

Post-Crisis Global Financial System: development trends and main issues¹

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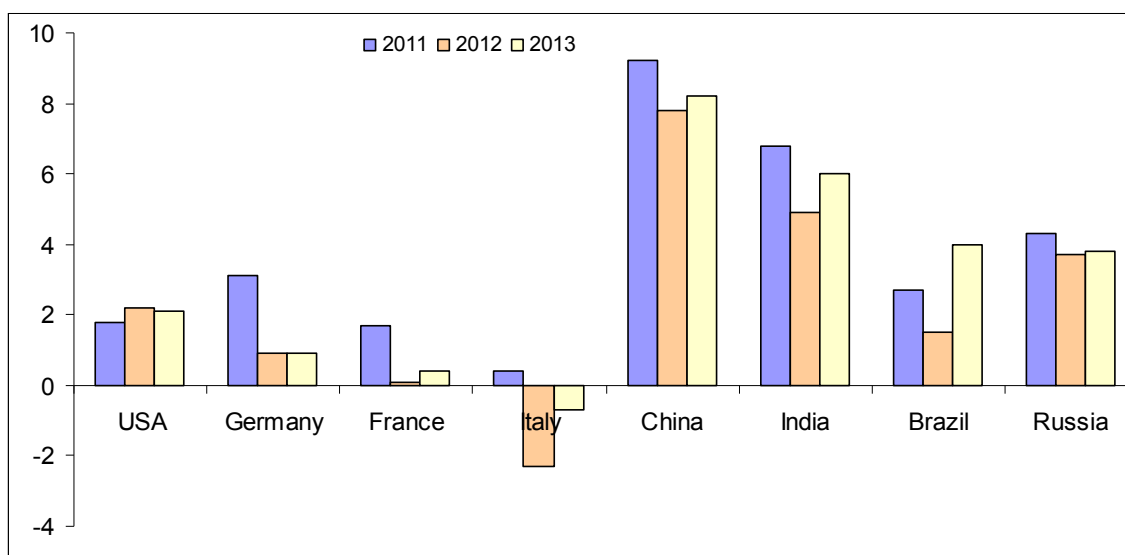
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The OECD forecasts the modern world to face large-scale changes in the mid-term. The aggregate GDP of China and India² is forecast to exceed the total GDP of G7 and even that of the OECD in the coming 50 years³.

It's possible that such systemic shifts would be preceded by significant disturbances in the global economy. Renowned international investor M. Faber estimates that in the coming 5 to 10 years, there will be ‘a colossal mess everywhere in the Western world’⁴. As such, an analysis of current development trends, their risks and outlooks becomes extremely important.

The post-crisis world has recorded some economic growth in most major countries (Fig. 1).

The situation, however, looks challenging. IMF Chief Economist O. Blanchard estimates that ‘it will surely take at least a decade from the beginning of the crisis for the world economy to get back to decent shape’⁵. The IMF also believes that ‘despite recent favourable developments in financial markets, risks to financial stability have increased since the April 2012 ... the euro area crisis remains the principal source of concern’⁶.



Source: IMF, October 2012.

Fig. 1. GDP growth rates in 2011 (actual) and 2012-2013 (forecast), %

¹ This article reflects the personal opinion of the author.

² At the purchasing power parity for 2005.

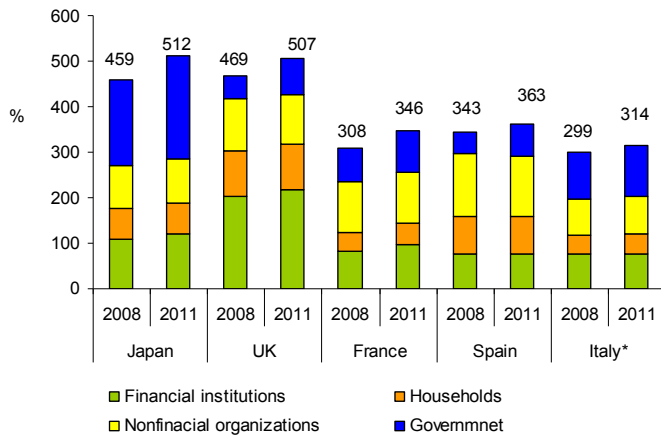
³ OECD, November 2012.

⁴ www.cnbc.com (October 22, 2012).

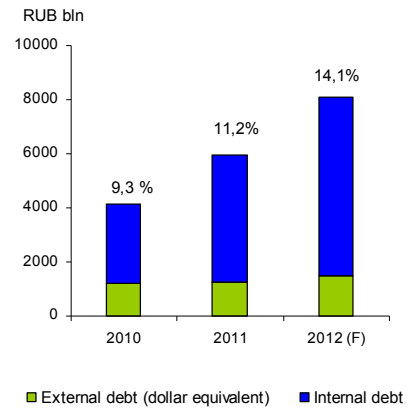
⁵ No recovery until 2018, IMF warns. The Guardian, 2012, October 3.

⁶ www.imf.org

a) Debt level in some advanced economies (2008 – Q2 2011), % of GDP



b) Government debt in Russia (RUB bln, % GDP)



* Q1 2011 data

Source: McKinsey Global Institute, January 2012.

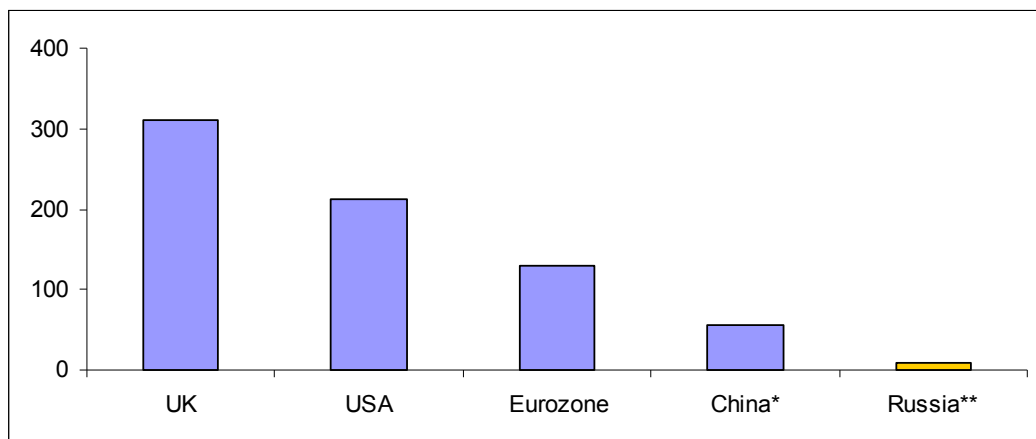
Source: Russian Ministry of Finance.

Fig. 2. Global debt growth

National regulators, mainly ministries of finance and central banks, used all their power to halt the development of crisis processes worldwide, which, naturally, had both - positive and negative effect. Among other things, many countries saw their debt increase (Fig. 2).

About the role of central banks

After the crisis, central banks whose assets have grown sizable have started playing an even more significant role (Fig. 3).



* growth in 2008-2011

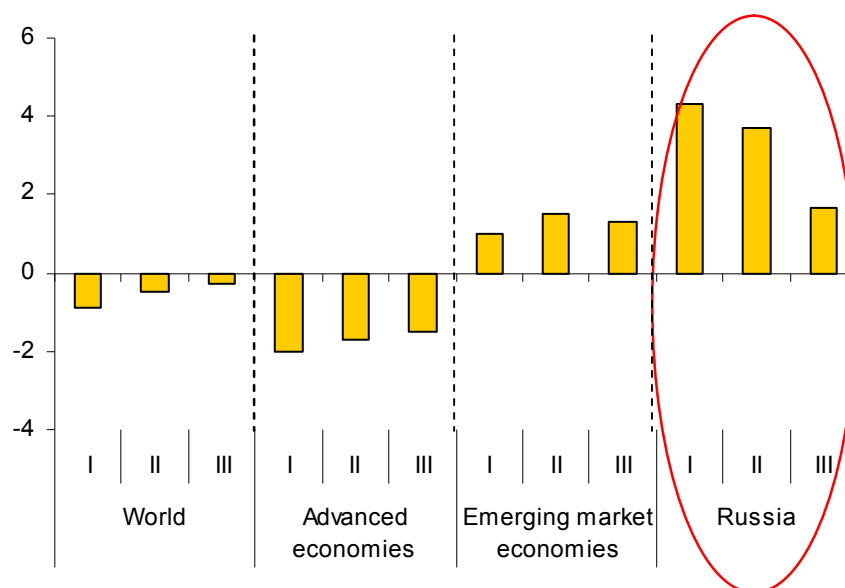
** growth in 01.01.2008-01.01.2012

Source: Bank of England, US Fed; ECB; BIS; Bank of Russia.

Fig. 3. Growth of total assets of central banks from 01.01.2008 to 01.08.2012 (%)

Their role as a source of short- and long-term financial resources has become ever more important, while the price of recourses which are provided hit record lows and reached lower-

than-inflation levels (Fig. 4). In this connection, the phenomenon known as *liquidity trap* is spreading ever wider.



Source: BIS, 2012. June; Bank of Russia.

Fig. 4. Real refinancing rates (broken down by groups of countries), 2012, %

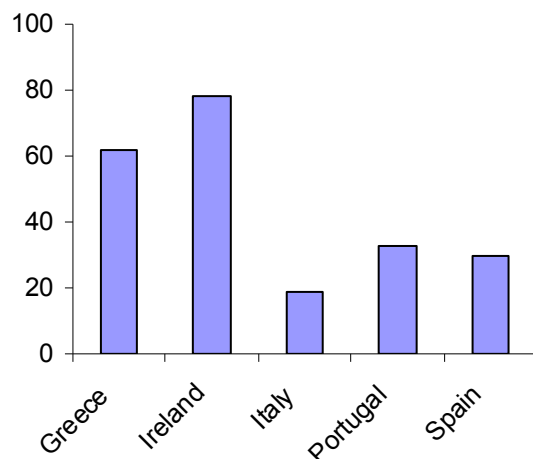
We know that in Russia the refinancing rate plays more of a fiscal rather than monetary role. But even in Russia the refinancing rate serves as a benchmark for other rates and the market overall (otherwise why would we need to change it on a regular basis? Surely not just for fiscal adjustments?!). Much softer policies of other countries are believed to help them be more efficient in overcoming crisis consequences and bolster growth.

REPO mechanisms currently play an important role in the funding of the economy (primarily short-term).

As of early 2010, the US REPO market stood at USD 12 trln (EUR 8.8 trln). The European Central Bank (ECB) estimates that as of December 2011 the European REPO market was EUR 6.2 trln⁷.

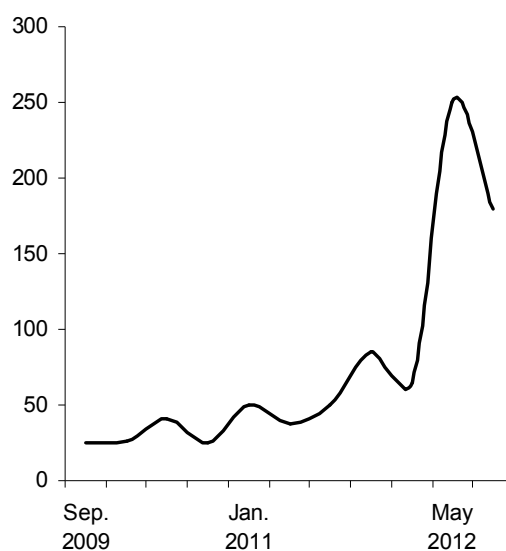
In general, some Eurosystem countries have to borrow from the ECB and national central banks on a large scale (Fig. 5 and 6).

⁷ ECB. April 2012.



Source: IMF, October 2012.

Fig. 5. Borrowings from central banks as of July 2012 (% GDP, 2011)



Source: IMF, October 2012.

Fig. 6. Eurosystem: claims to the banking sector (EUR bln)

The exposure of commercial banks to the central bank has become so heavy that the ECB has had to admit that the banking sector will not be able to cover its liquidity needs without recourse to Eurosystem refinancing operations⁸.

In the recent years, the participation by the Eurosystem (that includes the ECB and national central banks of euro area Member States) in financial assets of the euro area has increased by more than 60% (Table 1).

⁸ Ibid

Shares in the total assets of financial institutions of the euro area

	2007 (Q2)	2011 (Q2)
	% of total assets	% of total assets
Banks	54.0	51.5
Other financial intermediaries	17.9	19.9
Eurosystem	3.5	5.8
Other	24.6	22.8

Source: ECB. April 2012.

If we consider the primary role played by banks (particularly in Europe and in Japan (Fig. 7)) in accumulating financial resources of both households and other financial market players, we will see that financial support given to the banking sector looks quite clear.

Enhanced role of “long” money

The European Central Bank has been extensively recurring to LTRO (*long-term* (three-year) *refinancing operations*) to expand its lending and investing capabilities (Fig. 8).

For two LTRO rounds only, their participants have obtained more than EUR 1 trln. We would point out the difference in *ideologies* of approaches used in the euro area and in Russia: 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 (note that they were not accompanied by depletion of a non-renewable resource base.).

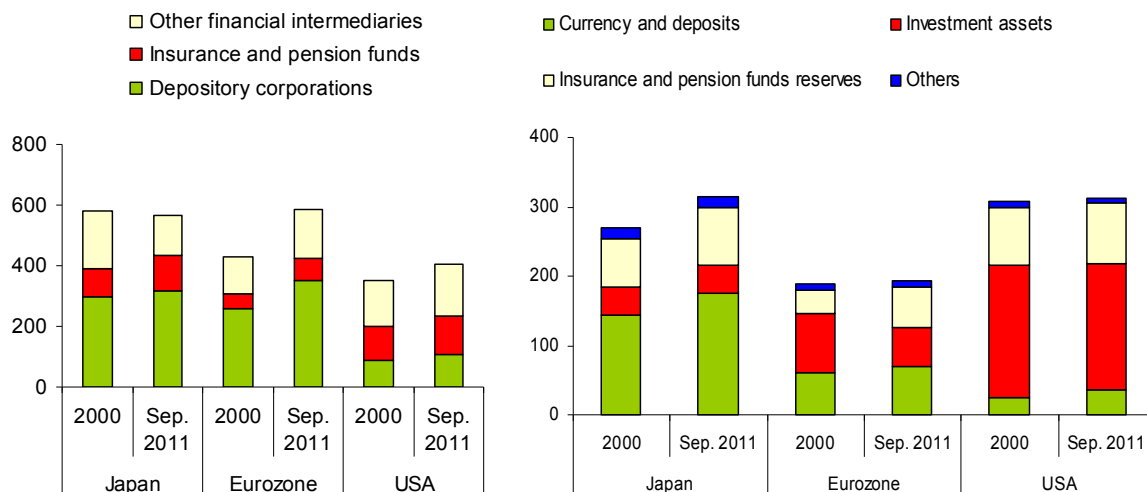
When it comes to creating long-term funds in the developed countries the “monetary-industrial” policy (*mondustrial policy*) starts playing increasingly important role. Such policy took shape during the crisis and post crisis and consists in the implementation of monetary approaches in correlation with industrial priorities, i.e. its sectoral and corporate elements⁹.

a) Size of financial asset holding by different

b) Type of Financial Assets held by

⁹ www.investopedia.com

financial intermediaries (% of nominal GDP) households (% of nominal GDP)



Source: Bank of Japan, April 2012.

Fig. 7.

LTRO allotted to banks by ECB (EUR bln) Number of banks seeking LTRO funds Use of ECB LTROs, (USD bln)

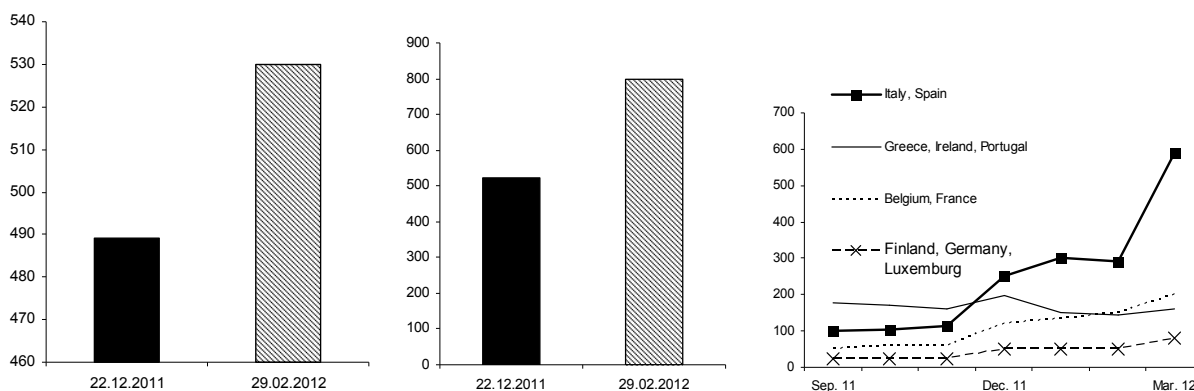


Fig. 8. Euro area: Long-term refinancing operations (LTRO) are expanding in terms of volume and the number of participants.

It is obvious that the real sector can only be supported if the economy has “long” money. Overall, major economies attach much importance to budget tools in the creation of the aggregate monetary base and especially its “long” component.

Fig. 9 and 10 show the principal channels through which the resource base of USD and JPY is created and which are used by the US Federal Reserve System and the Bank of Japan, respectively. The monetary base shown in the figures below actually indicates the total amount of USD and JPY that is currently circulating in the world. We can see that, at the time of their initial creation, about 90% of US dollars currently available across the globe were created as a result of funding allocated under various budget programmes. Then this money is channelled to

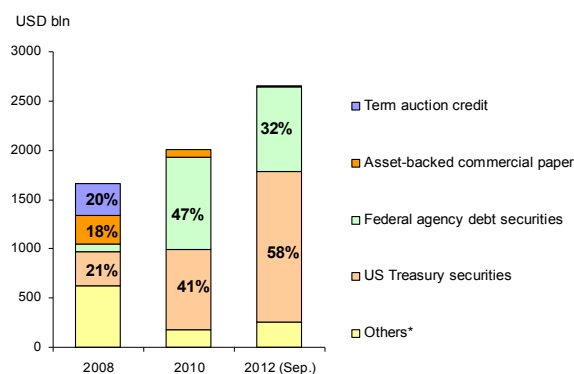
the secondary market and, through multiplication, turns into relevant monetary aggregates. Budget priorities also play a considerable role in the creation of JPY monetary base.

Such approaches are quite consistent over years and undergo only minor changes (that result rather from “fine-tuning” of monetary policy). Even during the years of budget surplus (e.g. in the late 1990s in the US) that should have decreased the role of the ‘budget factor’, the breakdown of portfolios did not change much, since cut-downs in funding as well as their reallocation to other targets could significantly damage the growth trends, which would have been undesirable.

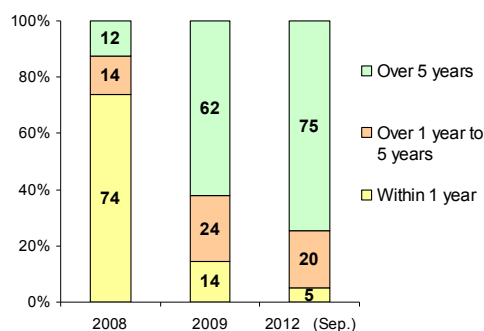
We would highlight that in the recent years (both before and after the crisis) money was created through “long” instruments (that account for at least 50% to 80% of the total monetary base) to build a more sustainable long-term basis for financial resources circulating in the economy.

A number of factors are of importance in this respect. First, securities bought by the central bank are not typically used in reverse transactions that imply the sale of securities in the market and sterilization of money created. Such government securities are usually placed on the balance sheet of the central bank until they mature (i.e. for the entire 10-, 15- or 20- years).

a) Instruments (USD bln)



b) Maturity (%)

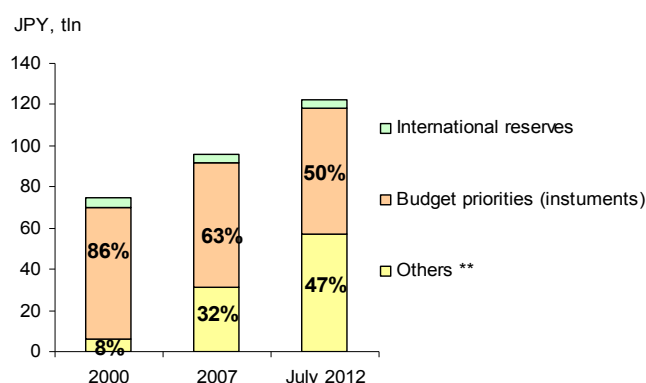


* Other include: receivables, swaps, gold, loans, etc.

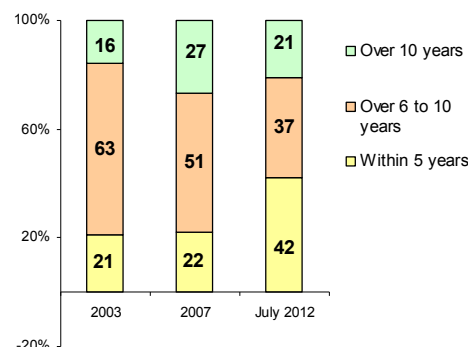
Sources: calc. based on US Fed data.

Fig. 9. USD monetary base (USD bln, %)

a) Instruments (JPY trln)



b) Maturity (%)*



* Government bonds (account for 65% of the monetary base).

** Other include, *inter alia*, asset-backed financing (with such assets as bonds, commercial papers, etc.).

Source: Bank of Japan.

Fig. 10. JPY monetary base (JPY trln, %)

To put it otherwise, the economy gets “long” and special-purpose/task investment resources. Moreover, when maturity expires, new emissions and purchases of securities often take place, which makes the process of maintaining “long” money in the economy virtually perpetual.

Second, the involvement of the central bank in the above mechanisms allows financing of budget targets without reducing the overall liquidity of the financial market. If government securities were simply offered in the secondary market, then, subject to interest by relevant market players for such securities, they would be purchased by private companies and banks, thus detracting funds since money invested by them would be used to finance the above government programmes. In such case, the money could not be spent for other purposes in day-to-day commercial operations (lending and so on). The economic science calls this phenomenon *crowding out*.

As a result, the picture where monetary authorities (the central bank - the ministry of finance) build a strong layer of special-purpose “long” money in line with the priorities of their economic policy (mortgage, small-business enterprises, regional programmes, etc.) becomes prevalent. Eventually, other sources of “long” money (pension, insurance, etc.) are added to create powerful financial environment that substantially expands investment opportunities.

Let us consider several issues given that the issue of “long” money has been extremely important for the Russian economy for a long time. Consider international markets where financial resources are indeed larger, cheaper and “longer” and where such money is, actually, created through the above mechanisms: are they the only opportunity to raise large amounts of affordable “long” money (which is necessary to address long-term challenges faced by the

Russian economy). We would also highlight that by raising such recourses the country is also increasing its external indebtedness.

Or on the contrary, is there a chance to start such mechanisms by ourselves where the key role is played by the national monetary authorities (as is the case of the strongest and the most mature financial systems of the world for many years)? In discussing this matter, we would prefer hearing a detailed technical (but not abstractly emotional, with “we-will-fail” type arguments) analysis of actual opportunities offered by this process, of existing risks (that will certainly be numerous) and of the ways to minimize them. There will surely be malfunctions and breakdowns, but is it a reason to say that the mechanisms are inoperable in general? Breakdowns (and often serious ones) do occur in all countries, but such countries have in place supervisory and regulatory authorities to prevent them. It’s like road traffic – everyone can violate the rules. But does it mean that the rules must be abolished because of such violations and that the traffic in general must be terminated? The answer is obvious.

Combating the credit crunch

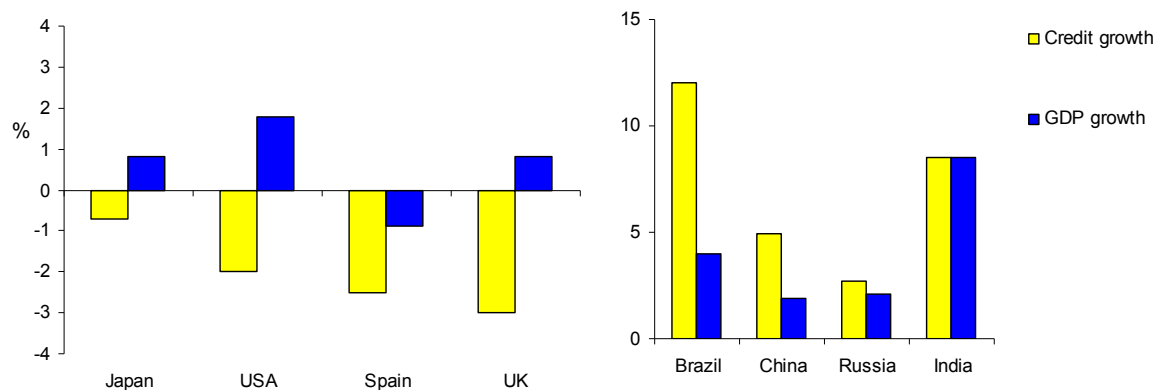
Despite all existing measures, the lending market in developed economies has stalled. ‘Healthy banks, with an ability to lend, are critical to the global recovery’¹⁰, is stated by the G20 summit of summer 2012.

On the whole, the credit crunch (Fig. 11) and large volumes of liquidity which is actually kept idle without getting into the economy reflect the persisting uncertainty of market players (primarily in developed economies) regarding their own stability and opportunities for growth.

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 approaches¹¹.

¹⁰G20. Los Cabos. June 2012

¹¹ See: *Bernanke B. Press conference. 20 June 2012*



Source: BIS. June 2012.

Fig. 11. Real GDP and lending growth in some countries* (%)

* In real terms, for three years, as of June 2012.

The post crisis financial sector records a number of other systemic processes. European banks tend to reduce their international exposure against the backdrop of *stronger national accents* in their operations. According to estimates by M. Carney, Governor of the Bank of Canada and Chairman of the Financial Stability Board, ‘unfortunately, the European financial system has aggressively renationalised in recent months. Intra-European cross-border lending - which had been growing by 25 per cent per year in the run-up to the crisis - has been falling at a rate of 10 per cent per annum since¹².’

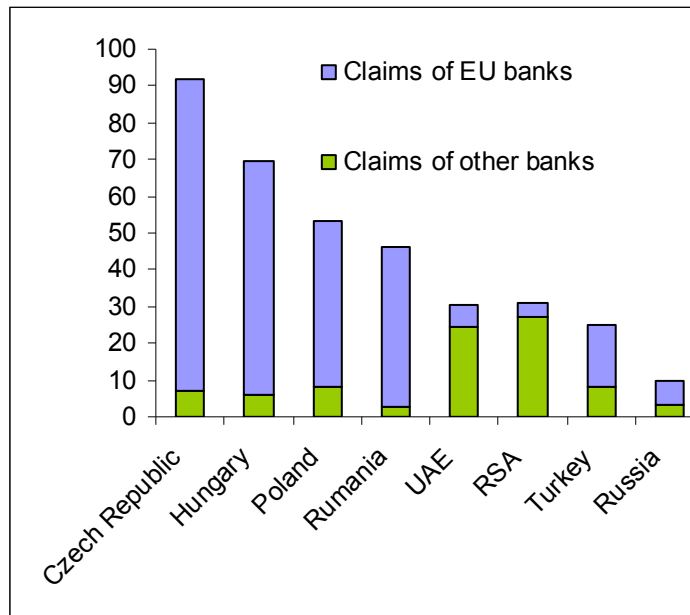
Speaking of the same issue, M. Sirakawa, Governor of the Bank of Japan, highlighted that ‘financial institutions have been increasingly asked to serve for the domestic ‘interests’ and sort of “financial nationalism” seems to have emerged¹³.’

Another peculiarity of the European post-crisis financial market consists in its *fragmentation* when different countries have different amounts of financial resources, their cost varies across regions, and the actual resources often tend to leave the countries of the European ‘periphery’ for more stable European economies¹⁴.

¹²Carney M. Financing the global transition, Remarks at the Atlantic Institute for Market Studies. Halifax. Nova Scotia. 21 June 2012.

¹³Remarks by Mr Masaaki Shirakawa, Governor of the Bank of Japan, at the Federal Reserve Bank of Kansas City's Annual Economic Symposium. Jackson Hole. Wyoming. 2009. 21 August.

¹⁴Speech by Mario Draghi, President of the ECB, at the 22nd Frankfurt European Banking Congress. Frankfurt am Main. 23 November 2012.

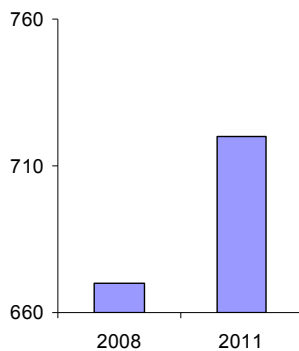


Source: Bank of Japan. October 2012.

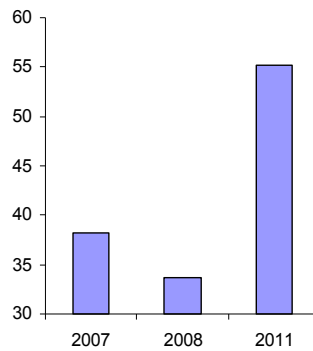
Fig. 12. Cross-border claims to developing countries (with regard to their nominal GDP),* %

* Data as of late March 2012. Nominal GDP of 2011.

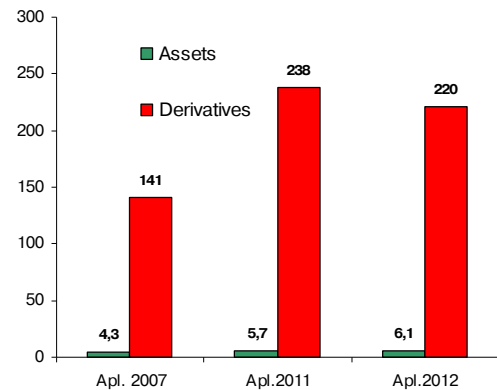
Size of OTC derivatives market (USD, trln)
a) World



b) Japan



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



Source: Bank of Japan. June 2012.

Source: US Comptroller of the Currency.

* 2007 – JP Morgan Chase Bank NA, Citibank National ASSN, Bank of America NA, HSBC Bank USA National ASSN, Wachovia Bank National ASSN, Bank of New York (49% assets of US banking system);
2011 – JP Morgan Chase Bank NA, Citibank National ASSN, Bank of America NA, Goldman Sachs Bank USA, HSBC Bank USA National ASSN, Wells Fargo Bank NA (53% assets of US banking system);
2012 – JP Morgan Chase Bank NA, Citibank National ASSN, Bank of America NA, Goldman Sachs Bank USA, HSBC Bank USA National ASSN, Wells Fargo Bank NA (50% assets of US banking system).

Fig. 13. Global growth of derivatives

Old risks return, new risks emerge

The crisis has become less acute across the world, but a number of risks persist or get even more pronounced.

Given the challenges faced by the European banking system, the situation when most European countries are almost totally exposed to lending by European banks requires thorough monitoring (Fig. 12). No doubt, if crisis becomes more intense, such situation might considerably aggravate the crisis impact on borrowing countries.

Table 2

Lending by European banks in US dollars, 2005 – 2007, %

Euro area countries	9
Other European countries	30
USA	99
Other North American countries	81
Asia	74
Latin America	97
Middle East	95
Africa	83
Total	43

Source: Fed. October 2012.

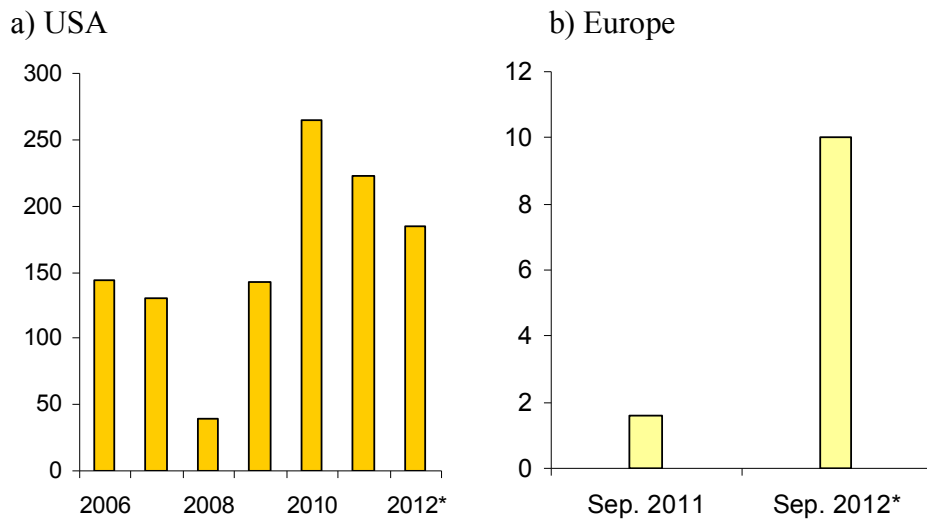
European banks themselves are significantly exposed to the currency risk arising from the large amount of loans (mostly syndicated) denominated in US dollars and household deposits denominated in Euros (Table 2).

This is particularly important as the world becomes increasingly exposed to former risks, including the growth of financial derivatives that as we remember played a negative role during the last crisis (Fig. 13). Their current volume significantly exceeds the pre-crisis maximums, which seems to be a consequence of attempts to ‘streamline’ balance sheets making them more optimal and minimize risks. We need to remember, however, that such arguments were brought before the crisis as well.

On the back of low yields, the amount of transactions with subprime higher-yield bonds is on the rise again (Fig. 14).

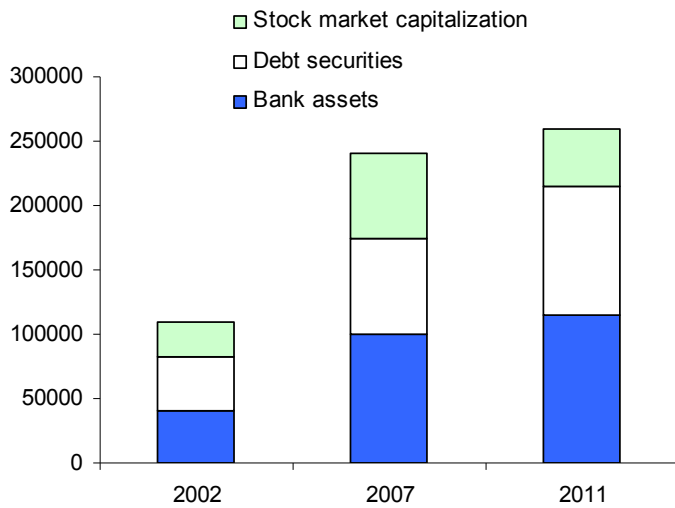
The growth of these and other transactions and instruments results in that the size of the global financial system has currently become even greater than before the crisis (Fig. 15).

Sustaining the stability of major economies participating in the financial system requires maintaining (and sometimes increasing) the current amount of funding (Table 3).



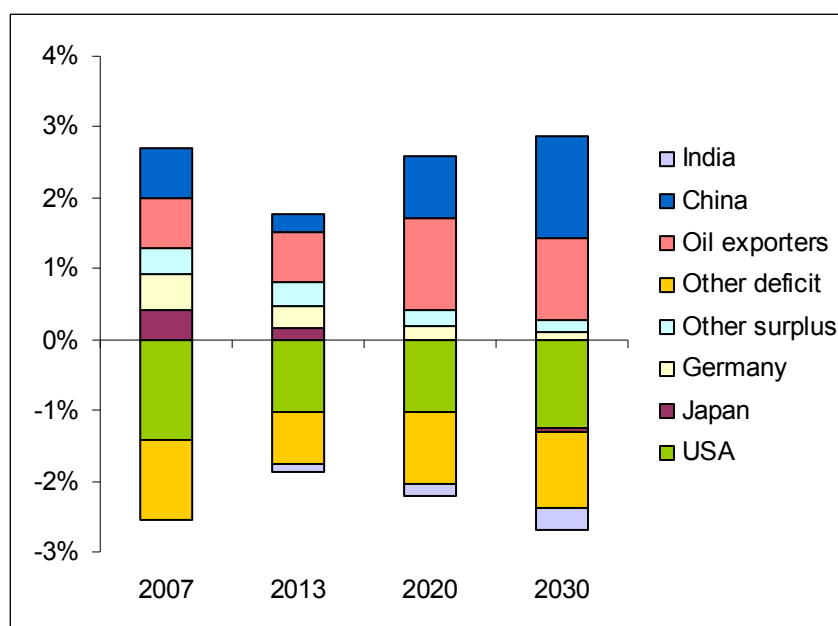
Source: Dealbook // The New York Times. Source: Financial News. 2012. Sept. 25 2012. August 15.

Fig. 14. Growth of junk bonds (USD bln)



Source: IMF. October 2012.

Fig. 15. Size of the global financial system (USD bln)



Source: OECD, November 2012.

Fig. 16. Current account balance* (forecast)

* Share in the global GDP (%).

Table 3

Funding needs,* 2012 – 2014, % GDP

Countries	2012	2013	2014
Japan	59.4	60.4	57.9
USA	26.3	27.3	26.1
Italy	30.1	25.3	25.4
Greece	28.9	17.6	17.4
Portugal	27.4	21.7	22.2
Spain	22.6	21.3	20.1
UK	15.1	14.7	15.1
Germany	8.5	8.3	5.7

*Funding needs consist of the need to repay debt (mainly) and debt service costs.

Source: IMF. October 2012.

As a result, the OECD estimates that the processes of certain levelling of global imbalances (due to stricter financial approaches) will resume their growth and enhance the overall instability of the financial system (Fig. 16).

Certain proposed crisis management measures

International experts kept saying of late: ‘The survival of the euro zone may well rest on its ability to forge a banking union’¹⁵. Indeed, given the nature and scale of challenges faced by

¹⁵ Europe’s banking union : made in Brussels / The Economist, November 17 2012

developed countries, they need to reinforce their fiscal integration in addition to the existing currency integration. A banking union that would provide clearer regulation and alignment of supervision and monitoring in its Member States is currently on the agenda. As such, the European Commission is intending to adopt a legislation that would harmonize all national economic ratios for banks, bank reorganization procedures, deposit insurance, etc. The first step towards the *Single Supervisory Mechanism* has already been taken. The Mechanism will, among other things, determine whether national banks could receive funding directly from the European Stability Mechanism if necessary. In December 2012, ministers of economics and finance from all 27 Member States of the European Union signed an agreement to set up the Single Supervisory Mechanism for the banking sector based on the European Central Bank (ECB). The ECB will directly monitor all banks in the euro area; its competence will cover banks whose assets exceed EUR 30 bln or are equivalent to 20% of GDP of their respective countries. The three largest banks in each EU Member States will be subject to mandatory monitoring by the ECB. Other banks will be monitored by national supervisory authorities. The ECB will be able to interfere if it identifies problems in any bank of the euro area. Countries outside the euro area will be able to join this supervisory system at their discretion.

Extra requirements to the capital of Systemically Important Financial Institutions (SIFI), which is particularly significant in the context of persisting capitalization issues, also seem to be of consequence¹⁶. We would also highlight measures aimed at preventing speculative capital flow and initiated in a number of countries. We would remind that France has already introduced the Tobin Tax. Other countries are expected to take similar actions. Even the IMF, despite its usual liberal approaches to capital flow has been recently compelled to admit that ‘in certain circumstances, introducing CFMs can be useful for ... safeguarding financial system stability’¹⁷.

About Audit of the Fed

Considering the scale of the US financial system, its role in the recent crisis processes and the issues it has been facing, we would highlight the progress in the adoption of the “Audit the Fed” bill (H.R.459) that has been approved by the Congress by 327 votes ‘for’ against 98 votes ‘against’.

So far, many key areas of the Fed operation are not subject to audit. Among them are monetary operations, including discount window loans (that allow direct lending to financial

¹⁶ 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.

¹⁷ The liberalization and management of capital flows: an institutional view. IMF. 2012. 14 November. P. 18.

market players); open market operations; and transactions with foreign governments and foreign central banks¹⁸.

It looks quite odd that key functions of the central bank (such as implementation of the monetary policy) cannot be controlled by taxpayers.

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'¹⁹. Despite such a negative response, it still looks likely that the bill may be approved.

According to estimates by B. Bernanke, head of the US Fed, *the situation in the banking system and in the financial sector in a broader sense has substantially improved for the several last years. The banks have reinforced their positions in terms of size of capital and volume of liquidity. The economic recovery has facilitated the recovery of capital and enhanced the quality of loans and other assets held on banks' balance sheets. Banks, however, still have a long way to go before they recover and adapt to the post-crisis regulation conditions and to the current economic environment*²⁰.

In general, according to forecasts contained in the World Economic Outlook (April 2012), 'the current recovery is predicted to be the weakest one of the postwar era for the advanced economies'. In the context of the persisting instability, the heavy exposure of Russia to exports (with a 28% share of exports in its GDP, while trade with EU accounts for 48%)²¹ and external factors on the whole (funds raising, etc.) gives rise to significant problems and risks for Russian growth under an downside global scenario. To expand development opportunities in the context of post-crisis threats, Russia needs to start setting up more stable mechanisms where the domestic market and domestic demand would play an increasingly important role.

¹⁸The Federal Banking Agency Audit Act, 1978 (31 U.S.C. 714).

¹⁹ House passes Ron Paul's Fed audit measure/ The Washington Post. 2012. July 25.

²⁰ *Bernanke Ben S.* At the 48th Annual Conference on Bank Structure and Competition. Chicago 2012. May 10.

²¹ As of 2011