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Global Financial and Banking System: Risks and Development Challenges[1]

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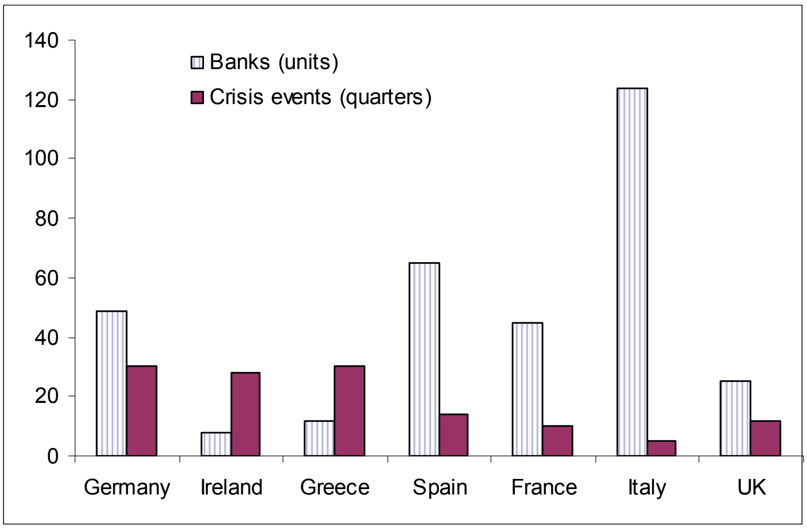
The aggravation of the crisis in Cyprus has prompted the European Central Bank to take unprecedented steps to restrict capital flow in the country. Although they have been able to quench the fire for a while, risks for the euro area still remain. The ECB estimates that ‘Macroeconomic and macro-financial risks remain elevated and surrounded by a high degree of uncertainty – both at the euro area and at the global level.’ Given the heavy weight of euro area countries in the Russian foreign trade, a set of crisis management measures would need to be used to help the Russian economy sustainably grow in an unstable environment.

Key words: crisis, central bank, refinancing, long money, targeted money creation, crisis management.

The aggravation of the crisis in Cyprus has prompted the Governing Council of the European Central Bank (ECB) to take unprecedented steps to restrict capital flow in this euro area country. The new rules will complicate business operations, while major depositors will lose up to 40% of their deposits. The fact is, however, obvious: these developments make us take a new glance at the challenges currently faced by the euro area to estimate the likelihood of future major outbursts. The ECB estimates that ‘Macroeconomic and macro-financial risks remain elevated and surrounded by a high degree of uncertainty – both at the euro area and at the global level.’[2]

We would note that in general major banks (assets over EUR 1 bln) have often experienced upheavals in Europe (Fig. 1).

Fig. 1. The number of banks and crisis situations in some countries*



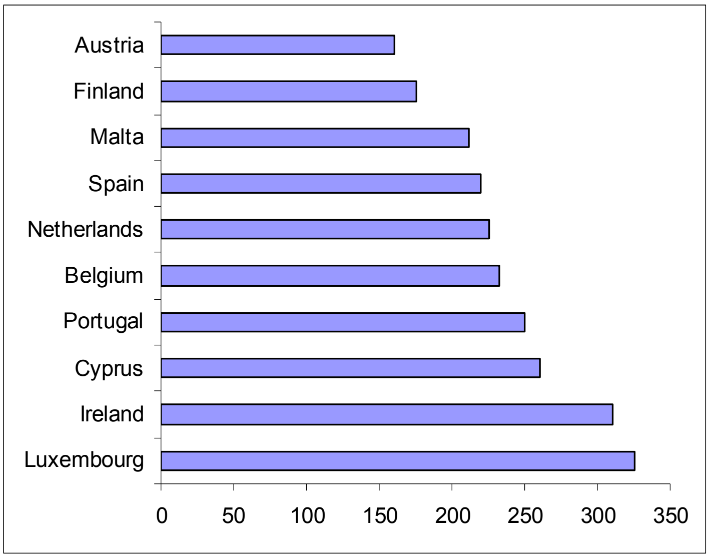
* From Q1 2000 to QIV 2011

Crisis situations include bankruptcies, winding-up, default, government interventions, etc.

Source: ECB, December 2012.

At the time being the extremely high private sector debt in Europe is of particular concern (Fig. 2). This debt results from the ever increasing global debt burden that at times exceeds 500% of GDP (Fig. 3).

Fig. 2. Private (non-financial) sector debt, % of GDP, 2011

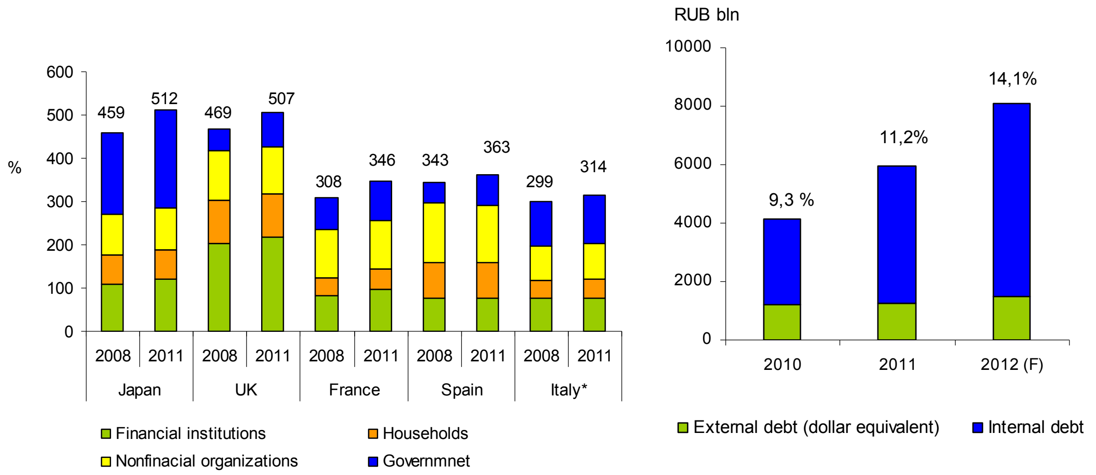


Source: The Economist, March, 16, 2013.

Fig. 3. Global debt burden increase

a) Debt owed by some developed economies (from 2008 to Q2 2011), % of GDP

b) Russian public debt (RUB bln, % of GDP)



* As of Q1 2011

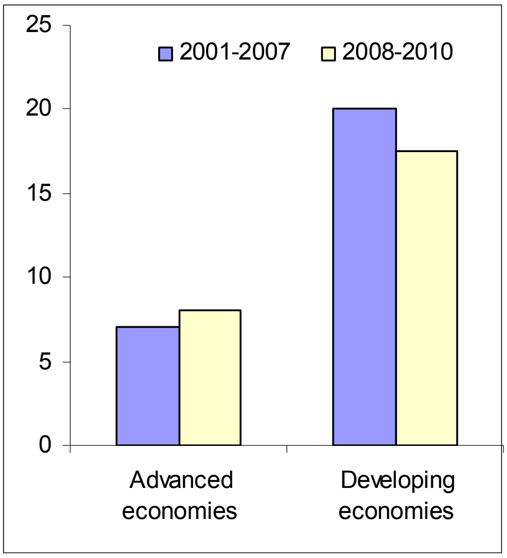
Source: McKinsey Global Institute, January 2012.

Source: Russian Ministry of Finance.

The role of the central bank

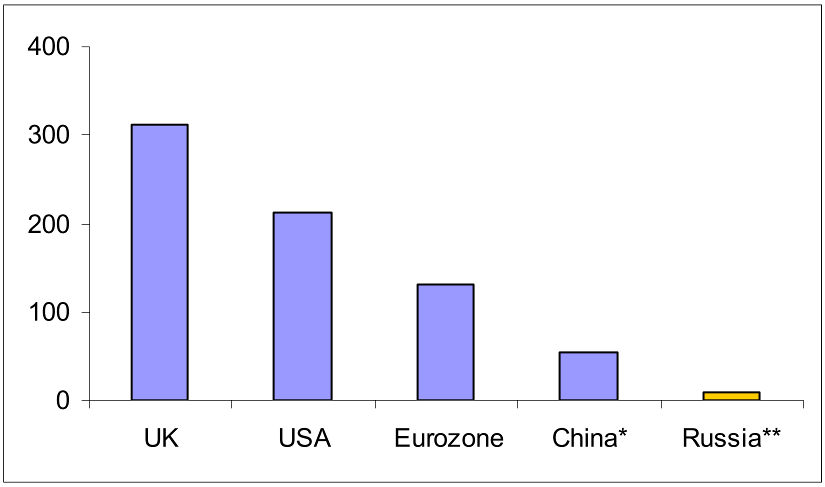
The global financial crisis has reinforced the concept that active government intervention in the financial sector would facilitate economic stability, growth and higher employment.[3] Indeed, the significance of government-owned banks remains quite high and has even recently grown in developed economies. (Fig. 4). The role of regulatory approaches, including by central banks, has similarly substantially increased, while their assets have also tremendously grown (Fig. 5).

Fig. 4. Assets of government-owned banks in the financial system (%)



Source: The World Bank, 2013.

Fig. 5. Growth of total central bank assets from 1 January 2008 to 1 August 2012 (%)

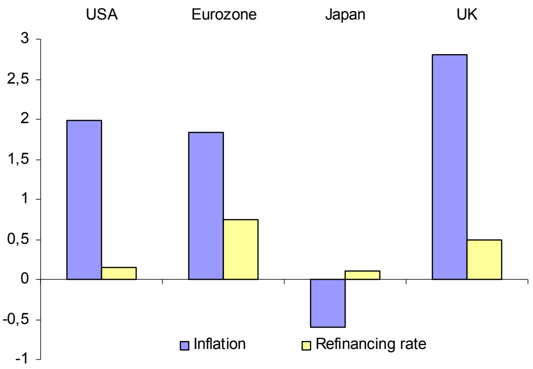


* Growth from 2008 to 2011
** Growth from 1 January 2008 to 1 January 2012
Source: Bank of England, Fed, ECB, Bank of Russia, BIS.

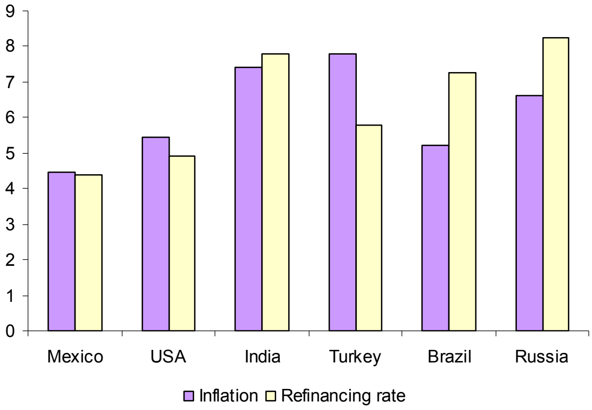
The role played by central banks as a source of short-term and long-term financial resources has become even more important, while their policy rates have hit record lows going below inflation rates (Fig. 6). In this connection, the phenomenon known as *liquidity trap* is spreading ever wider.

Fig. 6. Refinancing rate and inflation in some countries

a) advanced economies



b) developing economies



Source: Central banks of respective countries, World Bank, January 2013.

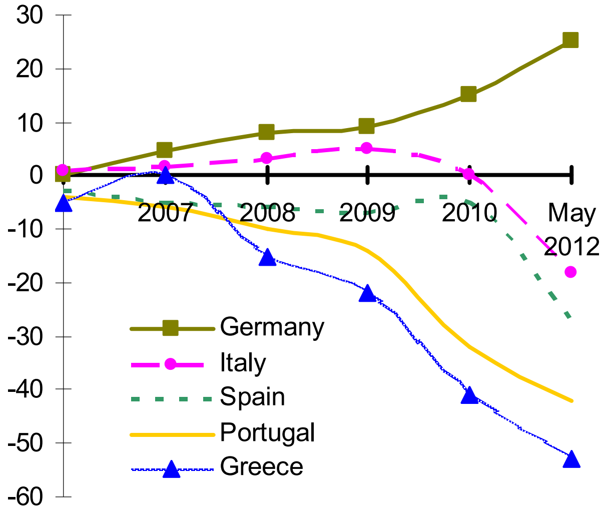
It is well known that in Russia the refinancing rate plays rather a fiscal than monetary role. But even in Russia the refinancing rate serves as a benchmark for other rates and the market on the whole (otherwise why would we need to change it on a regular basis? Surely not just for fiscal adjustments?!). As such, in Russia higher rates may put a drag on the economic growth. Much milder monetary policies in other countries apparently help them be more efficient in overcoming crisis consequences and bolstering growth.

Repo mechanisms currently play an important role in the funding (primarily short-term) of the economy. As of early 2010, the US repo market stood at USD 12 trln (EUR 8.8 trln). According to the ECB's estimates, the European repo market was EUR 6.2 trln as of December 2011.[4]

Some Eurosystem countries have to borrow from the ECB and national central banks on a large scale (Fig. 7 and 8).

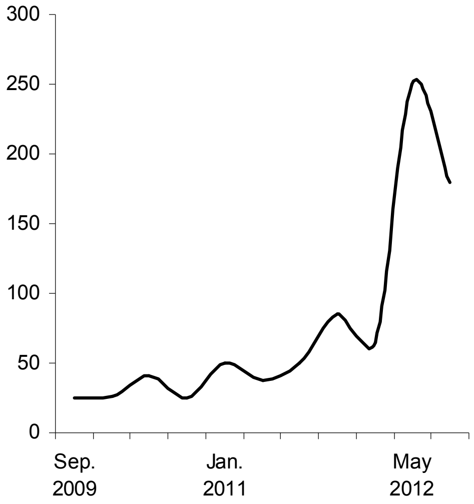
As shown in Fig. 7, most of the countries listed (Italy, Spain, Portugal, Greece) are debtors of the European Central Bank, and only Germany looks quite safe.

Fig. 7. Claims by euro area national banks against the ECB (% of GDP)



Source: IMF, July 2012.

Fig. 8. Eurosystem: claims against the banking sector (EUR bln)



Source: IMF, October 2012.

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 be unable to cover all their liquidity demand unless the Eurosystem refinancing operations are used.[5]

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

Table 1

Breakdown of total assets of financial institutions in the euro area

	Q2 2007	Q2 2012
	% of total assets	% of total assets
Banks	54.0	55.2
Other financial intermediaries	17.9	20.3
Eurosystem	3.5	5.8*
Other	24.6	18.7

Source: ECB, April 2012, February 2013.

If we consider the role played by banks in the economy of the euro area, the support provided to the banking sector is quite understandable and justified. The share of banking assets in total assets of financial institutions was close to 60% in 2003, 54% before the crisis, about 55% at present, and they still dominate the financial sector.

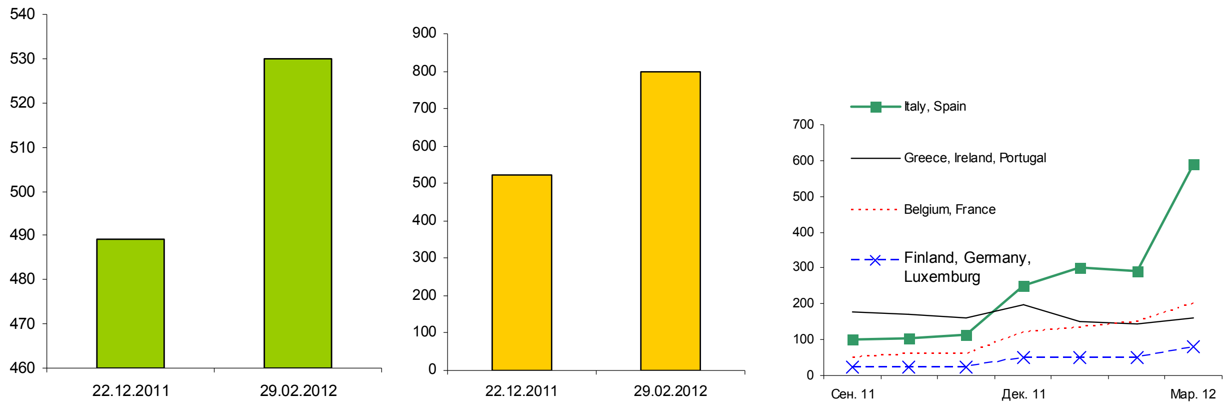
Enhanced role of long money in the economy

Central banks of many countries keep pumping long money into their economies, mainly through two channels: 1) refinancing (i.e. actually creation of long money to cover current operations); 2) targeted long-term (often super-long-term: up to 30 years) money creation.

Refinancing

To expand lending and investment opportunities, the European Central Bank has been recurring to 3-year LTRO[6] long-term refinancing facilities (Fig. 9).

Fig. 9. Euro area: the ECB's Long-Term Refinancing Operations (LTRO) are expanding in terms of volume and participants.


Funds allocated by the ECB to banks (EUR bln)

Number of LTRO participants

Use of ECB's LTRO (USD bln)

Source: ECB, BIS, June 2012.

Two LTRO rounds alone allowed their participants to raise more than EUR 1 trln. We would also point out the differences in the 'ideology' 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 pure money creation within several months (that, by the way, were not accompanied by depletion of a non-renewable resource base). We would remind that the longest refinancing term in Russia does not exceed 1 year.

Targeted Money Creation

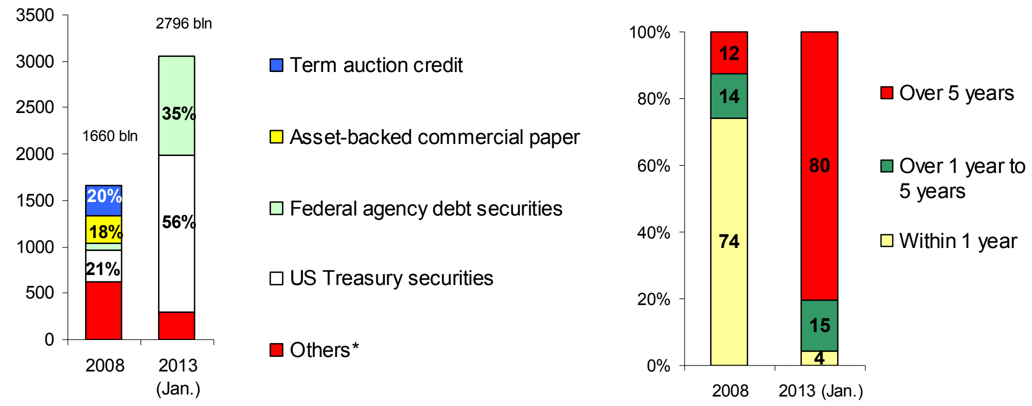
The *mondustrial policy* has an even greater impact on the creation of long money in developed economies. Such policy became most prominent during the crisis and post crisis and consists in the implementation of monetary approaches in correlation with industrial priorities, i.e. its sectoral and corporate elements.[7]

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 stock and especially its long component.

Fig. 10 shows principal channels for generating USD resource base that are used by the US Federal Reserve System (Fed). The monetary stock shown in the Figure actually indicates the level of all US dollars that are currently in use around the world. The data show that about 90%

of all US dollars currently available across the world were initially injected in the economy as a result of funding of various government programmes. Then this money get into the secondary market to multiply into relevant monetary aggregates.

Fig. 10. USD monetary stock (USD bln, %)
Instruments Maturities



*Other include: accounts receivable, swaps, gold, loans, etc.
Sources: US Fed; calculated based on US Fed data.

Such approaches are quite consistent over years and undergo only minor changes (that result rather from minor adjustments to the 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, for funding cut-downs or reallocation of funds to other targets could have materially affected the economic growth profile, 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 stock) to build a more sustainable long-term basis for financial resources circulating in the economy. Similar approaches are applied in other developed countries (Japan, UK, etc.).

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-year term). To put it otherwise, the economy gets long and targeted investment resources. Moreover, once the securities mature, the central bank would oftentimes create new money and buy new securities, which makes the process of maintaining long money in the economy virtually endless.

The involvement of the central bank in the above mechanisms allows financing budget targets without reducing the overall liquidity of the financial market. If government securities were simply offered in the secondary market, then, subject to appetite by relevant market players for such securities, they would be purchased by private companies and banks, and as such, 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). This phenomenon is known in the economic science as the crowding out effect.

As a result, monetary authorities (the central bank and the ministry of finance) increasingly often build a strong layer of focused long money in line with the priorities of their economic policy (mortgage, small-size enterprises, regional programmes, etc.). Eventually, other sources of long money (pension, insurance, etc.) are added to set up a robust financial environment that substantially expands the range of investment opportunities.

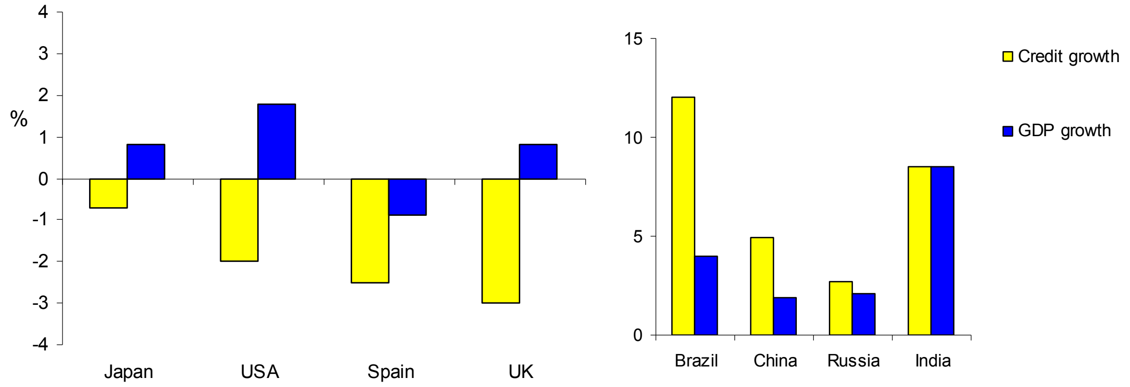
Let us consider several issues given that the issue of long money has been extremely important for the Russian economy for a long time. Consider international markets where financial resources are indeed larger, cheaper and longer and where such money is, actually, created through the above mechanisms: are they the only opportunity to raise large amounts of affordable long money (which is necessary to tackle long-term challenges faced by the Russian economy). We would also highlight that by raising this money the country is also racking up its public debt.

Or perhaps we can start using such mechanisms involving national monetary authorities similarly to the approaches that have been applied by the strongest and 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 arguments of the ‘we-will-fail-all-the-same’ type) analysis of actual opportunities offered by this process, existing risks (that will certainly be numerous) and 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 important ones) do occur in all countries, but such countries have in place supervisory and regulatory authorities to prevent them. If we compare the process to road traffic, those who want it are trespassing against the traffic rules, but does that mean that the rules themselves should be cancelled due to such trespassers? 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'[8] reads the statement of the G20 summit of summer 2012. The credit crunch (Fig. 11) on the back of large and growing volumes of liquidity actually laying as ballast without getting into the economy reflect the persisting uncertainty of market players (primarily in developed countries) regarding their own stability and growth opportunities.

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



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

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 provides for funding to commercial banks at a below market cost to expand lending to the non-financial sector for up to four years. The programme also provides for a sliding scale with debt cost rising for lower lending volumes, and vice versa. Other countries (such as the US) do not rule out similar approaches.[9]

The post crisis financial sector records a number of other systemic processes. European banks now tend to reduce their international exposure on the backdrop of ***stronger national accents*** in their operations. According to estimates by M. Carney, future Governor of the Bank of England and incumbent 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 since.'[10]

Speaking of the same issue, M. Shirakawa, 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 emerged.'[11]

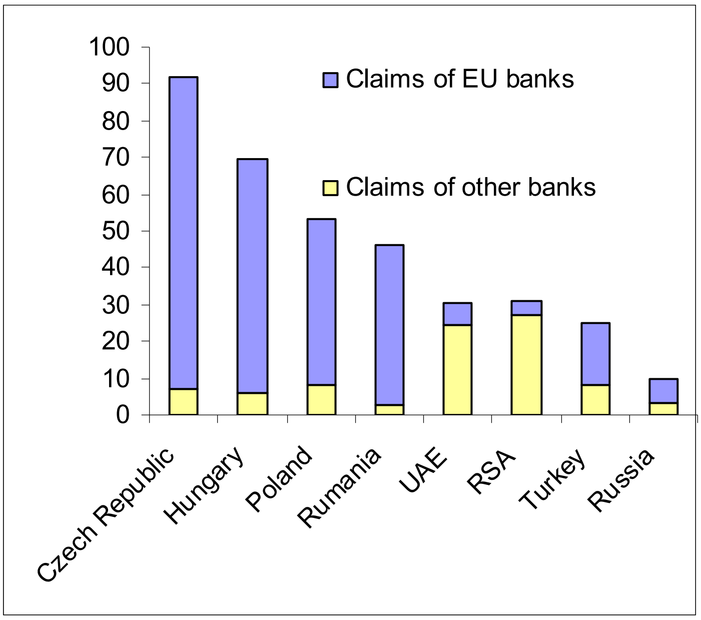
Another particularity of the European post-crisis financial market consists in its ***fragmentation*** when different countries have different amounts of financial resources, their cost varies across regions, and the actual resources often tend to leave the countries of the European 'periphery' for more stable European economies.[12]

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). There are no doubts that such situation might considerably aggravate the crisis impact on borrowing countries, should the crisis get worse.

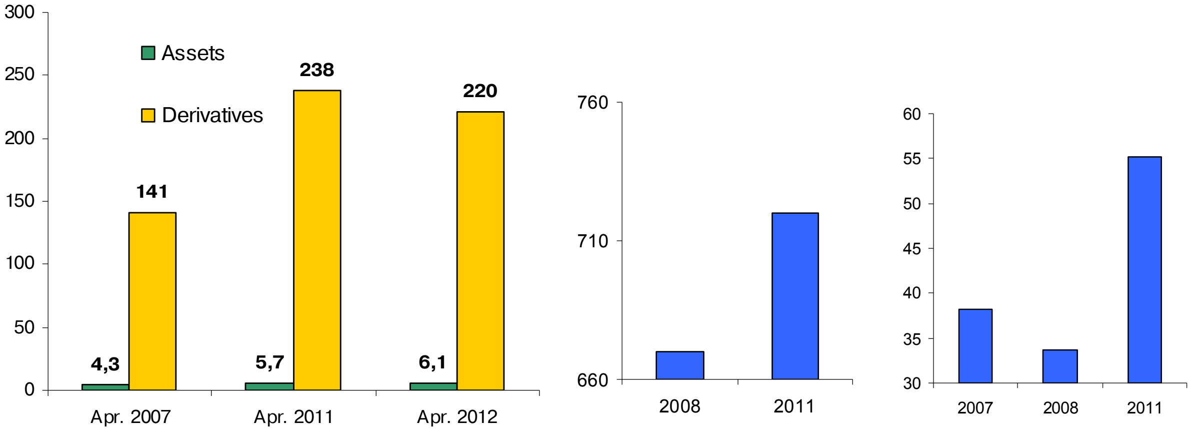
Fig. 12. Cross-border claims to developing countries (as compared to nominal GDP)*, %



* Claims data as of late March 2012. Nominal GDP for 2011.
Source: Bank of Japan, October 2012.

Moreover, 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 and minimize risks. We need to remember, however, that such arguments were also brought before the crisis.

Fig. 13. Global derivative growth



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

Source: US Comptroller of the Currency.

OTC derivative market size (USD trln)

a) World

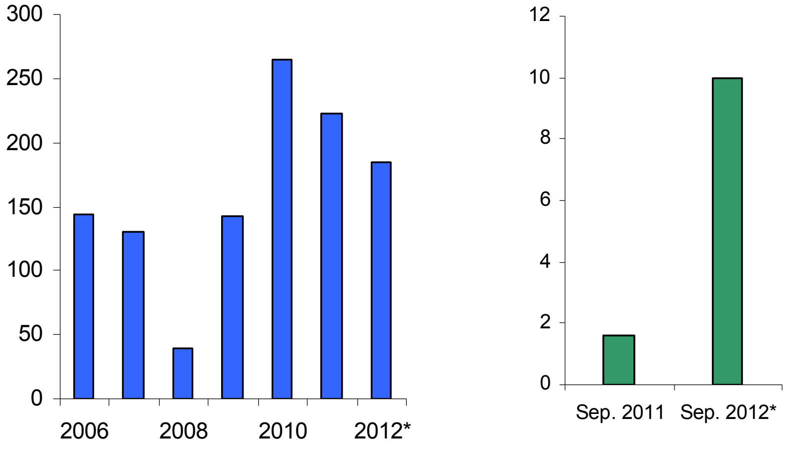
b) Japan

Source: Bank of Japan, June 2012

* 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% of US banks' assets).
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% of US banks' assets).
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% of US banks' assets).

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

Fig. 14. Junk bond growth (USD bln)



US

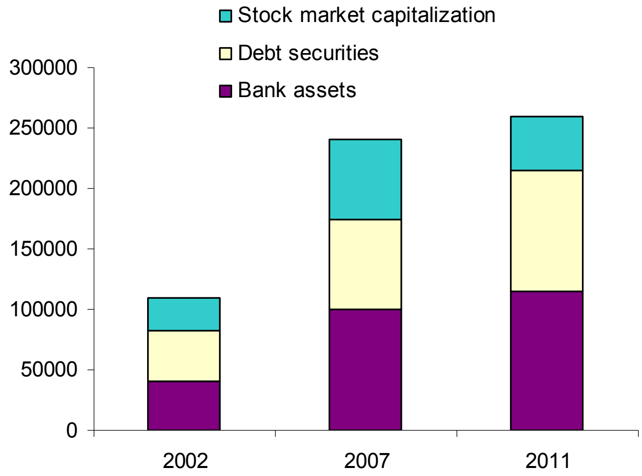
* Up to14 August
Source: Dealbook // The New York Times: August 15, 2012.

Europe

* Up to 24 September.
Source: Financial News. 2012. Sept. 25.

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

Fig. 15. Global financial system size (USD bln)



Source: IMF, October 2012.

Maintaining the stability of major economies participating in the financial system requires maintaining (and sometimes increasing) the current amount of funding (Table 2).

Table 2

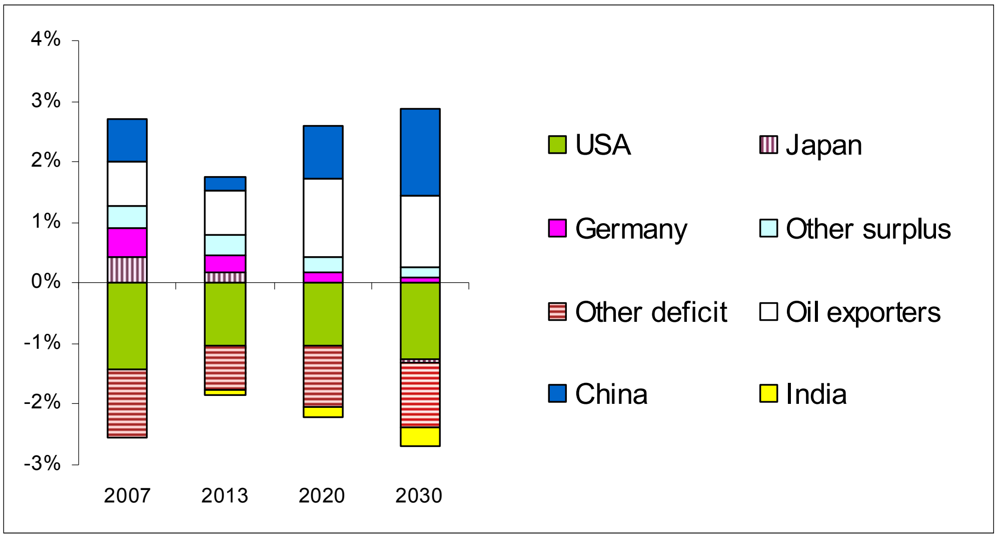
Financing requirements,* 2012–2014, % of GDP

	2012	2013	2014
Japan	59.4	60.4	57.9
US	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

*Financing requirements comprise repayable liabilities (mainly) and debt servicing costs.
Source: IMF, October 2012.

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

Fig. 16. Current account balance * (forecast)



* Share in global GDP (%).
Source: OECD, November 2012.

Certain proposed crisis management measures

International experts have kept saying of late: ‘The ability to form a banking union is critically important for the survival of the euro area’.[13] Indeed, given the nature and scale of challenges faced by 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 directive that would align all national economic ratios for banks, bank reorganization procedures, deposit insurance, etc. A *Single Supervisory Mechanism* is planned to be built. The Mechanism will, among other things, determine whether national banks could receive funding directly from the European Stability Mechanism and will become an important step towards the creation of ‘a single financial system that is not fragmented along national lines.’[14] 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 consequence.[15]

In general, the following measures are suggested:

Initiative	Description
Banking Union	The Single Supervisory Mechanism with the strong ECB’s role in overseeing all euro area banks (jointly with national supervisory authorities). Further proposals: common guidelines, common deposit protection measures, a single decision-making mechanism
Capital Requirements Directive (CRD IV)	Provides for the introduction of Basel III provisions in the EU. The key goal is to reinforce the stability of the

	banking sector while maintaining the funding to the economy and economic growth.
Deposit guarantee programmes	Mainly provide for harmonization and simplification of secured deposits, faster payouts, and better financing plans.
Financial recovery of banks	Provide for the necessary steps to ensure that bank bankruptcies are managed in a way to avoid financial instability and minimize taxpayers' costs (including preventive, operational intervention and recovery measures)

Source: ECB, December 2012.

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 action. Even the IMF, despite its usual liberal approaches to capital flow has been recently compelled to admit that 'in certain circumstances, introducing CFMs (capital flow management measures) can be useful for … safeguarding financial system stability'.[16]

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 a FED audit bill of law (H.R.459) that has been approved by the Congress by 327 votes 'for' against 98 votes 'against'.

Fed audit

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 market players); open market transactions; and transactions with foreign governments and foreign central banks.[17]

It is rather strange that key functions of the central bank (such as implementation of the monetary policy) cannot be controlled by taxpayers. As such, it is incomprehensible why such a generally advanced economic system that declares itself open and transparent and requires transparency from others remains so non-transparent in key areas of its operation.

Why has this issue not been brought to the agenda (which should have been done many decades ago!) and positively solved at once? It is hard to believe that the taxpayer is that indifferent (or rightless?!) in a so called 'developed democracy' to ignore the pivotal issues related to the operation of the national economy. Only a large-scale and profound crisis made it possible to voice this issue and try to solve it as in other civilized countries.

Quite naturally, these initiatives have been opposed by the US Fed management who has qualified a wide-range audit as a 'nightmare.'[18]

Some necessary steps

Thus, the situation 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'.[19] 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.' [20] Of particular concern remains the 'risk of disruptive withdrawals of funding by foreign banks active in the region', [21] while according to tougher estimates of renowned international investor M. Faber in five to ten years there would be 'a colossal mess everywhere in the Western world.' [22]

In the context of the persisting instability, the heavy exposure of Russia to exports (with a 26% share of exports in its GDP, while trade with EU accounts for 49%) [23]and external factors on the whole (debt raising, etc.) gives rise to significant problems and risks for Russian growth under a 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 increasing role.

In this connection, a set of crisis management measures would need to be used to help the Russian economy sustainably grow in an unstable environment. Some of them are listed below:

1. We need mechanisms to replace external sources of financial resources with internal ones. We should thoroughly review the existing approaches to the monetary supply breakdown: the role of export revenues and external loans should be balanced by domestic resource generation mechanisms subject to the needs of national economic entities, primarily in non-export industries. In much more developed global economies (US, Japan, etc.), monetary authorities play the leading role in this process. [24]

It would be desirable to work out comprehensive approaches to the monetary supply breakdown issue that would align the policy run by the Central Bank with the objectives of the budgetary, industrial and structural policies.

2. A stronger role of the domestic component in money creation will increase the significance of the policy rate by turning it into a really efficient mechanism that shapes the pricing in the financial market. Refinancing should be both short- and longer term (more than 1 year).

Furthermore, the above approaches will actually allow, first, ensuring that money creation is aligned with the structural policy objectives and, second, expanding the basis for longer money. As a result, both the economy and financial market will diversify the way we need, the market's liquidity will expand, and the investment potential of financial resources will grow. Given that even in more mature financial markets the basis for long money is built by national monetary authorities (through the above approaches), such practice is quite worth being applied to Russia since it can ensure the necessary amount of long financial resources needed by the Russian economy.

3. Given the need to enhance growth quality, maintain growth rates and diversify the market, we would need to consider an expansion of functions assigned to the Central Bank as is the case in major economies where, apart from the exchange rate and prices, central banks are often charged with the task of maintaining economic growth and employment.

4. Capital flows need to be thoroughly monitored, not only outflows, but also inflows. But there is no place here for formal principles such as 'any investment is good' and 'the more the better'. In a modern context, especially on the back of excessive global liquidity that seeks for niches to be invested, we need to pay attention to capital quality, terms, nature and purposes for which it is used, while aligning these parameters with economic priorities.

5. It is important to set up domestic conditions and incentives that would level the 'financial openness' effect by discouraging the outflow of newly injected liquidity to the foreign exchange market to prevent financial instability.

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According to the World Bank's report, 'there are sound economic reasons for the state to play an active role in financial systems.'[25] These processes are becoming ever important in the post-crisis world. Russia needs to take into account the developments, primarily due to the Russian economy becoming more open and the adhesion of the country to the WTO. Russian players should have appropriate competitive capabilities comparable to those available to their competitors. It is important to ensure sustainable growth of the Russian economy and national business on the back of the rising global competition; enhance the role of national monetary authorities that must lay the foundation for the above approaches; reinforce the necessary internal development mechanisms and minimize external risks.

[1] The article reflects the personal opinion of its author.

[2] ECB, December 2012.

[3] The World Bank, 2013.

[4] ECB, April 2012.

[5] Idem

[6] Long-term refinancing operations.

[7] URL: http://www.investopedia.com

[8] G20. Los Cabos, June 2012.

[9] B. Bernanke. Press Conference, 20 June 2012.

[10] Mark Carney: Financing the global transition, Remarks at the Atlantic Institute for Market Studies, Halifax, Nova Scotia, 21 June 2012.

[11] Remarks 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, 21 August 2009.

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

[13] Europe's banking union: made in Brussels/The Economist, November 17 2012.

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

[15] 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 gold 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.

[16] The liberalization and management of capital flows: an institutional view / IMF, November 14, 2012. P. 18.

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

[18] House passes Ron Paul's Fed audit measure/The Washington Post, July 25, 2012.

[19] No recovery until 2018, IMF warns. The Guardian. October 3, 2012.

[20] Imf.org.

[21] ECB, December 2012.

[22] Cnbc.com October 22, 2012.

[23] Data as of 2012.

[24] For more details see: Ershov M. Financial Mechanisms of Economic Growth // Voprosy ekonomiki. 2002. No. 12, and Ershov M. Financial Crisis: What's Next?; www.ershovm.ru.

[25] Global Financial Development Report, The World Bank, 2013. P. 1.