

POST-CRISIS DEVELOPMENT OUTLOOKS AND RISKS¹

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In autumn 2010, the National Bureau of Economic Research (US) stated the end of the recession in the United States: “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 In June 2009”².

Indeed, economic performance somewhat improved in a number of countries (Fig. 1).

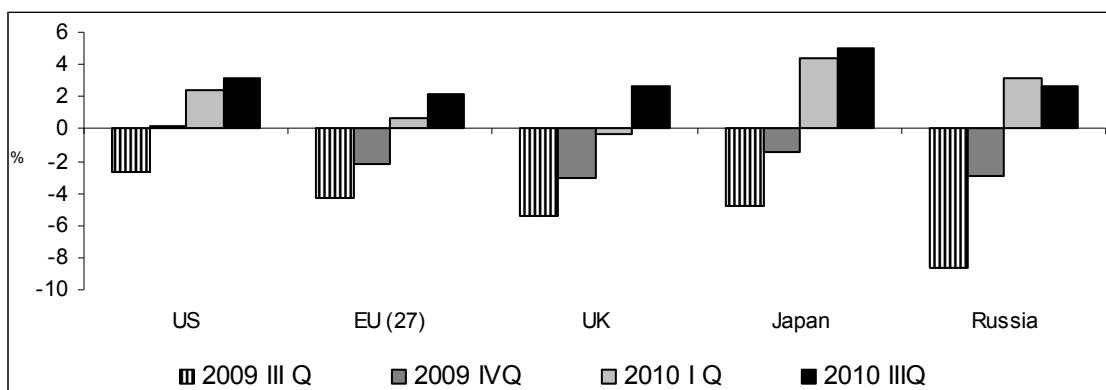


Figure 1. Real GDP growth in some countries (y-o-y, %)

Source: OECD, The Federal Statistics Service of Russia.

This was all the more important given the extent to which many markets fell down. In particular, such instrumental component of the US (and the global) economy as the US stock market faced one of the cruellest downturn in its recent history (Fig. 2).

¹ This article reflects the personal opinion of the author.

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² NBER, 20.09.2010

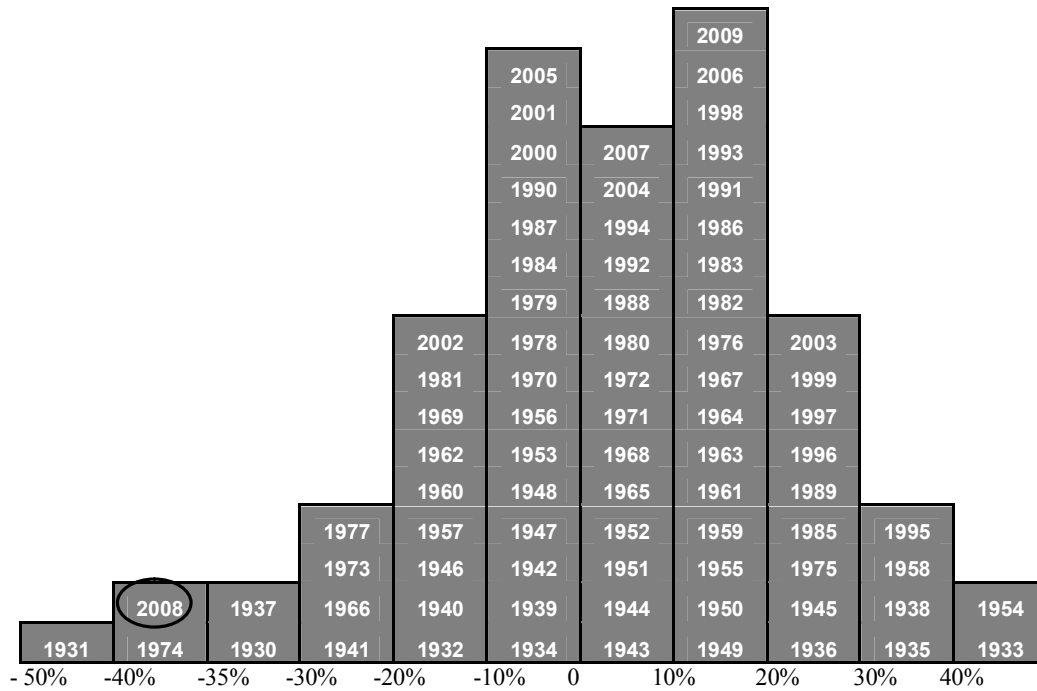


Fig. 2. Dow Jones performance in 1930-2009*

* Rate of increase; in real terms of chained 2000 dollars.
Source: calc. based on NYSE data.

At the same time, despite formal recovery signs in 2010, the situation does not encourage much optimism. In November 2010, the same US, in particular, announced another set of anti-recessionary measures, with their implementation meaning a new USD emission and further growth of the monetary base of USD supply by summer 2011 (by more than 300% of the pre-crisis level) (Fig. 3).

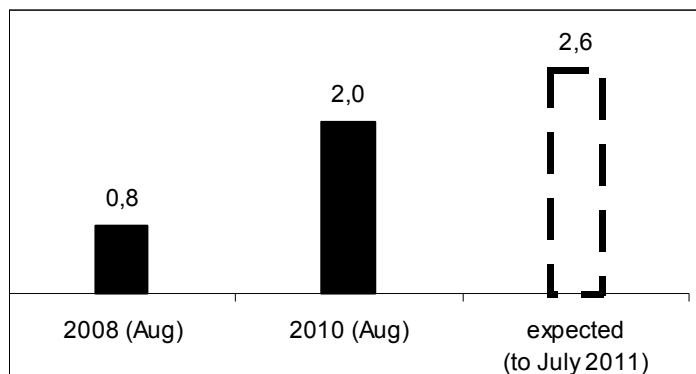


Fig. 3. USD monetary base (USD trln)

Source: US FED.

Many countries expanded the range of their anti-recessionary efforts at the same time, which also led to additional money supply growth as compared to GDP (Fig. 4).

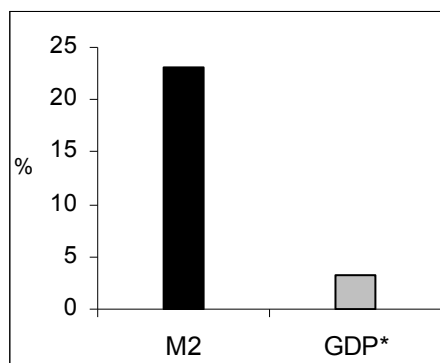


Fig. 4. Growth of money supply (M2) and GDP in major economies in 2007 – 2009 (December-on-December, %)**

* Growth of nominal GDP

** Euro area, US, UK, Japan, China, Russia

Source: based on data by Eurostat, US Fed, BEA, Bank of England, Bank of Japan, National Bureau of Statistics of China, Bank of Russia, Federal State Statistics Service.

It is already clear that the excessive USD liquidity and new plans of its further increase are obviously reinforcing destabilizing risks both for countries and markets where this liquidity comes (and then leaves) to form new ‘bubbles’. The risks also grow for the dollar itself. With free capital flows in place such risks will increase the likelihood of further regional crises and volatility of both - financial markets and the global economy on the whole.

As rightfully mentioned in international reviews, “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.”³.

The attempts of ‘efficient distribution’ of additional liquidity are quite important. Given that the financial sector is the principal addressee of financial aid even in the US, the injected liquidity, while normalizing the situation in this sector, may also disperse and leak into the real economy with all the ensuing problems: inflationary, sectoral, foreign exchange, etc.

Then, if the existing situation allows, the issuer of the major reserve currency would be interested in pushing the bubble outside, thereby solving both the issue of efficient allocation of extra liquidity (in particular, if external assets are undervalued) and pre-empting potential depreciation of the US dollar.

Emerging economies are an important and receptive market for ‘absorbing’ money resources. If these countries realize the destabilizing risks of the excess of global liquidity and

³ Gallagher K.P. "Losing Control: Policy Space to Prevent and Mitigate Financial Crises in Trade and Investment Agreements", UN report, No 58, May 2010.

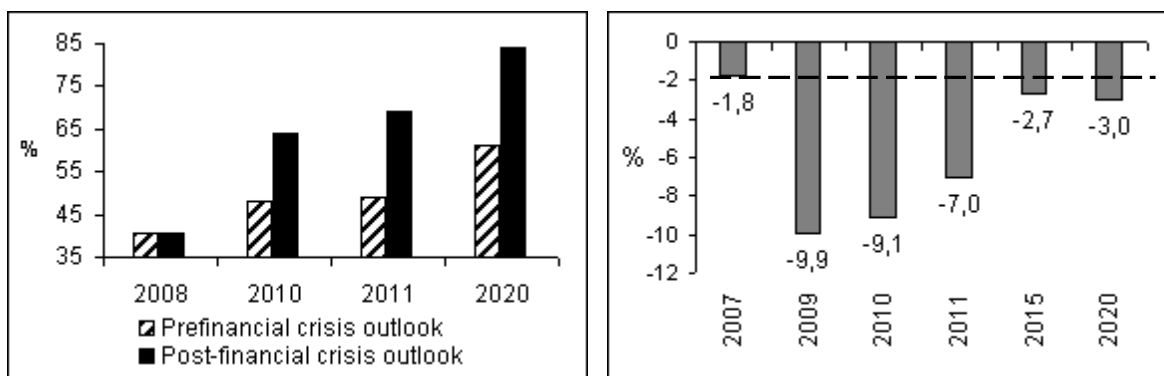
take measures to restrict the inflow of “short money” from countries with excessive emission (and they are already taking such measures), such turnaround will substantially hinder the achievement of the ‘new post-crisis levelling’. For this very reason when speaking of the need to counteract protectionism (almost always present in such documents of late) the statement of the London G20 lays an emphasis on the **unacceptability of financial protectionism, particularly measures that constrain worldwide capital flows, especially to developing countries**⁴.

Emerging markets will apparently take measures aimed at limiting capital operations and neutralizing the negative impact by speculative short-money inflow. A number of countries (in particular, Brazil, South Korea, etc.) have already taken such steps and such approaches may have a wider application.

Furthermore, the announced new amount of anti-recessionary measures (around USD 600 bln) account for almost one half of what was injected in the US economy at the most crucial – first – phase of the crisis. If so much support is still needed even now when the situation has ‘normalized’, a logical question arises: how stable will be the recovery and what new risks might arise?

It is obvious that the new efforts will enhance the risk of new spiralling growth of the national debt of developed countries (since the commercial debt will often have to be transformed into the public debt), thereby increasing the risks of country defaults in some of them.

Even taking into account the observed recovery trend in the US economy, its forecast of deficit will not reach the pre-crisis level even by 2020.



a) Budget outlook made before and after crisis * b) Federal budget deficit

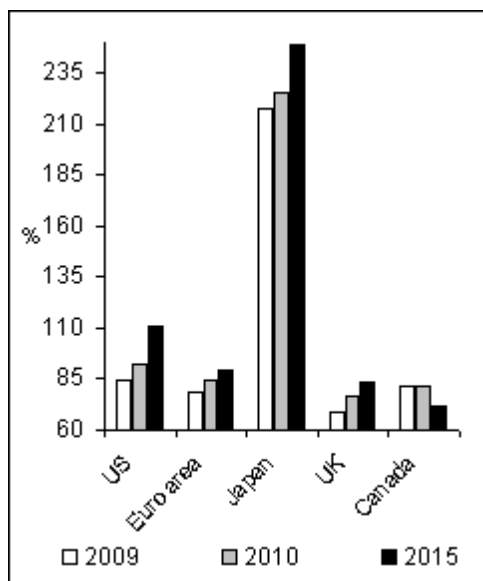
* The forecasts were made in December 2007 and January 2010

Fig. 5. US public debt and federal budget (as % of GDP)

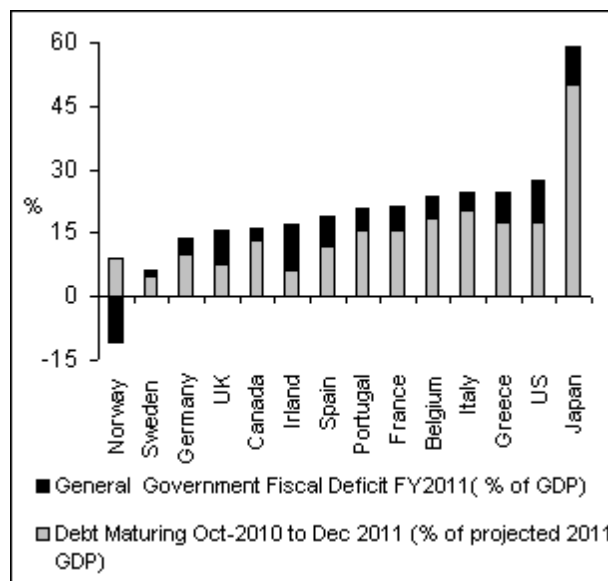
Source: Hearings in Financial Crisis Inquiry Commission, January 13 , 2010; Congressional Budget Office.

Projections for most developed economies look just as alarming, with a significant amount of debt maturing in 2011 in a number of cases (Fig. 6a, b).

⁴ G-20, “The Global Plan for Recovery and Reform”, 2 April 2009.



a) Public Debt



b) Public Debt and Budget Deficit

Fig. 6. Public debt in some countries (as % of GDP)

Source: IMF.

The persisting deficits will mean persisting problems with financing such deficits. We would indicate that on the whole the evolution of the issue of budget deficit in some countries and budget surpluses in others was interrelated with the consumption to savings ratio in respective countries (Table 1).

	Savings		Investments	
	2001	2008	2001	2008
Developed countries	20,0	18,8	20,6	20,4
US	16,4	11,9	19,1	17,5
UK	15,4	15,1	17,4	16,8
Japan	26,9	26,7	24,8	23,5
Germany	19,5	25,7	19,5	19,3
Developing countries	26,6	36,6	25,1	31,8
China	38,4	49,2	36,3	42,6
India	23,5	32,5	22,8	34,9
Russia	32,5	31,5	16,8	21,0

Table 1. Gross savings and investments (as % of GDP)

Source: BIS, 2009.

As a consequence, a number of countries have a surplus of free financial resources, while other nations have to look for sources to finance their budget deficits (Fig. 7).

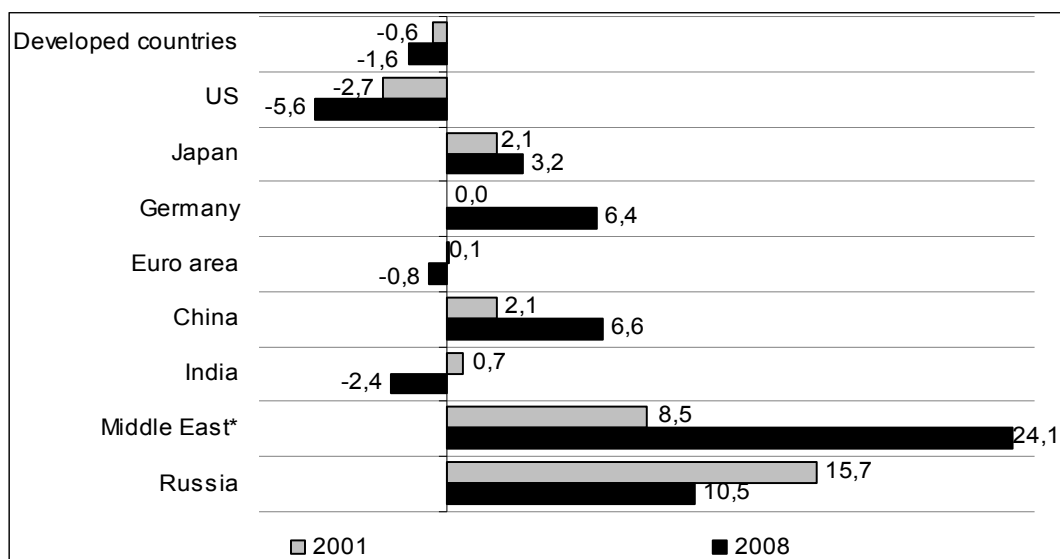


Fig. 7. Difference between savings and investments (as % of GDP)

* Iran, Kuwait, Libya, Oman, Qatar, Saudi Arabia, Yemen.

Source: calc. based on BIS data, 2009.

Russia stays among countries where the level of savings is higher than the level of investments, which potentially makes the country a source of financial resources for deficit-facing countries (we know that in reality a part of our financial resources kept both in specialized funds such as the Stabilization and other funds, and in gold and foreign exchange reserves was invested in US treasury bonds and instruments of other countries helping them to finance their budget deficits (Fig. 8)).

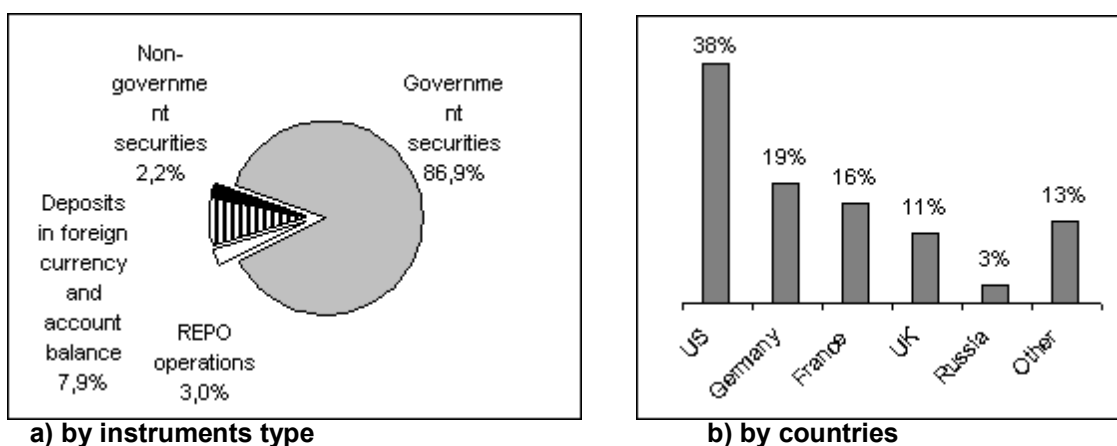
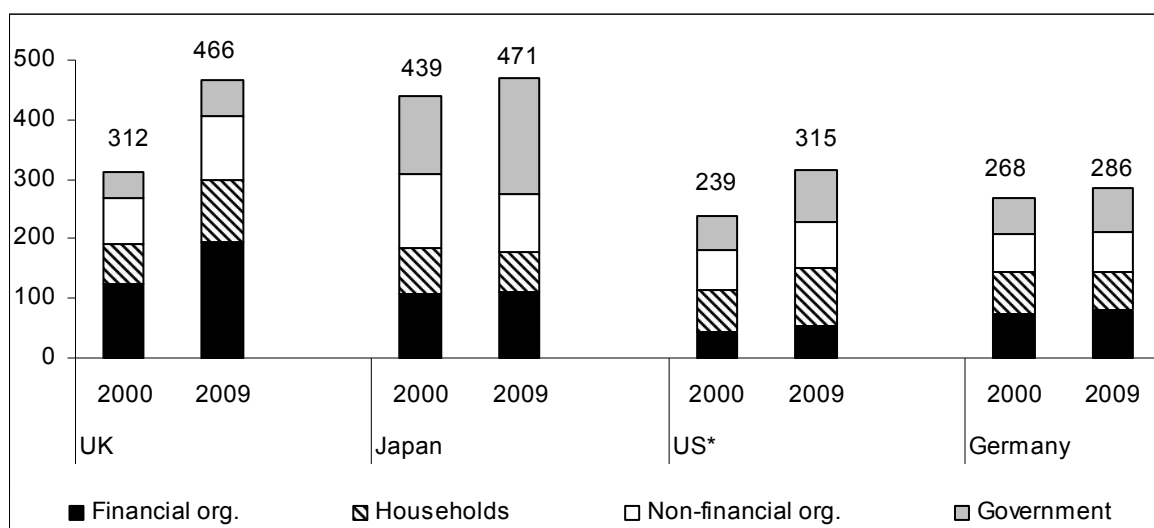


Fig. 8. Breakdown of foreign exchange assets of the Bank of Russia by instrument and by country (as of 31.03.2010, %)

Source: Overview of the foreign exchange asset management by the Bank of Russia. Bank of Russia, 2010.

As we know, the US is the biggest debtor, which makes the financing issue very important for them. Resources coming in this connection from countries with surplus of savings, among other things, suppress interest rates (that as we remember have stayed relatively low in the US for a number of years). This makes operations by financial market players less profitable and as a result they have to, first, turn to riskier and as a consequence to more profitable instruments, and second, must extend their debt that excessively overblows their balance sheets, thereby increasing the leverage, making them less stable and enhancing the crisis risk on the whole. It is also important to bear in mind that the high leverage of the financial sector is recorded in conjunction with massive debt owed by the public and private sectors, which substantially grew in the 2000s (Fig. 9).



* net of ABS. With ABS, the total debt to GDP ratio in 2009 will be 350-360%.

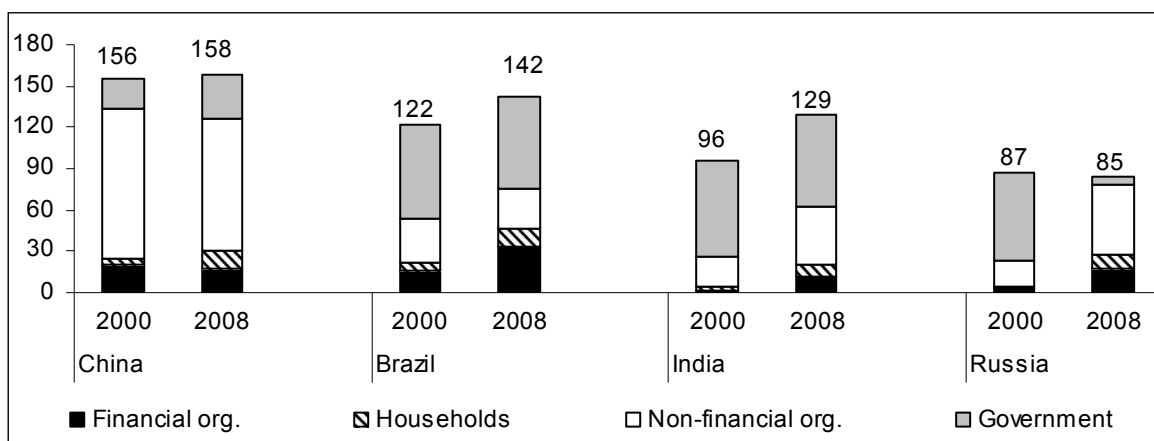


Fig. 9. Debt to GDP ratio (%)

Source: based on data by the Central Bank of the Russian Federation, Ministry of Finance, Federal Treasury of Russia, Federal State Statistics Service; Haver Analytics; McKinsey Global Institute.

We need to bear in mind that the issue of overblown balance sheets as well as wrong market behavior were important factors that aggravated the crisis. These issues not only still

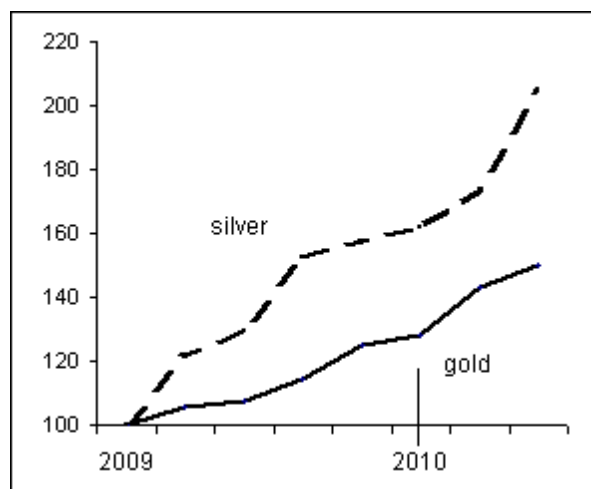
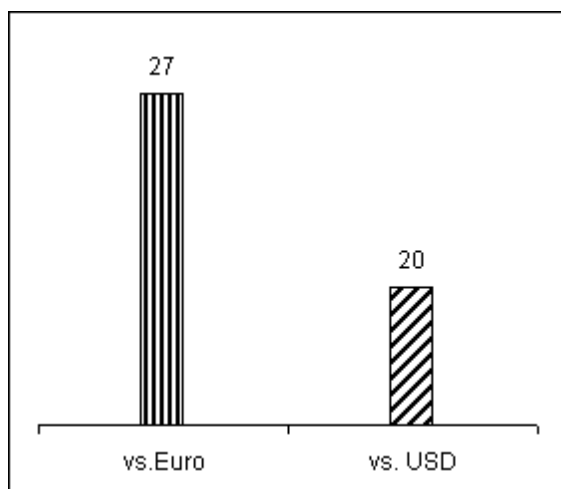
remain unresolved, but the attempts to mitigate them only generated further risks, which makes the whole situation extremely unstable not only in the longer run, but also in mid-term, and keeping the crisis-risks for the future (See more details at www.ershovm.ru).

Reducing the leverage of financial institutions will, in its turn, be accompanied by a downturn in their active operations, which, as a consequence, might increase the risks of an economic recession.

Given the scale of the problems, the reduction of the private sector’s leverage is also very likely to be imminently done **by means of increasing the public debt**. Otherwise put, the private debt risks transforming into the public debt (which is already extremely high), with the debt issue remaining an urgent issue for the global economy, thereby transforming into a long-term source of crisis risks.

Markets are clearly still viewing the situation quite tensely. Despite emerging shift of negative trends in the world economy (the beginning of economic growth, a slow increase in lending, renewed security issue), a whole number of indirect signs that typically offer a good view of the actual sentiment of investors indicate negative expectations of market players.

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 currency system, the role of the Swiss franc, a historical safe haven currency during periods of crisis, increases (Fig. 10).



a) Swiss franc strengthening vs. Euro and USD (July 2007 – September 2010)

b) Silver and gold prices (USD/troy oz, 01.01.2009=100)

Fig. 10.

Source: M. Ershov. “World Financial Crisis. What’s Next?” – M.: Ekonomika, 2011.

Forex markets gave a nervous response to Fed’s decision on further dollar emission, being of the view that the dollar would suffer much. According to international experts, “in the grand sweep of history we are witnessing the end of ‘Rome’ on the Potomac”⁵. “This is a historic moment the start of debasement of the world’s reserve currency”⁶. After the announced measures, its exchange rate went down with respect to many currencies (Fig. 11).

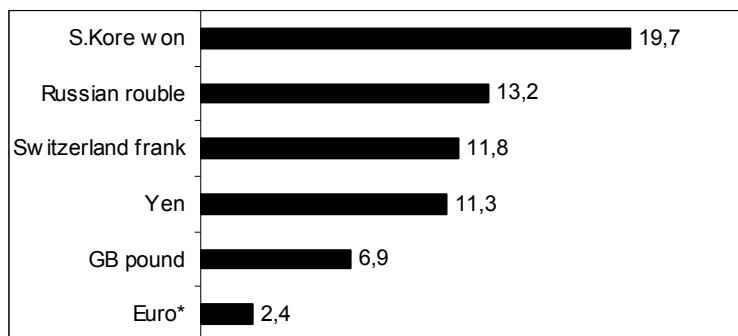


Fig. 11. US dollar depreciation (March 2009 – September 2010, %)

* March 2009 – October 2010.

Source: M. V. Ershov. “World Financial Crisis. What’s Next?” – M.: Ekonomika, 2011.

In general, over the recent years the dollar has actually entered the period of a continuous systemic depreciation (Fig. 12).

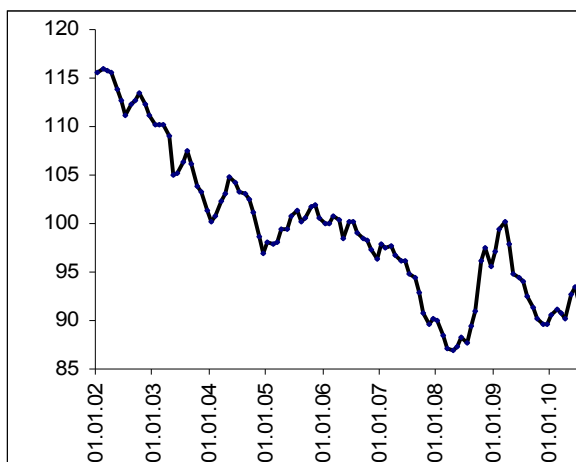


Fig. 12. Actual effective USD exchange rate (2005 = 100)

Source: BIS.

⁵ Bloomberg. 23.03.2009.

⁶ Idem

It is also obvious that any new downturn of the US economy as well as pumping it up with dollars within the framework of anti-recessionary efforts will negatively affect the positions of the US currency.

Back at the initial stages of the crisis, we warned that it would be expedient to increase the role of other currencies and the role of gold in forming gold and foreign exchange reserves in the context of the global instability.

Regarding Some Issues of Forming International Reserves

(For the meeting of the Banking Committee of the Russian Union of Industrialists and Entrepreneurs of **07.02.2008**)⁷

1. The high risks and turmoil in the international financial sector in 2007-2008, and related foreign exchange fluctuations brought forward the issue of a 'stability anchor' in the international currency system as well as the need to find least risk-exposed assets. In this connection, the attention was once again focused on gold, firstly, as an asset that is traditionally viewed as the most reliable asset in crisis times, and, secondly, as an asset whose price has been steadily growing over the last 3 years.

Given that the crisis trends in the global economy may deepen in the coming year, which might result in foreign exchange losses, we need to consider potential measures to diversify national gold and foreign exchange reserves by increasing the share of the gold component.

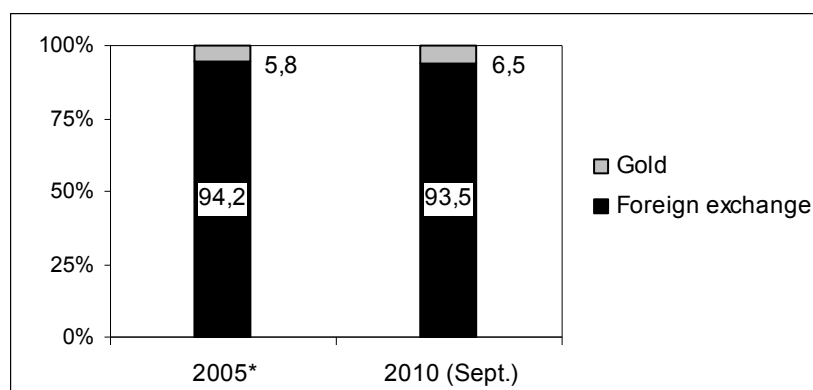
2. We also need to bear in mind the steady decline of the US dollar exchange rate against a number of currencies (Euro, Swiss franc, pound sterling, renminbi, rouble) over more than the last two years. Moreover, international organizations estimate that the US dollar still remains overvaluated (which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

Crisis trends in the US economy and lower interest rates may also contribute to the dollar depreciation by making investments in US dollars less attractive.

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

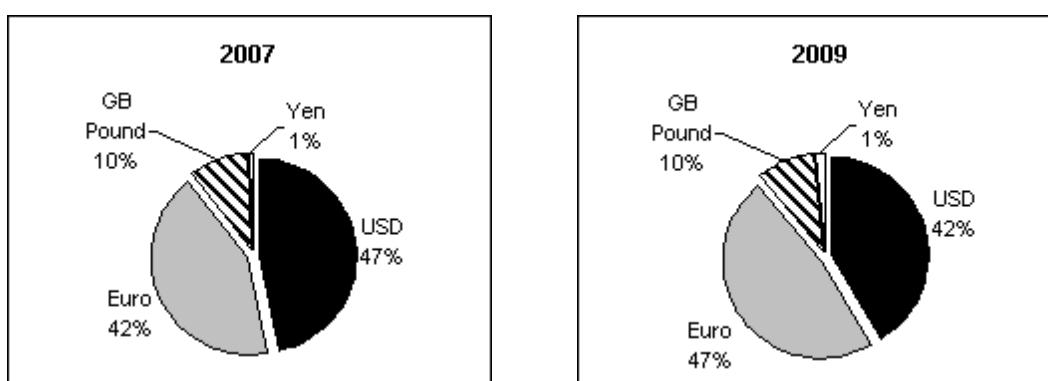
Indeed some changes in the above could be seen during crisis. However such changes still remain quite small (Fig. 13).

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



a) Breakdown of International Reserves of the Russian Federation (%)

* gold reassessed at the market price



b) Structure of foreign exchange reserves of the Bank of Russia (%)

Fig. 13. International Reserves of Russia

Source: Central Bank of Russia.

The markets' concerns and the overall uncertainty brought about once more the issue of new reserve currencies. Furthermore, at the high international level the discussions have been resumed the expediency of a wider application of gold as an 'anchor' of the international financial system. Thus, in particular, R. Zoellick, President of the World Bank said that "the system should also consider employing gold as an international reference point of market expectations about inflation, deflation and future currency values."⁸

Meanwhile, it is evident that the process of appropriate dollar substitution with other currency cannot be prompt and will probably face strong resistance at both geopolitical and geo-economic levels.

The flow of resources from budget surplus countries to budget deficit ones might become a factor exerting downward pressure on the level of interest rates (that are quite low already). As a result, yields from financial operations will go down, which will make banks to run more

⁸ Robert Zoellick, FT, 8.11.2010.

aggressive policies to boost their profits. On the back of low profits, they will be less choosy towards the quality of assets will display more interest towards high-yield but high-risk investment sectors. This trend became increasingly evident during 2010, when, first, junk bond emissions grew, and, secondly, the spread between government stock and high-risk bonds narrowed.

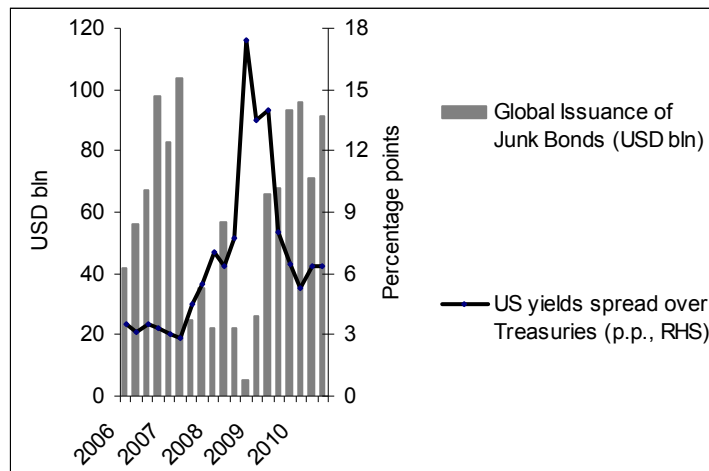


Fig. 15. Junk Bonds in the World

Source: The Economist, 30.09.2010.

It is clear that even despite regulatory and restrictive measures banks worldwide will build up their leverage and unreasonably blow up their balance sheets. **In other words, the risks being the precursors of the last crisis are reemerging again.**

These trends will quite naturally be of a large-scale and systemic in nature. As rightfully indicated by the Bank of Japan’s Governor, ‘most financial institutions will find it hard to resist pressures from equity holders to raise the return on equity under severe competition’.⁹

These factors show how fragile the achieved stabilization is and how high global and national economic risks are.

The above risks cast a shadow over the outlooks of global sustained development and requires Russian players to display an adequate state of readiness to be capable of counteracting new global risks and ensure a robust crisis-proof base for the Russian economy to develop in post-crisis circumstances.

It is all the more important to cement the recent signs of some improvement in the quality of the Russian economic growth.

⁹ Shirakawa M., Some thoughts on incentives at micro and macro level for crisis prevention. BIS, Papers No53, June 2009. P. 25-26.

A few words about possible positive trends

Well before the crisis, since 2005, Russia witnessed some changes in the growth structure when manufacturing output growth rates notably surpasses the growth rates of mineral extraction industries¹⁰. The World Bank indicated a rapid growth of the domestic demand and a steady increase in industries oriented at the domestic market. As a result, the World Bank concluded that “the observed changes in the structure of industrial growth (especially manufacturing)... suggest strong effects from the real appreciation of the ruble”¹¹.

In general, the above trends persisted until the crisis broke out, and although experts of the World Bank questioned then how long the turnaround in the manufacturing industry would last, they still stated that a number of manufacturing industries oriented at domestic demand ‘may continue to thrive in Russia’s booming domestic market’¹².

Thus, even before the crisis we could speak of the then emerging trend towards a better **quality of growth** and a gradual (though slow) shift of ‘growth drivers’, firstly, **from the upstream industries to downstream ones**, and secondly, **from external demand factors to domestic demand**.

In 2010, after the crisis, the World Bank restated again that ‘manufacturing and domestic demand’¹³ are the economic growth drivers in Russia (Fig. 16, Table 2).

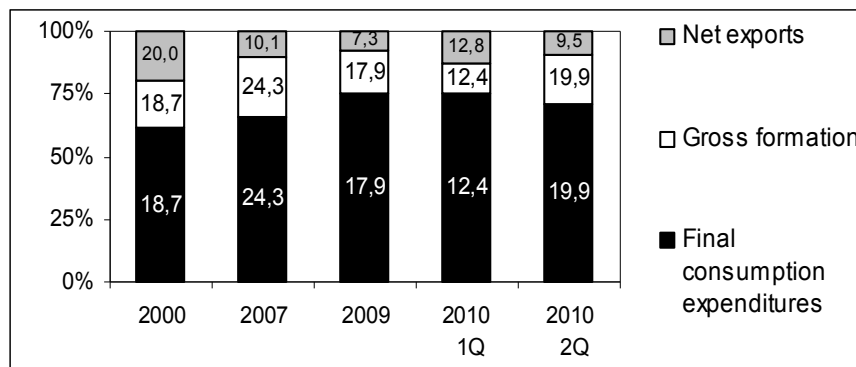


Fig. 16. Structure of GDP by use (%)

Source: calc. based on Rosstat data.

	2009	2Q 2010
Tradable sector	27,1	55,2
Agriculture, forestry	-0,1	0,48
Extraction industries	0,9	9

¹⁰ ‘Key Areas of the Unified State Monetary Policy for 2006’. Central Bank of the Russian Federation. P. 5

¹¹ World Bank. Russian Economic Report, November 2005, No. 11, p. 6.

¹² World Bank. Russian Economic Report, June 2007, No. 14, p. 5.

¹³ World Bank. Russian Economic Report, November 2010, No. 23, p. 5.

Manufacturing	26,3	45,8
Non-tradable sector	24,6	28,9
Electricity, gas, water production and distribution	9,4	1,8
Construction	1,9	-0,25
Whole sale and retail trade	10,7	11,6
Transport and communication	4,2	16,3
Financial services	-1,6	-0,9
Other	48,3	15,9

Table 2. Contribution by specific industries to the real GDP increase/decrease (%)

Source: calc. based on Rosstat and World Bank data.

If a similar trend continues, it must be made more persistent and stable by using all economic policy tools available. This will allow the Russian economy to gradually diversify away from its export- and commodity-based trend towards a more progressive development with a wider role played by manufacturing.

Regulators and market players need to pay more attention to new trends and peculiarities of the post-crisis growth to make the emerging positive trends more stable.

Our new book: M. Ershov. “World Financial Crisis. What’s Next?”¹⁴ to be published by Ekonomika in February/March 2011 discusses the issues of the global financial crisis, new risks and outlooks of global post-crisis development.

¹⁴ M. V. Ershov. “World Financial Crisis. What’s Next?” – M.: Ekonomika, 2011.