Published in journal “Voprosi economiki”, №12, 2010.

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NEW RISKS OF POST-CRISIS WORLD *

In early November 2010, the US Fed meeting adopted a decision on the new anti-crisis measures. It implies that the US central bank may repurchase treasury securities worth USD 600 billion (accounting for 50% of “emergency” purchases made during the first anti-crisis phase). As a result, the dollar emission and its monetary base will grow, thus aggravating the risks of excess liquidity and the dollar itself. Such measures indicate that the situation in the financial markets (and the US economy alike) remains challenging and its stabilization requires additional efforts.

Global Imbalances Persist

In September 2010, the National Bureau of Economic Research (NBER) determined that “a trough in business activity occurred in the US economy in June 2009. The trough marks the end of the recession that began in December 2007 and the beginning of an expansion.”[1] Indeed, following a lengthy drop, the economies of many countries saw renewed growth (see Figure 1).

However, despite emerging changes of negative trends in the world economy (the beginning of economic growth, a slow increase in lending, renewed security issue), markets viewed the situation quite ambiguously. Even before the most recent decision of the US regulators on additional large-scale emission as part of crisis management (evidencing that the real situation may be more difficult than officially reported), market participants were skeptical about earlier measures which couldn’t lay basis for future instability. Some indicators testify to overall negative expectations.

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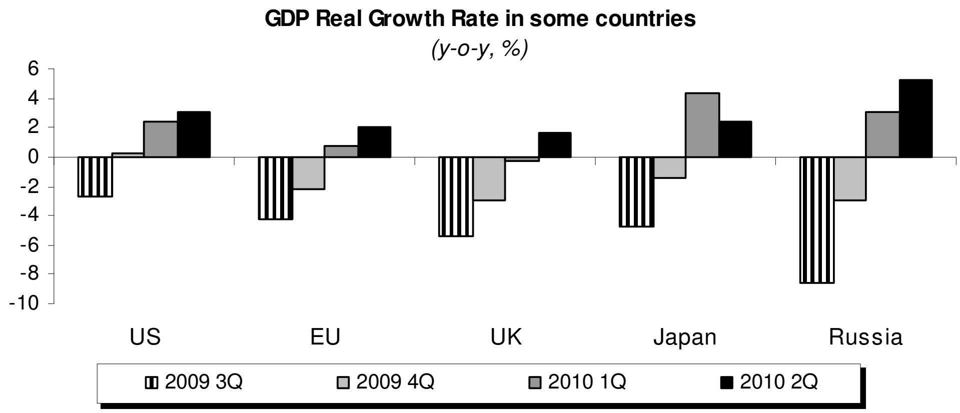
* This article reflects the personal opinion of the author.

[1] NBER. 2010. Sept. 20.

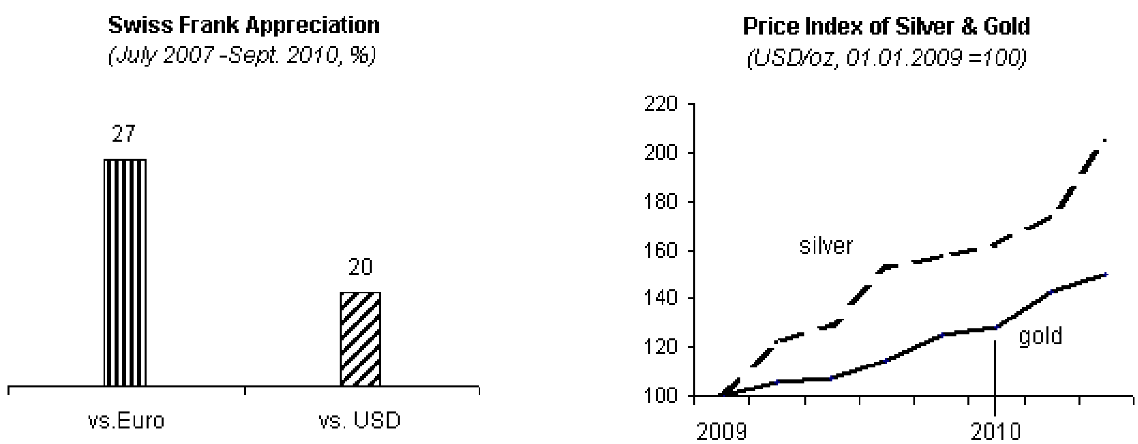
Fig. 1



Source: Eurostat, Rosstat

Gold and silver quotes demonstrate sustainable growth, which hits record highs, reflecting investors' uncertainty about world economic prospects and their willingness to invest in less risky assets. In the context of excessive dollar liquidity and the risk faced by the dollar and the whole global monetary system, the role of the Swiss franc, a historical safe haven currency during periods of crisis (see Figure 2), increases.

Fig. 2

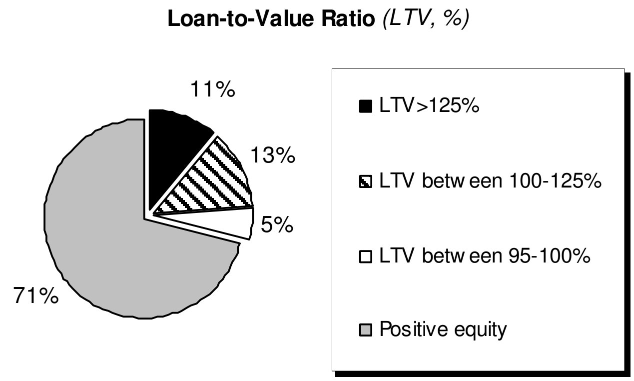


Source: calc. based on data from www.kitco.com

Pending issues in the US mortgage market also create risks associated with the shaping of sources of new possible crisis.

High loan-to-value ratio (LTV, see Figure 3) results in the continuing likelihood of defaults and preconditions for new future crises, especially if housing prices go down (see Figure 4). A high percentage of loans (about 30%), where amount of collateral almost equals the amount of loan, raises the vulnerability of borrowers to possible price falls and rates growth. This can make such loans unsecured and is fraught with an increase in defaults and non-payments.

Fig. 3



Source: IMF.

At present, measures are being taken to support the mortgage market (including the possibility of refinancing and sale of insufficiently secured loans), which can somewhat calm down the market participants. But it should be remembered that sharp reduction in household assets (see Figure 5) caused by the crisis, in general, considerably constricts mortgage demand.

Fig. 4

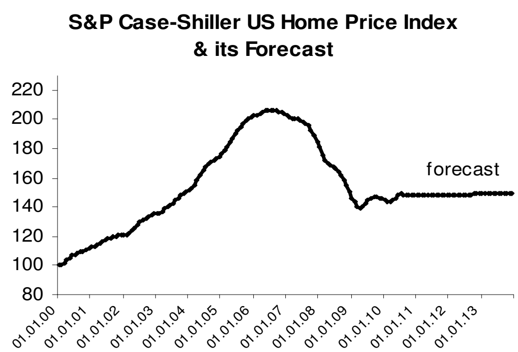
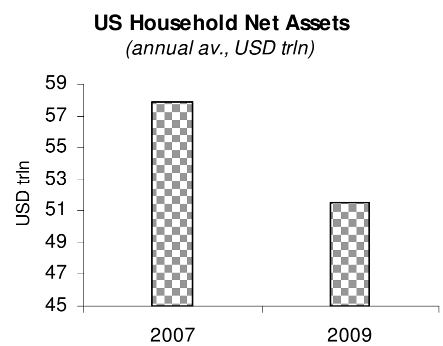


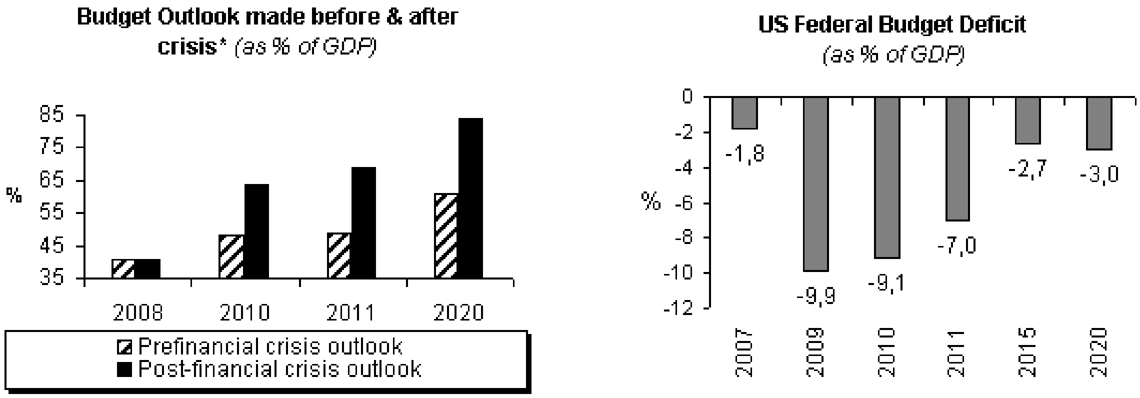
Fig. 5



Source: US Department of the Treasury, Sept. 2010; US Fed.

The growth of expenses in connection with crisis management activities aggravates budget deficit and government debt issues. According to forecasts, despite the first signs of trends towards the US economic recovery, the US federal budget deficit will not be back to its pre-crisis rate until 2020 (see Figure 6).

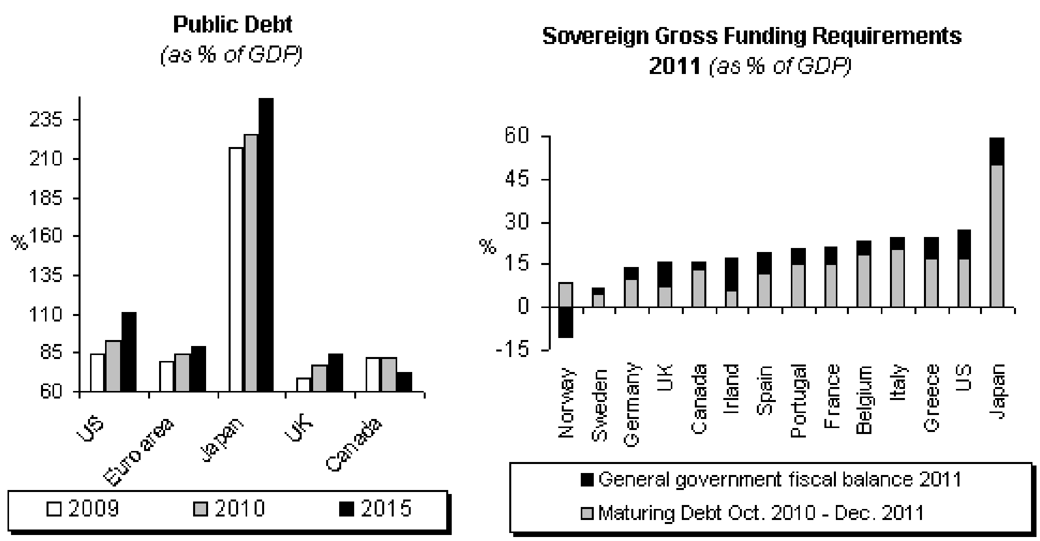
Fig. 6



Source: Hearings in Financial Crisis Inquiry Commission. 2010. Jan. 13; CBO.

The evaluation of prospective debt owed by most developed economies is disquieting too. Furthermore, in some cases, a significant amount of debt is scheduled to be repaid next year (see Figure 7).

Fig.7

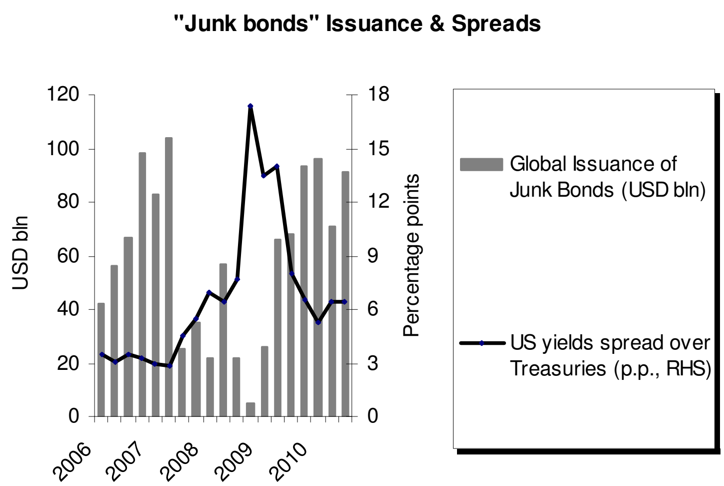


Obviously, as a result, global imbalances will aggravate. Moreover, countries with excessive liquidity (and often with high savings rate) will be compelled to finance, as before the crisis, countries with budget deficit, causing considerable financial resources inflows to such countries.[2]

[2] For details, see www.ershovm.ru and M. V. Ershov. *Financial Crisis. What's Next? Moscow: Ekonomika. [2011]*

Such flow can cause lower level of interest rates (let us remind you that in developed countries they are already low). This will lead to a decline in return on financial operations, compelling the banks to pursue more aggressive policy with the objective of increasing profit. In the context of lower return, they will assess the asset quality less strictly and become interested in more profitable and at the same time high-risky areas of investments.[3] Such tendencies became more obvious as early as 2010, when, first, demand for poor-quality bonds (junk bonds) and their issuance grew and, second, differences in (spread between) the yields on government securities and high-risk bonds diminished (see Figure 8).

Fig. 8



Source: The Economist. 2010. Sept. 30.

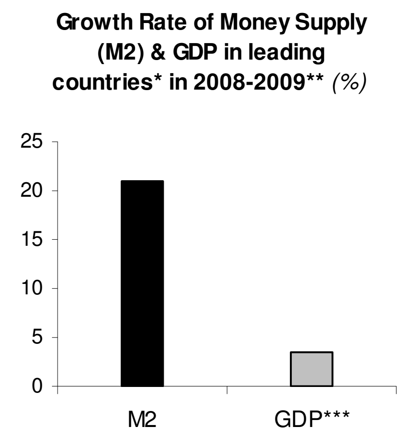
It is obvious that even despite regulatory and restrictive action taken, banks' leverage will grow again and their balances will be unreasonably overblown. In other words, risk accumulation will renew as was the case before recent crisis. Furthermore, the scope of this phenomenon may be large and systemic. As the head of the Bank of Japan rightly noted, most market participants "will find it hard to resist pressures from equity holders to raise the returns on equity under severe competition."[4] These circumstances show how fragile the achieved stabilization is and how high the risks faced by the world economy and individual countries. The risks even include the possibility of country defaults in the future which may lay basis for geopolitical crisis in the world.

[3] In 2009 we noted that such trends were possible (for more details, see *National Securities Market Association (NSMA) Conference. Panel Discussion Among Macroeconomists "Russia's Financial Market Outlook" (December 10-11, 2009). Booklet. Moscow, 2010*

[4] *Shirakawa M.* Some Thoughts on Incentives at Micro and Macro Level for Crisis Prevention / / BIS Papers. 2009. No 53. P. 25-26.

Another important circumstance affecting future risks is excessive global liquidity (above we mentioned a considerable grow of USD monetary base, among other things, to the ultimate USD 2.5 trillion). As a consequence of large-scale inflows as part of crisis management, in a number of countries the growth of money stock of leading economies significantly outpaced their GDP growth (see Figure 9).

Fig. 9

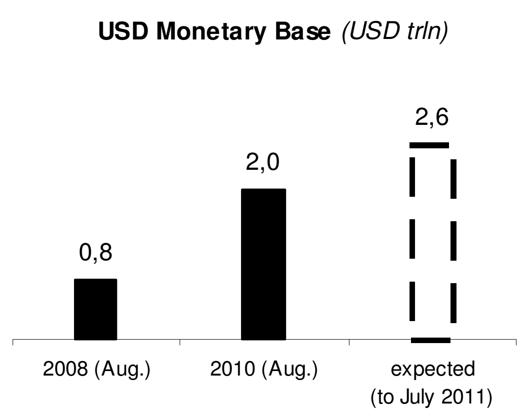


* Euro area, USA, UK, Japan, China, Russia.

Source: calc. based on data from Eurostat, US Fed, BEA, Bank of England, Bank of Japan, National Bureau of Statistics of China, CBR, Rosstat.

These trends will become even stronger due to another emission expansion planned by the USA (see Figure 10).

Fig. 10



Source: based on US Fed data.

Obviously, such resources will be looking for their placement: first flowing into the markets, heating them up, and then leaving and creating the risk of collapse. Amid free capital flows, this will aggravate the risks of new regional crises and the volatility of both financial markets and the world economy in general.

As international overviews correctly stated, “developed countries too quickly poured large resources into developing countries. This created an asset bubble in the mortgage and stock market as well as currency price growth.”[5] Under such conditions developing countries will seek to restrict capital operations and neutralize an adverse effect of the speculative inflow of “short” money. Certain countries have already taken relevant measures (such as Brazil, South Africa, South Korea). The use of this kind of approaches is likely to broaden.

In developed countries, primarily the US, with a view to mitigate negative impact on the financial sector, an attempt can be made first to transform the financial bubble into a general economic bubble by pushing it out from financial sphere, to the greatest extent possible, into the real economy. Since the prime recipient of aid is the financial sector, it is also the first sector to experience positive effects of rendered support. Obviously, in this case it will strengthen due to relative weakening of the real sector. This will allow allocating risks “more evenly” across the economy: the financial sector (which remains the main supporting point) will face lower risks, unlike other participants, resulting in all possible implications for the economy in general such as sectoral, inflation-related, currency-related, etc. Then, given the shaping conditions, the bubble can be pushed into the external environment, which will also allow solving the task of efficient placement of additional liquidity (especially if external assets are undervalued) and thus pre-empting future devaluation of the dollar.

Developing economies are an important and capacious field for such placement of funds. If these countries realize the risks of destabilization associated with excessive global liquidity and take measures to limit the inflow of “short” money from countries with excessive emission, this will considerably complicate the achievement of “the new post-crisis adjustment.” That is why the G-20 London Summit declaration, when referring to the need for opposing protectionism, lays an emphasis on the **unacceptability of financial protectionism, particularly measures that constrain worldwide capital flows, especially to developing countries**[6].

Under the worst-case scenario, one may not exclude the case when the entire range of both – economic and geopolitical tools are used to shift the center of crisis gravity to other world locations, with ensuing global destabilization. Simultaneously, this can contribute to “solving” pending debt issues.

Excessive liquidity can cause the aggravation of USD-related risks. In general, in recent years, it has shown lengthy systemic devaluation (see Figure 11). It is also obvious that any new

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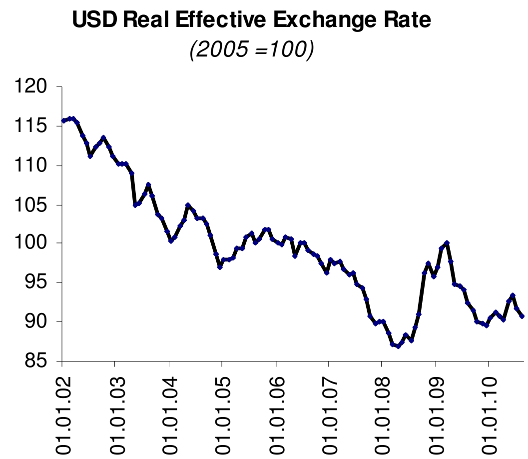
[5] *Gallagher K. P.* Losing Control: Policy Space to Prevent and Mitigate Financial Crises in Trade and Investment Agreements / / UN Report. 2010. No 58.

[6] G-20. The Global Plan for Recovery and Reform. 2009. April 2.

worsening of the US economic situation as well as new dollar injections make the future of US dollar more complex.

Fig. 11



Source: Bank for International Settlements.

Market uncertainty arises again the issues of new anchors or "supporting points" for international currency system. Various proposals are made in connection with the need to stabilize the currency system, including possible use of the "golden standard" in one form or another. According to World Bank President R. Zoellick, "The system should also consider employing gold as an international reference point of market expectations about inflation, deflation and future currency values."[7]

Situation in Russia

Let us look at the situation in Russia in view of the above trends in the world economy. We discussed (already in early 2008) the feasibility of increasing the role of gold and other currencies (apart from the dollar) in shaping Russia's international reserves amid global financial instability.

Certain issues related to gold and foreign currency reserves shaping[8]

1. High risks and excessive turbulence of the international financial sector in 2007 and 2008 coupled with associated exchange rate fluctuations highlighted the issues of "anchor – stability" in the international monetary system and issues related to searching for the least risk-

[7] Robert Zoellick, FT, 8.11.2010.

[8] *M. V. Ershov.* Material for the Meeting of the Banking Committee of the Russian Union of Industrialists and Entrepreneurs (RSPP). February 7, 2008.

exposed assets. In this regard, attention was paid again to the gold, first, as an asset traditionally considered the most reliable an a crisis environment and, second, as an asset whose price has steadily grown in the past 3 years.

Given that crisis trends in the world economy can persist for another year, causing possible currency losses, consideration should be given to the possibility of taking measures aimed at diversifying domestic gold and foreign currency reserves by increasing the gold component.

2. Another factor that should be taken into account is a steady decline in the US dollar rate against a number of currencies (euro, Swiss franc, British pound, Yuan, ruble) more than last two years. However, according to the estimates of international organizations, dollar is still overvalued (implying that the potential for its further devaluation remains).

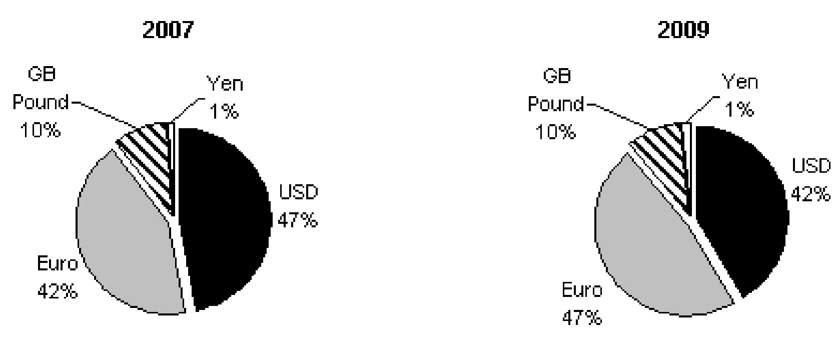
The dollar weakening can also be aggravated by crisis trends in the US economy and interest rate drop, making investments in dollars less attractive.

In view of the above, it is feasible to consider gradually diversifying the currency portfolio of gold and foreign currency reserves (as well as the currency breakdown of external turnover) by increasing the percentage of other currencies.

In a crisis environment, these processes began showing certain progress, yet in general the picture, so far, is changing slowly (see Figure 12).

Fig. 12

b) Structure of Foreign Exchange Reserves (%)



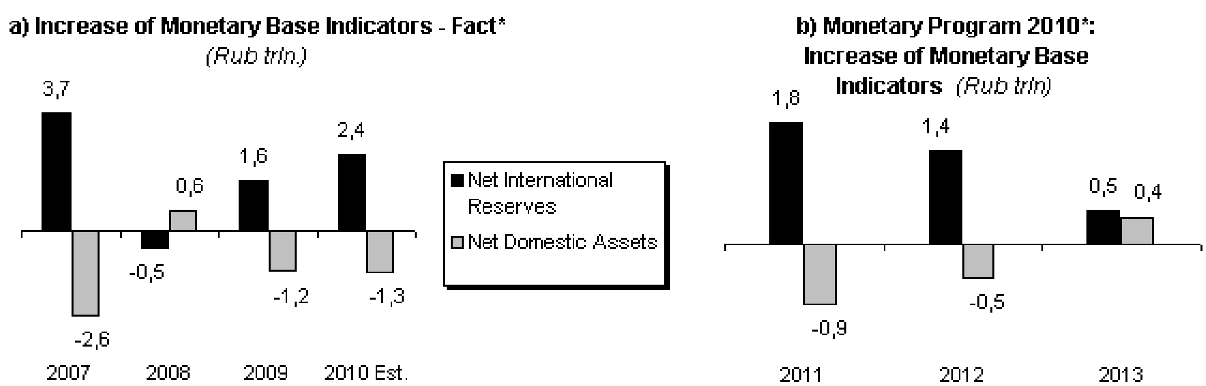
Source: Bank of Russia, calc. based on the Bank of Russia data.

The approaches of the Bank of Russia to creating liquidity in the Russian economy should also be revised by shifting the center of gravity from international to domestic sources.

Initially, the crisis made some adjustments to the policy of the Bank of Russia. As early as late 2007 (witnessing the first signs of crisis process in the world), virtually for the first time after many years, "Guidelines for the Single State Monetary Policy in 2008" provided for gradual weakening of the role of international factor in monetary base (up to 2010). A year later, in 2008, the Monetary Policy for 2009 and 2010/2011 strengthened focus on the growth of *domestic* resources (net domestic assets) whereas weakening role of the external factors in money demand creation was also planned. It was expected to allow "use more effectively the interest rate instruments of monetary regulation and make the interest rate channel of the monetary policy transmission mechanism work"[9]. Besides it was implied that the Bank of Russia's presence on domestic foreign exchange market will be diminishing which will "help make the exchange rate policy more flexible and implement a gradual transition to the free floating exchange rate regime."[10]

In fact, the role of external factor in 2008 weakened indeed and the role of domestic factor grew (see Figure 13a). However, the 2010 monetary program was developed assuming that the growth of net international reserves will be the principal source of monetary base expansion. In general, this implies the Central Bank's breakaway from its approaches declared earlier which were adopted when the crisis was in full swing and aimed at diminishing external risks thus relying on domestic sources of monetization.

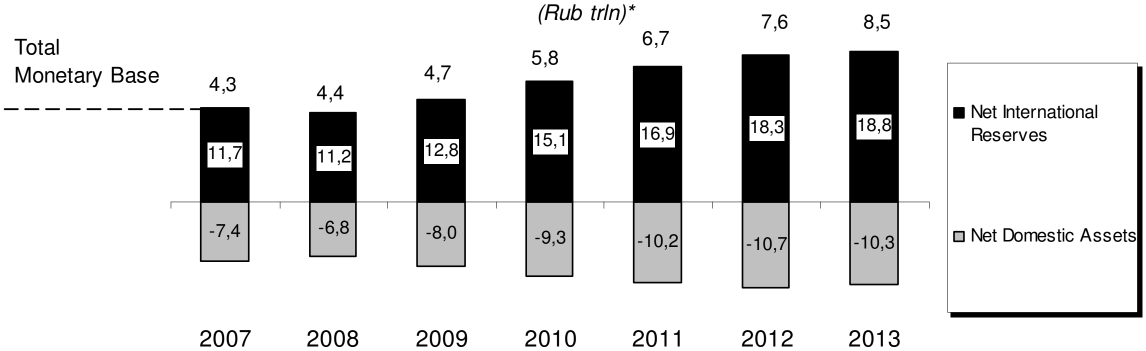
Fig. 13



[9] See: Guidelines for the Single State Monetary Policy in 2009 and for 2010 and 2011 / Bank of Russia. P. 27.
[10] See the same paper.

c) Sources of Rouble Monetary Base Formation

*(Rub trln)**



* 2010 - est. of CBR (Oct. 2010); 2011-2013 -projections of CBR according to the basic (second) variant of monetary program of 2010.

Sources: according to Guidelines for the Single State Monetary Policy in 2008 (the basic second version); Guidelines for the Single State Monetary Policy in 2009 and for 2010 and 2011 (the basic third version); Guidelines for the Single State Monetary Policy in 2010 and for 2011 and 2012 (the basic second version); Guidelines for the Single State Monetary Policy in 2011 and for 2012 and 2013 (the basic second version). Draft (October 2010) / Bank of Russia.

Now, external sources again become dominant in monetary base creation. Although their values are expected to decrease (see Figure 13b), the absolute contribution of the external factor to the shaping of monetary base will remain crucial (see Figure 13c).

Is it safe to say that the goals listed in the 2008 document lost their importance or the world economy risks which made the regulators modify its approaches disappeared? And what are the ways of accomplishing systemic structural tasks faced by the economy? The risks inherent in the external monetization channel are associated with the possibility of resource raising (or impossibility, as was the case in recent crisis). Furthermore, as a consequence of the above-mentioned approaches, the Russian economy continues to rely on exports and raw materials and national leaders view easing such focus as a critical systemic objective. A raw materials exporter, when selling currency gains and receiving additional rubles, actually shapes demand for the rest of the economy, which starts servicing the needs of oil and gas sector to an increasing extent, expanding its positions both – in exports and GDP. This situation has been observed for many years. At the same time, the inflow of financial resources to non-export industries grows, transmission mechanisms cannot effectively secure resource flows and interest rates inadequately reflect the price of resources for the economy.[11]

The accumulation of gold and foreign currency reserves, obviously, creates a certain safety net for the economy, and their stabilization role was proven by crisis developments. Yet this does not imply the necessity of switching to the *currency board* mechanism (or close in

[11] We have repeatedly pointed out these and other drawbacks of such approaches earlier (see, for example, *M. Ershov*. Economic Growth: New Challenges and New Risks / / Voprosy Ekonomiki. 2006. # 12).

meaning if not literal), when the entire domestic liquidity is shaped only based on the currency inflow and the central bank virtually abandons its key function of the primary source of monetary resources which are equally available to export and non-export industries. Exports revenue and external loans will flow into the economy in any event. However their role in shaping monetary base should be balanced by internal mechanisms and adjusted for the needs of national economy participants, primarily non-export industries. Their development is a prerequisite for the real economic diversification and overcoming of its focus on raw materials.

Certainly, raw materials supplies are necessary for the world economy. In the absence of effective alternatives, Russia has to act as such supplier. Yet is this function sufficient for the country and will it allow ensuring its long-term systemic role in the world? And what should we rely on when non-renewable resources of the Russian economy decrease?

The 2010/2011 monetary program includes the reduction of net loans to both banks and enlarged government (see the table below), implying additional withdrawal of funds from the economy. Moreover, this will again necessitate raising required funds from external sources, thus strengthening national dependence on the world market situation and aggravating the associated risks with all the consequences that come with it.

Table. 2010-2013 Monetary Program Indicators (as of the period end, Rub trln)*

	2010	2011	2012	2013
Monetary base (narrow definition)	5.8	6.7	7.6	8.5
Net international reserves	15.1	16.9	18.3	18.8
Net domestic assets	-9.3	-10.2	-10.7	-10.3
including				
net loan to enlarged government	-4.7	-4.6	-4.7	-4.8
net loan to banks	-2.1	-3.1	-3.5	-2.6

* 2010 - est. of CBR (Oct. 2010); 2011-2013 - projections of CBR according to the basic (second) variant of monetary program of 2010.

Source: Bank of Russia, Guidelines for the Single State Monetary Policy in 2011 and for 2012 and 2013. Draft. October 2010.

Measures of monetary policy which are due to be implemented

As we've shown, the approaches which have led to crisis (in the industrial countries) or made its development more deep (as in Russia) begin to take shape again. Since global risks remain high, mechanisms neutralizing the effects of external shocks should be created. In this regard, several important issues are to be considered.

1. Obviously, there is a need for mechanisms of replacing external sources of financial resources with external ones. The existing approaches to shaping of money demand should be revised drastically: the role of export revenue and external loans should be balanced by domestic mechanisms of resource creation adjusted for the needs of domestic participants, primarily non-export industries. In developed economies (USA, Japan, etc.) monetary authorities play a key role in this process.[12]

2. As we have repeatedly stated earlier, even in mature markets the foundation for "long" financial resources is shaped by monetary authorities. When a foreign central bank buys a "long" paper from its ministry of finance (even from secondary markets), it actually makes a special-purpose long-term emission by extending a "long" loan to the ministry of finance. Such loan will then enter the economy, and via multiplier will create a multi layer structure of "long" resources of different durations. In the absence of such approaches, we will depend on the possibility (or impossibility) of raising these resources from external markets.

3. We should be ready to take risks associated with the excessive volatility of foreign exchange rates caused, among other things, by excessive global liquidity and its flow throughout the world. The flow of "hot" money (particularly when their volume is on the rise) can drastically destabilize different national economies and again compel them to use leverage to control capital flows. Such "hot" money pose risks for Russian economy as well and makes measures to diminish them important.

4. Excessive capital inflow can be accompanied by the ruble appreciation. We have already discussed the pluses and minuses of the strong ruble in this magazine. In the current situation, it should be noted that its appreciation (as a dynamic trend), as such, encourages the inflow of speculative capital since, in the future, appreciated rubles can be sold and profit can be capitalized. At the same time, statically more expensive ruble could be some kind of a filter, making the negative impact of such speculative inflows less strong.

We should also remember that the rouble rate based on PPP (purchasing power parity) is undervalued by around 80%[13]. This partly solves trading balance issues but simultaneously the Russian economy, virtually, becomes exposed to the threat of excessive capital inflow, especially in the context of liberalization of capital operations; furthermore, capital raising efficiency is extremely low (one thing is when every dollar is equivalent to 17-20 roubles; quite a different thing is when dollar is equivalent to 30-32 roubles. Apparently the latter means undervaluation of all domestic assets as well).

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[12] For details, see M. Ershov. *Financial Mechanisms of Economic Growth / / Voprosy Ekonomiki. 2002. # 12;* M. V. Ershov. *Financial Crisis. What's Next?*; www.ershovm.ru

[13] In other words, if comparison is based on the PPP rate, its 80% depreciation gives us the current nominal market ruble vs. dollar rate (about 30 rubles).

In general, cheaper ruble means lower currency value of our national wealth, GDP and other indicators characterizing the level of country's development. The same is true about Russian investments in external markets: expensive ruble gives more "weight" to such participation weightier whereas cheap ruble considerably lowers the efficiency of such investments.

> It is curious that when analyzing the stimulating role of exchange rate the attention is being paid exclusively to foreign trade. Russian investments abroad are practically ignored in this context. Certainly, foreign markets are interested in us primarily as in raw materials suppliers or a market for their products and no one waits for us there as buyers or shareholders of their companies (certain attempts of large Russian companies to purchase significant Western assets show which obstacles they have to face). Moreover, cheap ruble, in general, is some kind of protection for Western markets against our efficient entry into the capital of their companies. However, it does not imply that we should view their interests as an "objective reality"; we should seek to change the situation in our favor, expanding our real and systemic presence in Western markets.

A greatly undervalued ruble complicates the objective of neutralizing "hot" money inflow. Amid the excessive global liquidity, more expensive ruble prevents it from entering the Russian market (this is a pricier option), resulting in higher price of all ruble-denominated assets for external speculators (and other investors).

In the absence of measures aimed at regulating "hot" money flows, gradual ruble appreciation will not solve the issue of speculative cash inflow. At the same time, exchange rate changes can be made through a number of one-at-a-time appreciations (if regulators deem it feasible), bringing the rate nearer to the level which reflects more closely general economic price level (PPP included) and at the same time solves the task of neutralizing the inflow of excessive and short-term global liquidity. Simultaneously, it is desirable to take the necessary tax and monetary policy action aimed at achieving these goals.

Foreign trade consequences of such steps can be offset by fiscal and tariff policy measures as well as by taking steps to support exporters.[14] The use of the ruble as the currency of price and settlements for Russian export supplies may be an important factor as well since it will cause changes in the exchange rate preferences of exporters. They will be interested in the national currency appreciation as they will benefit more from receiving payments in a stronger monetary unit.[15]

> Naturally, a more expensive ruble strengthens competition with imported goods. However, first, this is an impetus for increasing the competitiveness of domestic producers. If they can not adequately compete with external suppliers, it may be feasible to apply trading

[14] For details, see M. V. Ershov. *Currencies in International Trade. M.: Nauka, 1992;* M. V. Ershov. *Monetary and Financial Mechanisms in the Modern World (Crisis Experience of the late 90s). M.: Ekonomika, 2000;* M. V. Ershov. *Economic Sovereignty of Russia in Global Economy. M.: Ekonomika, 2005;* M. Ershov. *Important Areas of Economic Policies // Voprosy Ekonomiki. 2003. # 12; www.ershovm.ru.*

[15] M. Ershov. *Important Economic Tasks / / Voprosy Ekonomiki. 2004. # 12.*

policy leverages, which *will ensure protection for the relevant businesses* (since, foreign exchange rate can only be used efficiently for the purposes of foreign trade regulation if combined with other trade policy measures).

Second, less expensive imports cheapen external supplies for domestic production, thus reducing costs. Depending on chosen priorities, selective policy can be pursued, ensuring low price level for imported goods which are critical to domestic producers, and, on the contrary, *protective measures can be introduced* in respect of goods the production of which needs to be developed domestically.

5. In "geoeconomic" terms, it should also be remembered that the ruble environment is something that is shaped and managed by national monetary authorities and national economic entities. The more "weight" and stability such ruble environment has the more weight the country, its companies and banks will have in the world.

* * *

The diversity of existing challenges and risks makes the measures to mitigate them very important. Decisions on the nature of these measures will be made by regulators and market participants. However, the approaches based on "reasonable rationale" become increasingly relevant in the modern world, when more and more countries rely on economic common sense. Such approach often contradicts the approaches or theoretical dogmas that dominated during "normal times". To oppose new emerging risks adequately it makes it necessary to use the full range of measures that may be needed in a particular situation; and all such measures should be considered. The faster we learn how to rely on economic common sense, the more reasonable and balanced our decisions will be and the more opportunities our economy will have for successful development in a new environment.