and maturity, %)



* Of the total amount (100%)

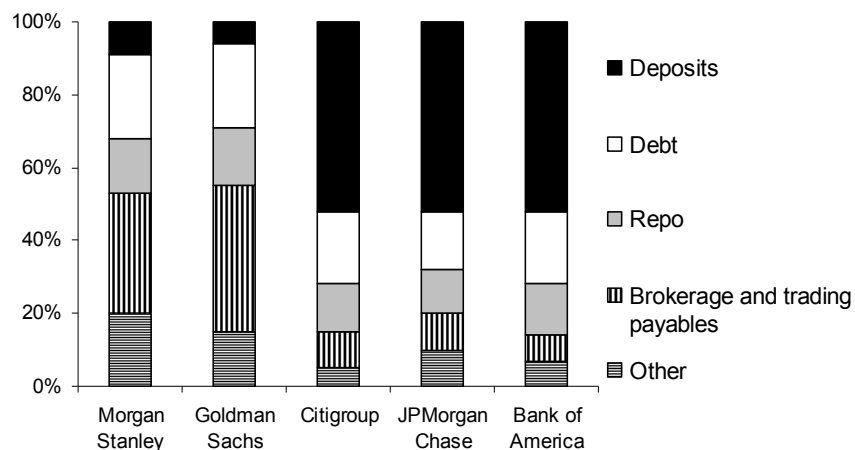
Source: ECB.

Fig. 12

The same is true for a number of major US bank holdings where the share of deposits themselves as relatively more stable funding sources stays extremely low in some cases, while short funding sources are significant (see Fig. 13). In general, this situation makes the system more unstable, which may be especially undesirable in a crisis scenario.

Since 2011, the regulators began to apply ratios that assess the ability to repay short-term liabilities (to be fully implemented in 2015). At present, however, most banks have the liquidity coverage ratio below the recommended 100%, which gives rise to certain risks for their balance sheets (see Fig. 14).

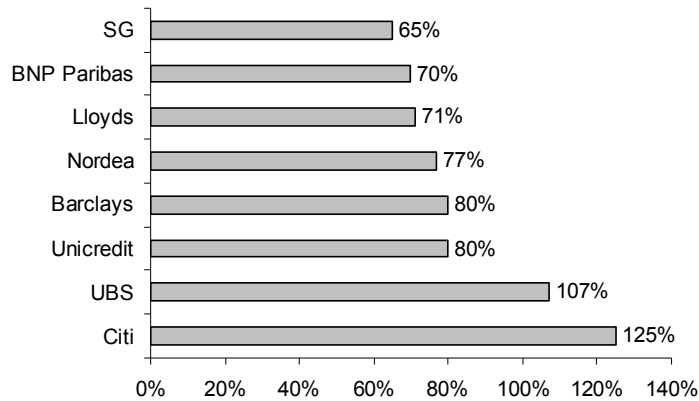
Liabilities of US bank holding companies, as of late 2011 (%)



Source: IMF, Oct. 2012.

Fig. 13

Liquidity coverage ratio, as of late 2011 (%)



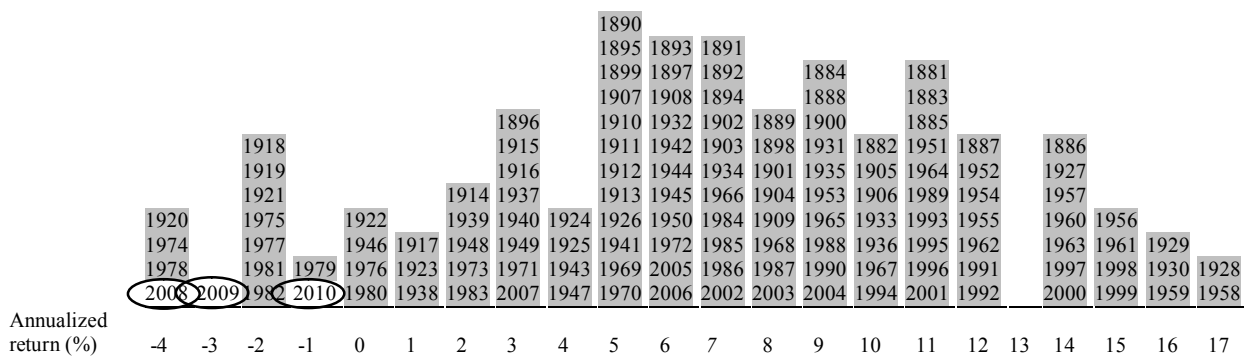
Source: JP Morgan, June 2012.

Fig. 14

Low yields provoke high risks once again

It is obvious that by making funding cheaper for the economy, low interest rates at the same time set the path towards a general reduction of return on financial instruments across the world. This is especially true for such an important area of investments as the stock market. For example, the recent years are estimated to record the lowest returns on the equity market over more than the last 100 years (see Fig. 15).

Return on equity in the US, * 1881-2010 (%)



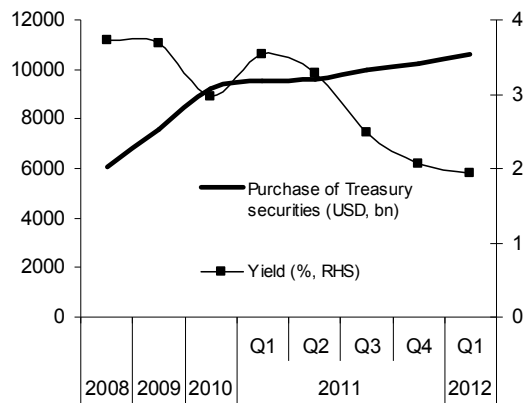
* Distribution of the rolling 10-year annualized equity returns. Each block represents the end point of a 10-year period and shows the annualized total real returns to shareholders.

Source: McKinsey Global Institute, 2011.

Fig. 15

Against the backdrop of low returns which prevail as well as excessive free liquidity which seeks ways to be used, high demand for US treasury securities retains. This instrument adequately meets the needs of investors, although its yields are low and the US economy itself is living through hard times (see Fig. 16).

Purchase and yield of US treasury securities



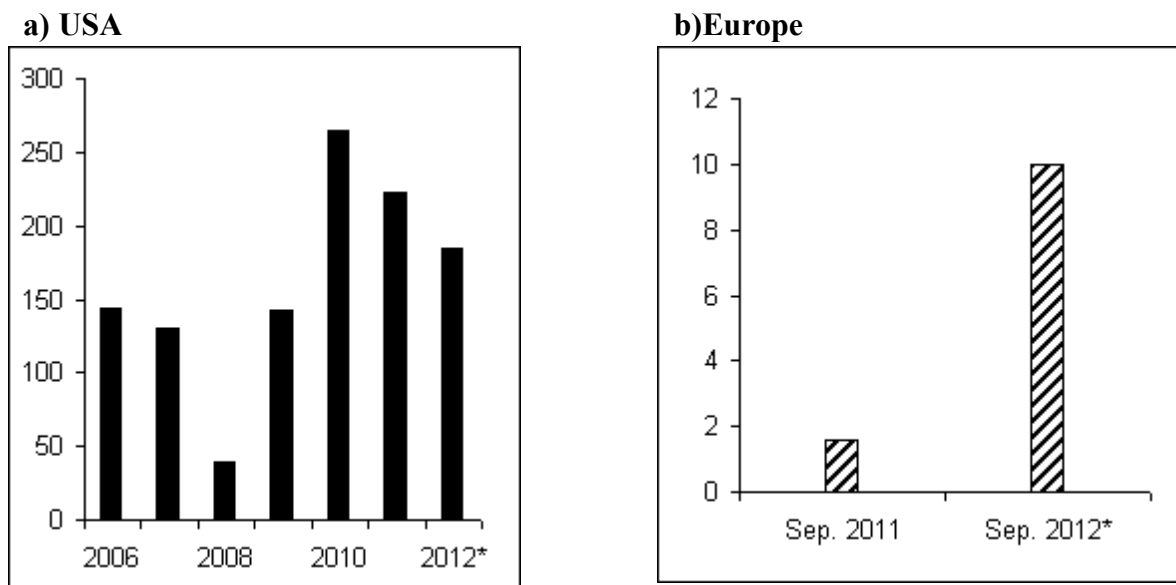
Source: US Fed.

Fig. 16

Junk instruments offering high yield are back in fashion (see Fig. 17). The growing prices for such instruments result in their lower yields, which may currently reach 4 to 5% (and not 10% and more, which is typical for securities of their grade). The demand for riskier and higher yield debt securities as an alternative to treasuries is expected to persist (Lattman, 2012). In other words, the negative trends that aggravated the development of the last crisis are re-emerging.

The growing volumes of derivatives in major financial institutions raise equal concerns. For instance, the amount of derivatives in the top six banks of the US (accounting for 50% of assets of the US banking system) exceeds the pre-crisis maximum by more than 1.5 times (see Fig. 18).

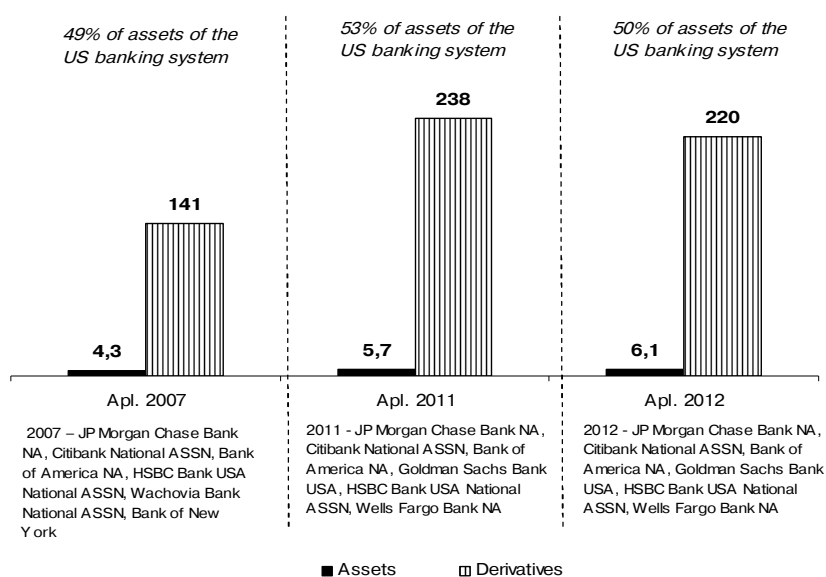
Junk bond growth (USD bln)



Sources: a) Lattman, 2012; b) Financial News. 2012. Sept. 25.

Fig. 17

Assets and derivatives of the top 6 US banks (USD trln)



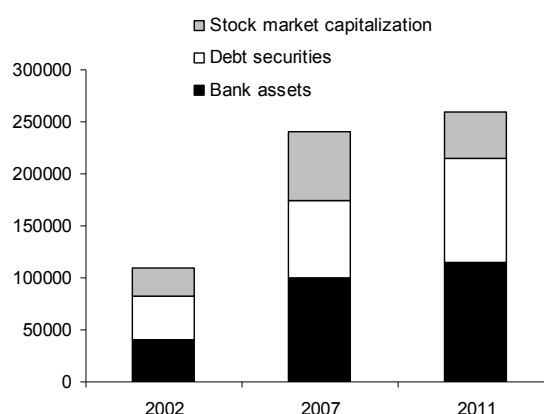
Source: US Comptroller of the Currency.

Fig. 18

We remember the negative role they played in spurring up the crisis of 2007-2009. Although some say that this growth results from portfolio restructuring and from attempts to mitigate and distribute risks, we have heard similar arguments prior to crisis as well.

In general, despite the global crisis trends, the post-crisis size of the global financial system has grown (see Fig. 19). The volumes of bank assets and of the debt security market have grown, while the stock market capitalization has diminished.

Size of the global financial system (USD bln)

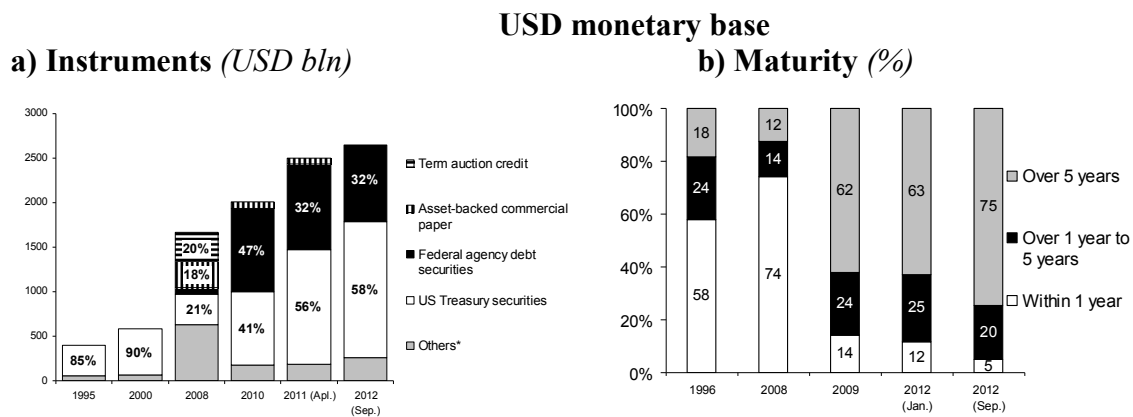


Source: IMF, Oct. 2012.

Fig. 19

Large-scale long money creation in the world

Central banks of all developed countries continued creating long financial resources and on the whole expanded the long money supply in the economy (see Fig. 20 to 23). For instance, in early 2012, the US announced an approach that provided for an increase in the share of long treasury bonds while reducing the share of short securities in the Fed portfolio (Operation Twist) that was repeatedly reiterated later (including the FOMC meeting in September 2012). As a result, more than 90% of the total amount of USD injected into the economy was created by the Fed by buying long treasury bonds (up to 30 years).⁴

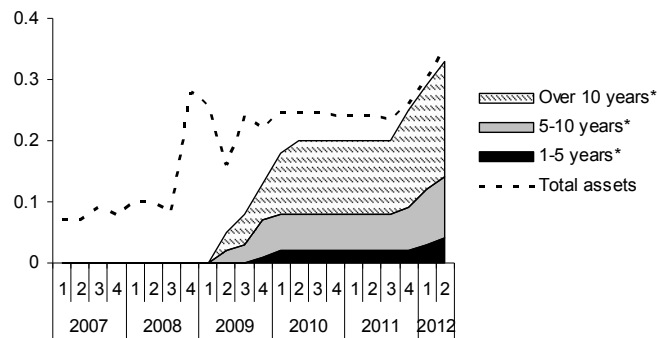


* Other include: receivables, swaps, gold, loans, etc.

Sources: US Fed; based on US Fed data.

Fig. 20

GBP monetary base (GBP trln)



* Gilts (government securities) holdings of the Asset Purchase Facility.

Source: BIS, June 2012.

Fig. 21

Other central banks also relied on the creation of a long monetary base. The ECB launched a Long-Term Refinancing Operation program (LTRO) in the scope of which more than

⁴ For more details see: Ershov, 2011

1,200 participants received more than EUR 1 trln at two auctions alone. Most funds were raised by Italian and Spanish banks (see Fig. 24.)

Russian approaches to necessary liquidity supply are totally different from those of the developed economies. The same amount of liquidity that was derived by the Russian economy from crude exports over 10 years (!) was raised in the Euro Area by running two rounds of money creation (purely emission-like in nature) within several months; the rounds that, by the way, were not accompanied by depletion of a non-renewable resource base.

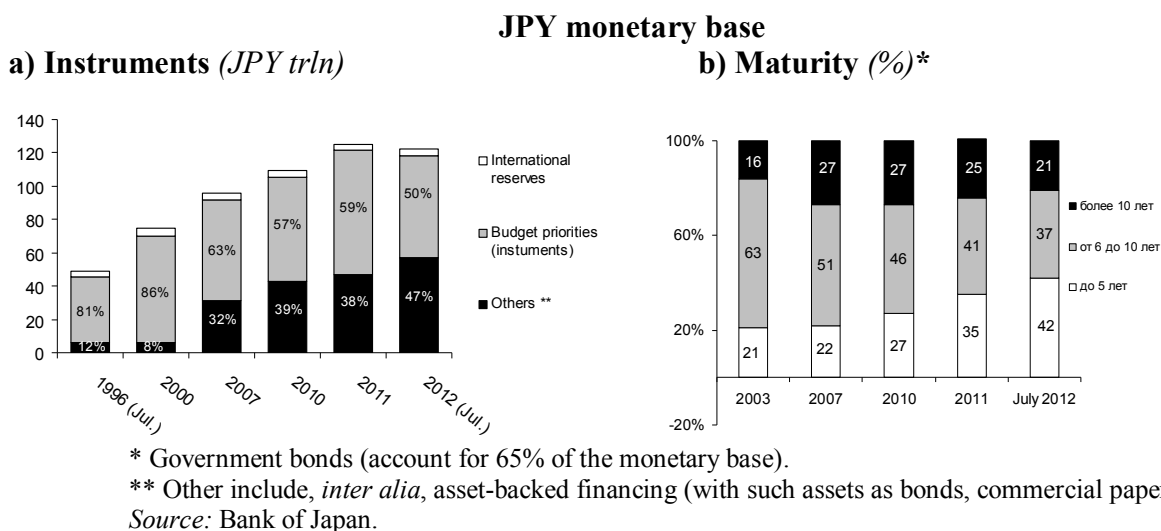
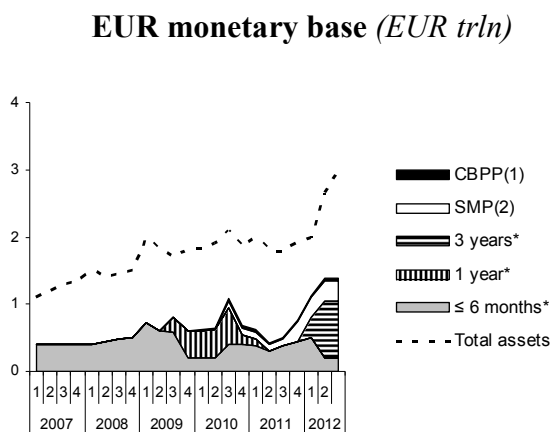


Fig. 22



(1) Covered bonds held under the Covered Bond Purchase Programme CBPP1 and CBPP2.

(2) Securities held under the Securities Markets Programme.

* REPO.

Note. Assets on the ECB's balance sheet also include gold, claims to Euro Area non-residents in foreign currencies, claims to Euro Area residents in Euro, claims to Euro Area non-residents in Euro etc.

Source: BIS, June 2012.

Fig. 23

We would highlight again the leading role of the central bank (ECB) in the reinforcement of the foundations of the local financial system in the aftermath of crisis (see Fig. 25). Moreover the situation with liquidity in the Euro Area is so complicated that it allows the ECB to draw the

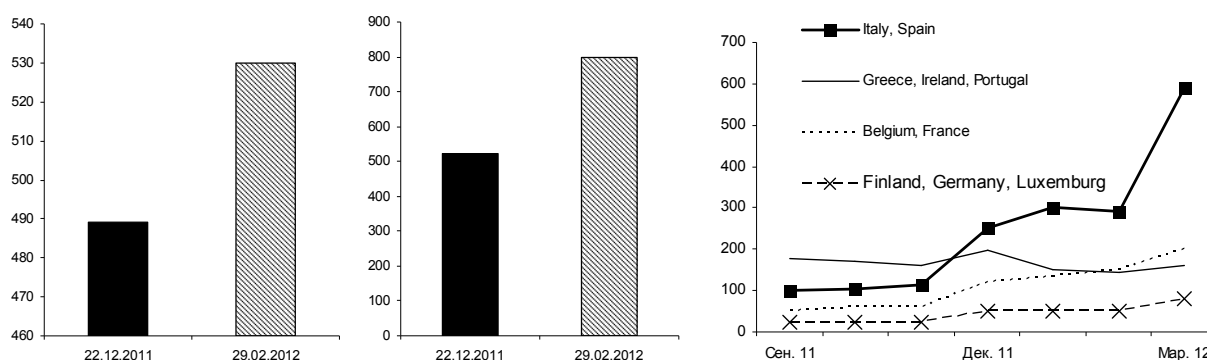
following conclusion: ‘Without recourse to Eurosystem refinancing operations, the banking sector will not be able to cover its liquidity needs.’⁵ In other words, problems in the Euro Area economy and financial sector are so significant that the banking sector will be unable to operate properly by itself in the current post-crisis situation without support of regulators. The decisive role of the ECB is also obvious when it comes to the future of the European currency. According to the ECB management, given the ‘amount of *political* capital that is being invested in the euro.... the ECB is ready to do whatever it takes to preserve the euro (highlighted by the author. — *M. E.*)’ (Draghi, 2012). We have previously indicated that ‘the political factor rather than economic one was decisive when Euro was created. This is likely to continue in future’ (Ershov, 2011. P. 247). Taking into account the political effort that was put into the creation of the single currency it looks quite likely that the European currency will be preserved. ‘Unless global destabilization is on the agenda, then it is obvious that decisions of international players should focus on retaining Euro positions in the international monetary system’ (Ershov, 2011. Pp. 247-248).

Euro Area: Long-Term Refinancing Operations (LTRO) of the ECB

LTRO allotted to banks by ECB
(EUR bln)

Number of banks
seeking LTRO funds

Use of ECB LTROs,
(USD bln)

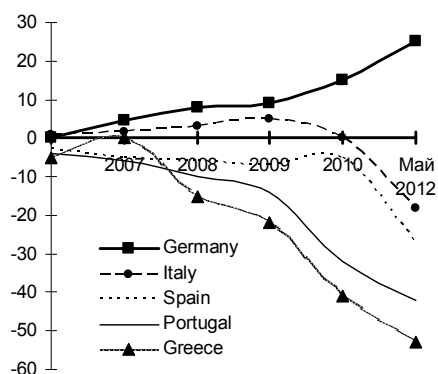


Sources: ECB; BIS, June 2012.

Fig. 24

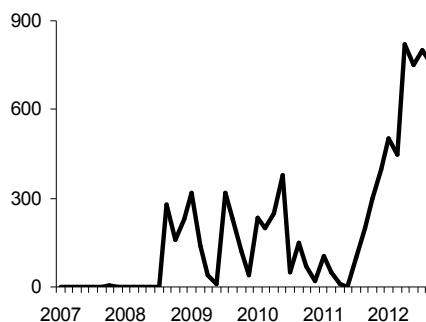
⁵ ECB, April 2012

Claims of Euro Area national banks to the ECB (% GDP)



Source: IMF, July 2012.
Fig. 25

Deposits with national central banks of the Euro Area (EUR bln)

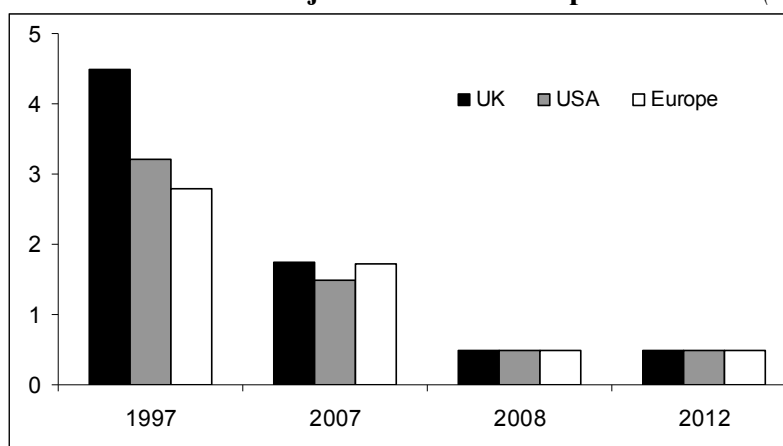


Source: BIS, June 2012.
Fig. 26

Market players seek to keep large amounts of available liquidity. For these purposes, they place their free cash in interest-bearing deposits with their central banks (see Fig. 26).

In general, as a result of the massive supply of liquidity to banks and their capitalization growth, their share prices approached the balance sheet figures (while the gap between those figures was significant before the crisis) (see Fig. 27). In some countries (Germany, France), banks' shares grew in price. This testifies to their capitalization growth, which on the whole leads to the creation of 'stability centres' in the system. (It was quite the opposite in Italy, Spain and some other countries where banks' shares became cheaper, i.e. their measures of capitalization proved to be insufficient, with the market perception being still sceptical about the outlook of these banks). Furthermore, the market becomes fragmented in Euro countries, which constrains resource flows and impedes the equalisation of interest rates (we would remind that the market fragmentation was also in place in USSR in its last years).

Price to book ratios of major banks in developed countries (times)



Source: Bank of England, June 2012.

Fig. 27

The capital adequacy issue may need additional attention once again when adopting Basel III accounting principles. Among other things, they require withdrawal of various elements from equity that are currently still recognized as equity and play an important role (see Table 3).

Given the nature and scale of problems developed countries are facing, they need to reinforce fiscal integration in addition to the existing currency integration. The set-up of a banking union that would provide stricter regulation and harmonization of supervision and control in EU Member States becomes intensely relevant. In this connection, the European Commission expects to adopt a draft law by the end of 2012 that would harmonize all national economic ratios for banks, bank reorganization procedures, deposit insurance, etc. Additional requirements to the capital of systemically important financial institutions (SIFI) are important, which becomes even more important in the light of persisting capitalization issues.⁶ Given the scale of the US financial system, and its role in recent crisis processes and challenges it is still facing, we would highlight the progress in adoption of the “Audit the Fed” bill (H.R.459) that has been approved by the US Congress with 327 votes ‘for’ against 98 ‘against’ (see Insert 2).

Table 3

Trust Preferred Securities TruPs in some major banks*

Bank	Share of TruPS on the capital, %
JPMorgan Chase	10.2
Citigroup	9.5
SunTrust Bank	8.9
Capital One Financial	8.7
Bank of America	6.2
Goldman Sachs	3.8

* Data as of 31 March 2012

Note. The law provides, among other things, for restrictions for Tier 1 capital regarding hybrid instruments (that combine debt and capital parameters), such as trust-preferred securities (TruPs); a hybrid instrument is recognized in Tier 1 capital and has high values. TruPs will be fully withdrawn from Tier 1 capital of US bank holding companies (with balance sheets above USD 15 bln) by 2016, i.e. even faster than under Basel III plans.

Source: IMF, Oct. 2012.

Insert 2

About Audit of the Fed

Such key operations of the US Fed as monetary operations, including discount window loans (providing direct lending to financial market players); open market operations; transactions with foreign governments and with foreign central banks are still excluded from the scope of the audit.* It looks quite odd that key functions of the central bank (such as implementation of the monetary policy) cannot be controlled by taxpayers.

⁶ The instability of the US and global economies compels certain countries, such as Germany, to take additional measures to strengthen their financial systems. For example, in October 2012, Deutsche Bundesbank decided to repatriate a part of its golden reserves held in the US (the gold was expatriated during a period of tension with the Warsaw Pact countries). A part of the German gold is also held in the UK and in France.

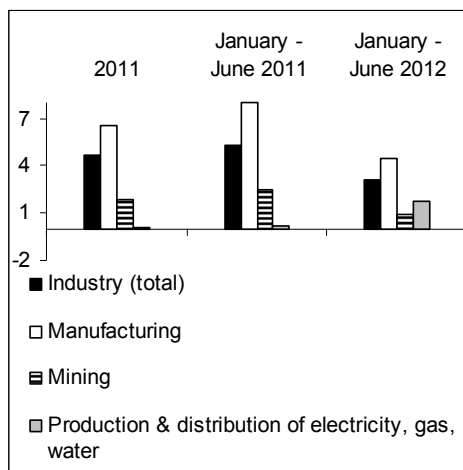
One can hardly understand how in principal such modern economic system, which declares itself open and transparent and which requires openness from others, remains so non-transparent in its key operational spheres. And why has this issue not been brought to the agenda (which should have been done many decades ago!) and positively solved at once? Can the taxpayer be so indifferent (or powerless?!) in the environment of the so called "developed democracy" so as to ignore such pivotal issues that relate to the operation of the national economy. Only a large-scale and profound crisis made it possible to raise voices about this issue and try to solve it as it is solved in other civilized countries. Quite naturally, these initiatives were opposed by the Fed management who qualified a wide-range audit as a 'nightmare scenario' (Dinan, 2012). Despite such a negative response, it still looks likely that the bill may be approved.

* The Federal Banking Agency Audit Act, 1978 (31 U.S.C. 714).

Some Russian risks in the post-crisis world

In the context of persisting high external risks, the Russian government needs to have strict control over the trends of national economic development that may be especially noticeable under external shocks. A higher role of internal factors compared to external ones has become an important parameter in the operation of the Russian economy in the recent years. We would note that the transition from a growth-model which is based on exports and external demand to a growth-model primarily relying on domestic drivers (the latter is a feature of more developed and mature economies where domestic demand is the key growth driver) testifies to better quality of such growth in general. The higher role of manufacturing industries vis-à-vis extracting sectors, which has been also recorded in Russia in the recent years testifies to the above fact (see Fig. 28-29).

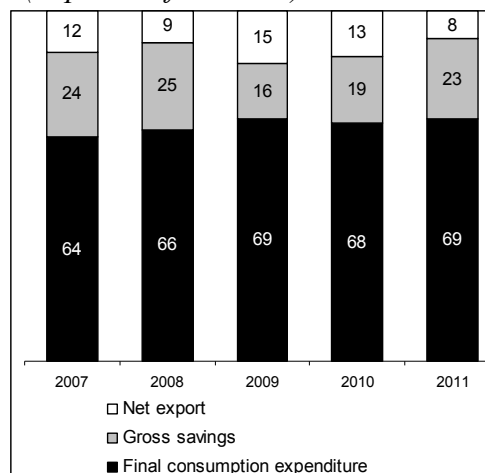
Industrial and sectoral growth in Russia (% year-on-year)



Source: Russian Federal State Statistics Service.

Fig. 28

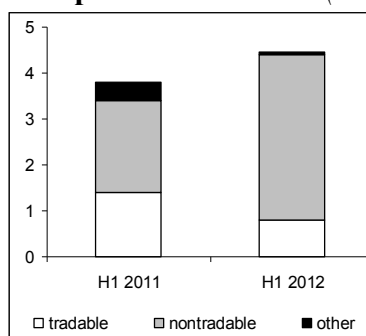
Elements of GDP use in Russia (in prices of 2008, %)



Source: Russian Federal State Statistics Service.

Fig. 29

GDP growth composition in Russia (% year-on-year)



Source: World Bank, October 2012.

Fig. 30

Likewise, nontradable operations, which actually illustrate the input by non-export sectors in the economic growth, have become more important (see Fig. 30). In this connection, we would agree with the statement by the Ministry of Economic Development that the ‘support of the economy by means of government demand is of special relevance in the current macroeconomic reality where the export sector has lost its role of a strong economic growth driver’. Moreover, while in 2003-2007 more than half of economic growth (3.5 to 4 percentage points out of 7 to 8% of GRP growth) was contingent on external economic factors, in the coming three years their impact is expected to be less than 1 percentage point.⁷

We would remind that until recently the Russian monetary policy focused on external sources of money supply (mainly export receivables and external debt). As a result, the financing of domestic economic processes did depend on the opportunity to draw on external loans and on the global juncture. This actually made a “home-bias” of monetary policy (which is the case in

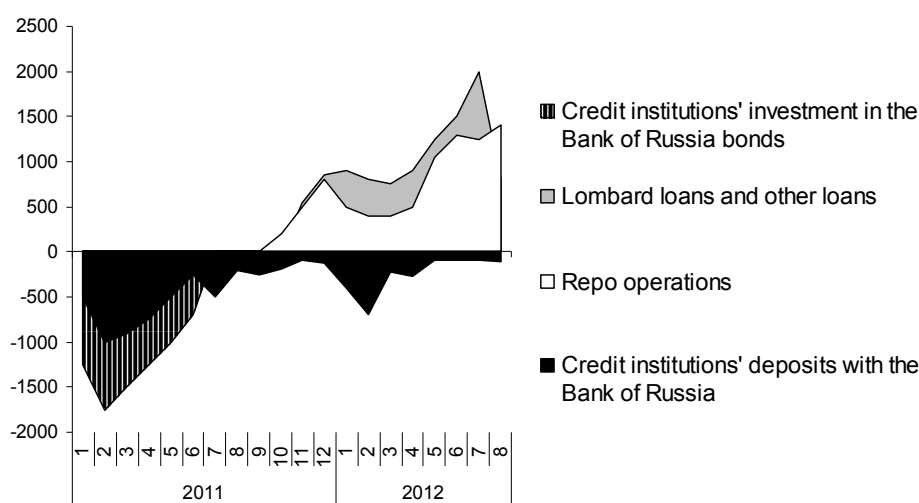
⁷ government.ru. 20 September 2012.

developed countries where domestic component of monetary approaches prevails) less efficient, diminishing the role of its domestic focus.

Moreover, such approaches fail to solve the long-standing, but still relevant issue of long money creation in the economy: in mature financial systems, monetary authorities have always been at the origin of such processes, while their role has become decisive after the crisis. Given that the Russian economy will be unable to achieve its long-range systemic goals without generating the appropriate amount of long investment resources, Russia has to choose between two principal options to achieve these goals. Either enter international markets where such resources are abundant and relatively low cost, for monetary authorities do everything they can for this (see above). This path, however, will mean a rising external debt for the Russian economy. Or, and this path seems to be more reasonable for a nation that intends to play a systemic role in the global economy, to make its national monetary and financial approaches comparable to those practiced in developed and mature financial systems. This is also extremely important given the accession of Russia to the WTO where our competitors can rely on large-scale, long and cheap financial resources, and where regulators take important steps to stimulate the economy.

Recently, in the context of post-crisis instability, Russian regulators also intensify their presence in the Russian economy (see Fig. 31). Among other things, they increase money supply by expanding gross lending to banks (its volume reached about RUB 1.5 trln from January to July this year).

Bank of Russia gross credit to credit institutions and Bank of Russia debt on absorption operations (RUB bln)



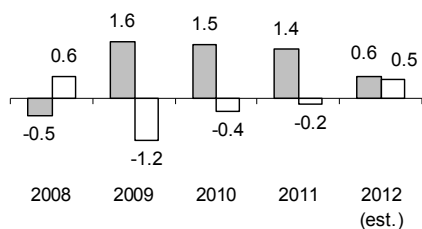
Source: Guidelines for the Single State Monetary Policy in 2013 and for 2014 and 2015: Draft (October 2012) / Bank of Russia.

Fig. 31

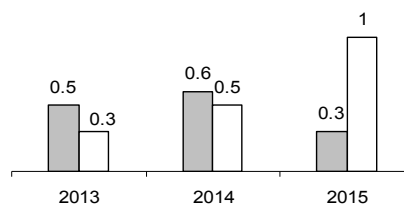
The Bank of Russia estimates that, in 2012, ‘the reduction of money supply via the foreign exchange channel will be substituted by an increase in the refinancing of lending institutions’.⁸ At the same time, since the coming years are expected to record a smaller surplus of trade balance, ‘on the back of the growing need of the economy for resources to finance domestic investments, this will cause the need to increase external borrowings’.⁹

The money supply creation based on external factors starting from 2013 also testify to the above (see Fig. 32). (In 2015, however, the trend is expected to reverse towards an increase of the domestic component). Residents are assumed to expand their international borrowings.

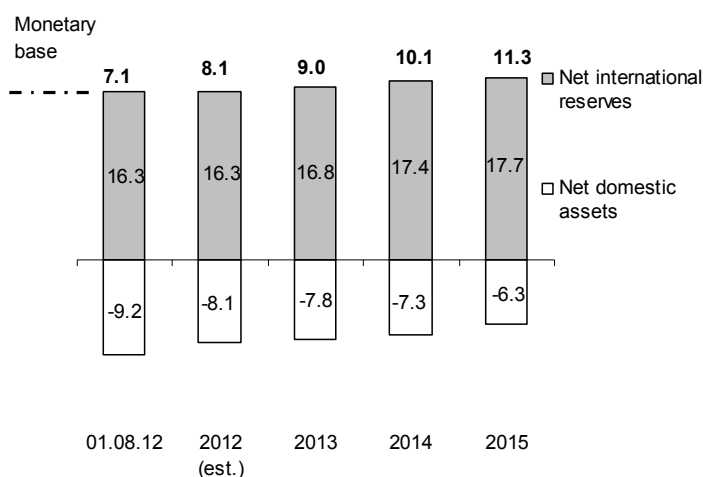
a) Growth of monetary programme indicators
(as of the end of the period, RUB trln)



b) Planned growth of the monetary programme from 2012* (RUB trln)



c) Rouble monetary base generation sources (RUB trln)*



* 2012: estimate by the Bank of Russia (October 2012), 2013-2015: forecast by the Bank of Russia, baseline (second) scenario of the monetary programme starting of 2012

Source: Guidelines for the Single State Monetary Policy for respective years.

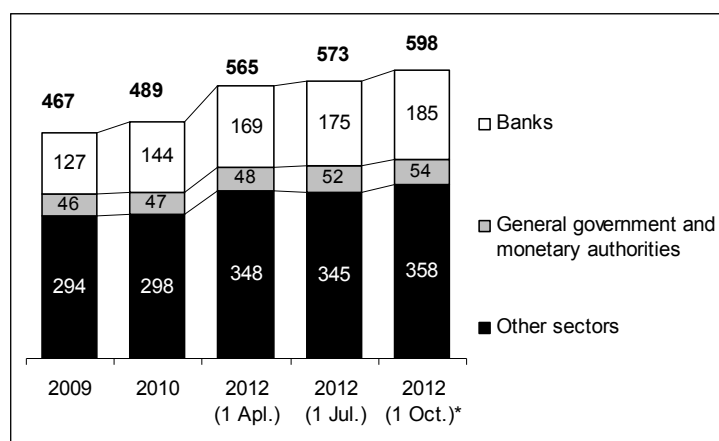
Fig. 32

At present the role of international funding sources is rising again. Again, the external debt of Russian companies and banks is growing (see Fig. 33).

⁸ Guidelines for the Single State Monetary Policy in 2013 and for 2014 and 2015 P. 17.

⁹ Ibid. P.23.

Russian external debt (USD bln)



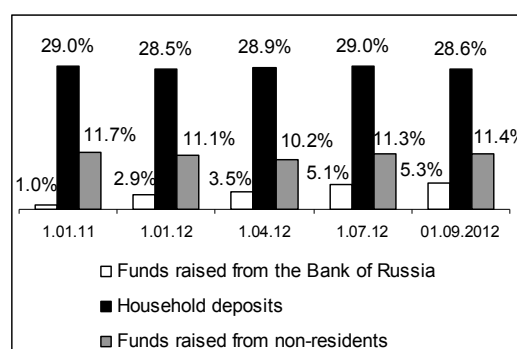
* Estimate.

Source: Bank of Russia.

Fig. 33

The share of non-resident resources in the funding of Russian banks is starting to grow again. Moreover, the role of the central bank itself is also increasing, while the contribution by domestic market players is changing insignificantly (see Fig. 34).

Breakdown of liabilities of Russian banks (%)



Source: Bank of Russia.

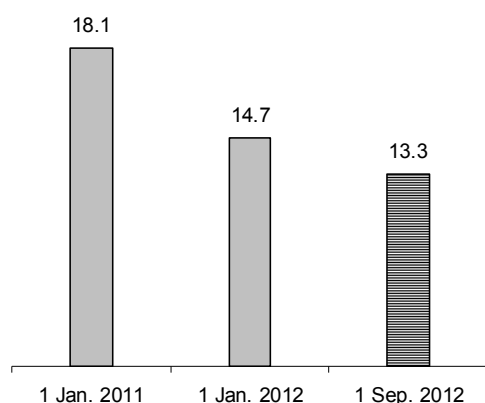
Fig. 34

It is also worth noting that active operations by banks (primarily lending) tend to grow at accelerated rates as compared to their capital growth, which results in a gradual decrease of their capital adequacy ratio, thus decreasing the stability of the banking system (see Fig. 35). In general, in BRIC countries growth of real lending outpaces growth of real GDP (see Fig. 36).

The growth rates of consumer lending in Russia were so high (estimated at 60% a year),¹⁰ that the Bank of Russia announced its plans to tighten relevant regulations. Among other things, the Bank of Russia is planning to double the reserve requirements to unsecured retail loans since March 1, 2013.

¹⁰ Central Bank Expresses Concerns About Fast Consumer Lending Growth //Vedomosti. 2012. 5 October.

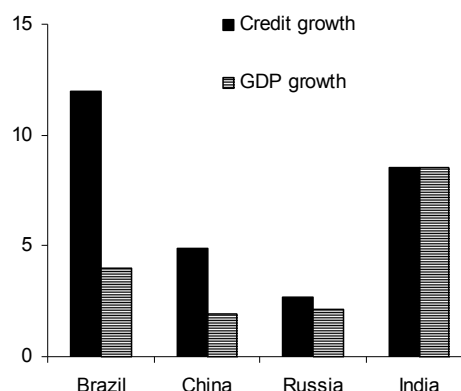
Capital adequacy ratio (H1), Russia (%)



Source: Bank of Russia.

Fig. 35

Real GDP and lending growth in BRIC countries (%)*



* In real terms, over 3 years, as of June 2012

Source: BIS, June 2012.

Fig. 36

About the WTO

The above trends in the economy and banking system become vital due to the accession of Russia to the WTO. The Russian financial system now should support both its own competitiveness and appropriate funding of other economic sectors, this time against much tighter competition.

We have shown above how regulators of major nations support their economies. If approaches of Russian regulators are inappropriate, and business environment (funding opportunities, availability of necessary long money, its cost, etc.) becomes tighter, this will actually mean that each Russian company will find itself in less favourable conditions as compared to its foreign competitors. In such case, the basic WTO principle of ‘factually equal competitive opportunities’ (as opposed to implicit barriers which create conditions of competitive disadvantage) will be breached. (Compare to boxing: formally, the rules are the same for everybody, but you will never see a heavyweight fighting against a light-weight sportsman. Moreover, given the differences in regulation and training opportunities, a light-weight sportsman would wear heavier shoes that limit his mobility). Furthermore, in global terms, Russian companies (save for some exceptions from the commodity sector) are still rather small: of 2,000 largest companies in this year Forbes list, only 20 companies are Russian, while only 4 made it to the top hundred. Cf.: the list comprises about 530 US companies (31 in the top hundred), about 140 Chinese firms (8 in the top hundred), and about 100 German businesses (7 in the top hundred).¹¹

¹¹ forbes.com/global2000.

Even more important is that, due to essential differences in regulation, Russian market players will actually have to compete against the economic *systems* of developed nations rather than against individual foreign companies. For such foreign companies will be able to fully rely on the entire strength of their economies and on large-scale business support mechanisms, while support of Russian business by Russian regulators is more modest. The outcome of such competition is obvious.

Russian regulators did manage to mitigate the crisis in the recent years. But we need to set up a systemic, long-range and efficacious environment for diversification of the economy which enables its departure from commodities-led and export-led growth to growth based on manufacturing sectors and business development. In such a new competitive environment, regulators should totally revise their approaches to offer Russian market players and the overall economy factually equal competitive opportunities that match the new geoeconomic reality.

* * *

The situation in developed economies is still not simple. Intensive crisis management efforts have reduced the severity of the past problems, but the problems themselves have not disappeared. Decisions taken give rise to new risks. Furthermore, many problems became more intense at present: the EU crisis, excessive debts, global liquidity glut against the backdrop of its deficit in a number of market segments, the ‘fiscal cliff’¹² in the US, etc. Problems that are building up pose risks of systemic disruptions. Famous international investor M. Faber estimates that in the coming 5 to 10 years, there will be ‘a colossal mess ... everywhere in the Western world’.¹³ Even according to more moderate estimates by O. Blanchard, Chief Economist of the IMF, ‘it will surely take at least a decade from the beginning of the crisis for the world economy to get back to decent shape’ (Inman, 2012).

Let’s hope that the less negative scenarios will occur. But even in that case strong efforts will be required from Russia and other countries to neutralize external shocks and ensure a steady economic growth. With Russia being now in the WTO and with competitive risks for national companies and the entire national economy thus emerging, these challenges become even more important. It is obvious that in such circumstances robust industry and banks that lay economic basis for the country as well as active economic policy of the government are extremely important for stable and long-term development of Russia (Ershov, 2011).

¹² Automatic cut-down of budgetary expenditures and tax allowances in the absence of agreement on the budget deficit reduction.

¹³ cnbc.com. 2012. Oct. 22.

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