Interview to 'Economic Policy of Russia - XXI Century' Magazine, October-November 2008

About Forecasts And Crisis-Fighting measures

If forecasts made before were correct we should carefully review the new ones

(Interview with Mr. M. Ershov, doctor of economics, Senior Vice President of Rosbank)

Editor (Ed.): In an interview to our magazine as early as October 2007 you noted that the negative impact of crisis events in global financial markets "has put on the agenda certain issues related to the fundamentals of the Russian stock market, ways of reducing its speculative nature, and possible stabilization measures in case of a market crisis".[1] You also wrote that as " processes in the Russian market to a large extent are precipitated by actions of foreign players pulling their assets out of the Russian market, this necessitates an analysis of various issues of external risk mitigation in general".[2] This situation became even more obvious with the aggravation of the current crisis.

M. V. Ershov (M.E.): Indeed foreign participants are now reducing their overseas operations and consolidating liquidity at their head offices. The problem looks serious indeed: despite certain measures taken – for instance, the "Paulson Plan" of financial rescue, allocating $700 billion for buy-out of bad debts, larger access to FRS discount window (as opposed to only commercial banks in the past), certain international agreements to provide dollar liquidity, etc., all this showed that the scope of problems was evidently bigger than it seemed from the outset. Thus high volatility persists in international markets, the markets themselves keep going down and players consolidate resources from across the world.

Since the problem is of a global scale, other countries also take measures to support their respective markets. Amounts of such support are huge indeed. Some leading European countries are allocating about $1.8 trillion – just for the purposes of providing guarantees to their interbank markets!

Ed.: One can agree then with your earlier comments in favor of "strengthening the domestic base of liquidity creation and of financing the economic growth in the country. Equally important are

[1] 'Economic Policy of Russia – XXI Century' magazine, October 2007, p. 102.
[2] Ibid., p.102.

measures to promote the domestic component of Russian stock market ".[3] In view of the recent events these approaches seem highly relevant.

M.E.: Now it is the most proper time to shape new approaches allowing real strengthening of the fundamentals for future development. Those who want to leave the Russian market are free to do so. Share prices will as a result go down. This will enable domestic players (provided the domestic funding is available) to take leading position in the market. Besides, once the global panic subsides, foreign investors will resume looking for appropriate investment opportunities to use their cash.

Ed.: In this connection you have noted that "a more thorough monitoring of capital flows is needed, both out of and (no less important) into the country, at the same time paying due attention to the quality of capital, terms and nature of its allocation, incentives to bring the above parameters in line with the economic priorities".[4]

M.E.: Obviously, such "market re-entry" principles should reckon new realities, new rules of the game. A "code of conduct" in the Russian domestic market should be set, using certain measures to discourage speculative transactions (e.g. using tax measures) and stimulating long-term investors. I emphasized earlier that "to mitigate the market distortions, we can regulate margin trade, control the use of leverage and encourage to use deposit collateral".[5] It is important to promote the inflow of funds into the most important areas promoting modernization of Russia's economy.

Ed.: You also emphasized "the necessity to strengthen the most essential components of the financial sphere … as well as the importance to increase capitalization of banks to make them more resilient to "external shocks". It is important to bring into the domestic economy the funds that were earlier withdrawn. Also such funds should be used in a more focused way – all this must give the financial system a higher degree of stability. Monetary authorities should play a more active role – and this is of particular importance in the Russian environment where cross-border capital flow regime is liberalized but the level of monetization of both the banks and the economy is still inadequate".[6] Recent initiatives of the Russian regulators give hopes for a significant improvement of this situation.

[3] Ibid., pp. 105-106.
[4] 'Voprosy Ekonomiki' (Problems of Economics) magazine, No. 12, 2006, p.36.
[5] 'Russia's Economic Policy – XXI Century' magazine, October 2007, p. 106.
[6] Ibid., p.105.

M.E.: The economic developments force us all to find the appropriate solutions. Indeed, funds start flowing into the financial sphere. Regulators are making decisions to provide resources to support the stock market. Commercial banks will get additional opportunities to refinance their foreign loans, an unsecured lending facility is being introduced (though here one should exercise close control over the situation to avoid creating new sources of risks), reserve ratios are being lowered. It is important to avoid failures in the payments system – such failures may endanger further development of the economy.

Ed.: How can one ensure that the funds flow into the spheres of high priority rather than sit in the banks' accounts or are converted into foreign currency?

M.E.: In the crisis environment the banks around the world are reluctant to lend neither to one another nor to non-banking institutions, preferring to hoard liquidity. Regulators in the developed countries were even forced to guarantee the interbank loans to jump-start the interbank market operations. Similar measures are considered in Russia. In general, to find a solution we need a better streamlined management and structuring of financial flows. The international experience has many examples. For instance, the so-called '5-3-3-2' investment rule existed in Japan until the mid-1990s. This rule set certain recommendations for market players regarding the structure of their investment portfolios (in compliance with the country's economic priorities). Some economic ratios were applied to re-direct the foreign funds of Japanese banks into domestic yen-denominated transactions. In case of non-compliance the opportunities for banks to obtain emergency funding from the Central Bank at previous, preferential terms were reconsidered. Similar approach was used by other countries.

To discourage speculative FX pressure more strict regulation of currency positions, currency swaps, capital adequacy ratio, etc. can be used to make domestic currency transactions more attractive.

In general, the global regulatory community has accumulated vast experience on these issues.

Ed.: Much depends so far on how the situation in leading countries evolves. As early as 2005, you wrote: "The global currency system is going through hard times. It will have to live through serious transformations and should undergo significant changes in order to regain systemic stability and avoid an extensive, system-wide crisis".[7] Does it mean that many risks were obvious even then?

[7] M.V. Ershov, «Russia's Economic Sovereignty in the Global Economy». Moscow: 'Ekonomika' Publishers, 2005, p.72.

M.E.: In 2000, I pointed at the rapid growth of financial innovations as well as the faster growth of money supply vis-à-vis the growth of GDP in US[8]. Apparently there were risks attached to that, for example - debt burden. By late 1990s the aggregate debt of the US federal government, private sector and households had approached 200% of the country's GDP.

We should also remember the long-standing deficits of trade balance and current account (the "twin deficits"), and inadequate reserve-base of the US dollar (which was instrumental to the collapse of the Bretton-Woods system). All of the above reflected, among other things, the increased use of financial innovations and derivatives. Naturally, the growth had its objective limits (despite the efforts of monetary authorities to postpone "the hour X"). In 2005 I also wrote that even though "proper economic policy measures may cushion these problems to a certain degree, it is obvious that at certain time the critical point of no return can be passed – and all the accumulated imbalances may manifest themselves in full ".[9] Today we are witnessing this very process.

Ed.: The changes are really large-scale and rapid.

M.E.: These are salient features of globalization. In essence, we may speak about total, radical restructuring of many well-established approaches and mechanisms – or even economic systems. Indeed, the crisis events in the US of the second half of 2008 were so grand and violent and the rescue measures were so unprecedented that gave reasons to question the efficacy of the American system of financial capitalism her se, as well as its viability in the global market conditions. A number of key elements of the system have been actually damaged beyond repair and the system itself proved incapable to functioning independently in conditions of free market with the number of its key elements (institutes) being nationalized or put under government control.

There are reasons to expect that the crisis will continue for a relatively long time and will change regulatory approaches, market structure and the global economy as a whole.

Ed.: In the same book of 2005 you made a number of forecasts that have turned out to be correct as well, - referring to the US dollar rate, US stock market, ruble undervaluation (at that time) and possibility of its appreciation, a number of other topics. In particular, in the above-mentioned book and in your earlier publications (dated 1999) the conclusion was made that " the US stock market is

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[8] M.V. Ershov, "Currency and Financial Mechanisms in Today's World: Crisis Experience of the Late 1990s". Moscow: 'Ekonomika' Publishers, 2000, p.39.

[9] M.V. Ershov, «Russia's Economic Sovereignty in the Global Economy». Moscow: 'Ekonomika' Publishers, 2005, p.17.

"overheated" and a significant drop in equity prices may well be expected».[10] Mr. N. Simoniya, a well-known Russian economist, Academician and Secretary of the Russian Academy of Sciences Department of International Relations, wrote regarding the prediction of yours, "[Mr. Ershov's – *Ed.*] book went to press in October 1999. Against the background of the general economic prosperity in the USA, favorable figures of economic growth, low unemployment level, steady rise in share prices the above conclusion might have seemed too alarmist. However in less than six months - by mid-April, a sharp drop in NASDAQ index became a reality."[11] That decline continued for over three years. In other words, many future events could have been foreseen or expected?

M.E.: In my publications of the late 1990s I stressed that tremendous "mismatches" had accumulated in the American stock market by that time and they were doomed to reveal themselves sooner or later. Even before the year 2000 many shares were more overvalued (in relative terms) than they were on the eve of all major crisis "market meltdowns" such as in 1987 or during the Great Depression. For instance total market cap of the US stock market by early 2000 was about $10 trillion, with top 10 'new economy' companies accounting for around 25% of the total. Quite clearly, sooner or later the distortions were to be brought in line with the reality - and just during the year 2000 the NASDAQ dropped by nearly 60%. And that decline continued for over three years indeed.

Ed.: And has the current market decline hit the bottom – or will the crisis gain further momentum?

M.E.: Apparently, the crisis will last for quite a long time and its size may be significantly greater than it looks today. So far the situation still looks quite distressing. Yes, a $700 bln. rescue -
-package has been adopted in US – but so what? First, the actual losses are likely to exceed this figure. Moreover, after the elections the US Senate is going to initiate an additional package of measures for a total of $150 billion to stimulate the domestic demand. It will primarily focus on infrastructural projects (roads, bridges, and so on). Second, the crisis started spilling over into other sectors (e.g. commercial banks), and into other countries. If US commercial banks normalize their balance sheets, their net assets may reduce significantly and a lot of banks will face the threat of default. And this is not just an economic issue – but a social problem as well. Thirdly, problems in the mortgage sector and financial sector will affect real economy (the recent unemployment

[10] M.V. Ershov, "Currency and Financial Mechanisms in Today's World: Crisis Experience of the Late 1990s". Moscow: 'Ekonomika' Publishers, 2000, p.23.
[11] Izvestia Daily, 25.04.2000.

numbers show that such risks are high). Finally, the outlook for the US dollar becomes quite uncertain.

Ed.: In your publications of 1999 and 2000 you pointed out that "the global monetary system is facing the real perspective of a full-scale currency crisis and the possibilities to mitigate such crisis and preclude its destructive consequences for the global economy as a whole depend on adequacy and coordination of efforts on the part of the key states".[12] What issues should be reckoned with in the first place?

M.E.: The "credit history" of the US dollar is far from being ideal. We may recall the events of 1971 when France and Great Britain decided to use their right to exchange US dollars for gold as it was then provided for by the existing international accords then in force. However, the US dollar base (high-powered money) by far exceeded the US gold reserves which made such exchange impossible. As a result, the gold-exchange standard collapsed. All holders of US dollars worldwide could no longer do such conversion at previously agreed-upon price. In other words the world has experienced the largest default in its history.

Currently the US dollar base is still covered by US international reserves by less than 25%. If we also take into account the US national debt (which may also be converted into US dollars thus potentially expanding the money base), the cover of such "broad dollar base" by reserves will fall below 5% . Therefore, we are dealing with an even larger bubble than the one that has provoked the current mortgage and derivative crisis. At present when the shortage of liquidity remains acute this increases the demand for dollars and its appreciation . However, if the general deterioration of the economy triggers at first the departure from the dollars and at later stages even the flight from the US currency (as was the case in 1971), then these developments may seriously deepen the economic crisis.

Ed.: What are your predictions as to regulatory measures required to reduce the likelihood of the crisis in the future?

M.E.: In the global economy environment, the necessity of many measures is quite evident and experts arrive at them quite independently. At the technical level, in particular, some aspects of the

[12] M.V. Ershov, "Currency and Financial Mechanisms in Today's World: Crisis Experience of the Late 1990ies". Moscow: 'Ekonomika' Publishers, 2000, p.45.

Paulson plan were proposed as early as in March 2008 (and later brought to a more detailed form) implied the following:

1. Need for integrated coordination of regulatory activities in different financial market segments since "the current system of functional regulation … maintains separate regulatory agencies across segregated functional lines of financial services",[13] which precludes a regulatory system from having a required level of coordination.

2. Further extension of the FRS functions to assure the overall issues of financial market stability [14] (in addition to its traditional role of promoting macroeconomic stability).

3. To give regulators "additional emergency authority to limit temporary disruptions".[15]

4. Need for "strengthening the capitalization of financial institutions of every size".[16]

For comparison, I will tell you what I proposed, for instance, back in 2007:

1. "The financial system may no longer be viewed as a number of sectors with their separate development guidelines and autonomous principles of regulation. Unified principles and approaches are needed to strengthen the foundation of the financial system… It implies multidisciplinary coordinated efforts of all market regulators and players".[17]

2. "The Central Bank should become a real lender of last resort. Both stability of financial sphere and the development of the economy as a whole will depend its due and timely actions.[18]

"The question of extending the Central Bank's functions needs to be addressed…".[19]

"Monetary policy instruments should be also used for stabilization of the situation in the stock market".[20]

3. "Contingent mechanisms and levers for emergency situations should be developed and be used promptly in the event of a crisis".[21]

4. "The strengthening of the banking sector as the pillar of the financial system and the increase of the banking sector's capitalization"[22] are also important.

As one can see there are a lot of similarities in the suggestions above.

[13] US Treasury, Henry M. Paulson, "Blueprint for a modernized financial regulatory structure", March 2008, p.4
[14] Ibid., p.15
[15] US Treasury, Opening Statement by Henry M. Paulson, July 10, 2008, p.30
[16] US Treasury, Statement by Secretary Henry M. Paulson, Jr. on Financial Markets Update, October 8, 2008, p.2
[17] 'Voprosy Ekonomiki' (Problems of Economics) magazine, No. 12, 2007, p.26.
[18] Ibid., p.26.
[19] Ibid., p.26.
[20] Ibid., p.26.
[21] Ibid., p.25.
[22] 'Voprosy Ekonomiki' (Problems of Economics) magazine, No. 12, 2006, p.35.

Moreover, these lists include only a number of potential technical measures. If we look at it from a systemic standpoint many more actions could also be put in place, particularly at the times of crisis.

Ed.: Does that imply new economic approaches?

M.E.: The new magnitude of risks requires new approaches. Companies are intensely looking for new sources of funding. Sovereign wealth funds from Asian countries start playing a higher role with this problem having not only economic but political ramifications as well. Funds may flow in from countries whose approaches to a wide scope of geopolitical issues may differ significantly from the position of the recipient countries. This will enhance the importance of control and regulation which will become increasingly strict in the developed economies moving closer in their approaches to the arbitrary methods from Russia's recent past. As one example, US and Great Britain initiated rescue-loan provision to their banks in exchange for their shares. That means another phase of nationalization.

Ed.: What other measures are required?

M.E.: The top priority should be given to identification of new sources of risks. Development of comprehensive strategy of key economic players in the changing conditions is important. Russia needs to assure long-term and stable development even in the turbulent global environment.

In this regard I will briefly say once again that Russian economy needs, first of all, to strengthen the domestic base of financial markets which should primarily rely on domestic funding (preferably long-term one) rather than external sources (often of speculative nature). It is important to broaden the functions of Russian Central Bank as mentioned above. Of particular importance (especially today) are anti-crisis support mechanisms. Efficient coordination of regulators' efforts is necessary. Final decisions should be made at the highest level possible so as to surmount any inter-agency disputes.

We should consider more focused approaches and opportunities of integration into the global financial system, trying to avoid dispersion of our investments among 'mega-targets' like US mortgage giants Freddy Mac and Fannie Mae where we are just one of many other investors and our voice is absolutely not heard. Instead, we should consider possibilities of buying a sizable stake in a first-class bank seeking such an external investor (as was the case with Citigroup and Mitsubishi or as it might have been in the case of bankrupt Lehman Brothers, had there been a buyer).

Regarding new risks in the short run – these are new sectors affected by the crisis, for instance, commercial banks, and also the novel derivatives that may aggravate the situation (e.g., the CDSs - credit default swaps, etc.). Then, as already mentioned, we have risks in the FX area – with the US dollar to be watched closely. In the longer run, we can speak of risks stemming from mergers of commercial and investment banking operations in US (by way of a reminder – such a merger preceded the Great Depression) with all potential economic and social consequences.

And certainly, efficient regulation of cross-border financial flows is important.

Ed.: Indeed, as early as 2004, when new approaches were formulated in relation to currency liberalization, you noted a number of potential risks, "The very fact that Russian companies can borrow "directly" in global financial markets … poses threat of serious debt problems to Russian business".[23] This exact problem is currently in the spotlight.

M.E.: Yes, it was also written that "in essence, it is the question of liberalization of the so-called "cross-border transactions". Usually such transactions are allowed only at the final stages of liberalization of a country's financial system".[24]

Moreover, it was clear that when the economy grows and internal sources of funding are not fully developed and when the liquidity is placed with foreign instruments, the players have no other option but to use the external markets for funding to ensure their own growth. And this is precisely what we observed on a massive scale. As a result, by now the aggregate foreign debt of the corporate sector (banks and companies) reached US $500 billion. We have to bear in mind though that the debt was accumulated during a favorable period of economic growth - now the situation has changed which makes the refinancing of existing debt quite a problem. When I wrote about such tendencies I tried to draw attention to these potential risks.

Ed.: As for new risks we should re-assess once again the destabilizing effect of "hot money". As you already noted, "with all significance of currency and financial liberalization, it must be implemented step by step, as the country's market develops and increases its resilience to external shocks".[25]

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[23] "BANKOVSKY RYAD" magazine, spring-summer 2004 (1-2), p.6.
[24] Ibid., p.6.
[25] 'Voprosy Ekonomiki' (Problems of Economics) magazine, No. 12, 2006, p.36.

M.E.: In the case of Japan, for instance, the currency and capital flow liberalization took place more than 30 (!) years after the liberalization of current transactions in the mid 1960s. By and large, all industrial countries, even during ordinary ,"non-crisis" periods, employed a broad set of regulatory measures to maintain the stability of their financial and currency markets. Many of these countries embarked on real liberalization only after they gained prominent and stable positions in the global economy (Western Europe and the USA in late 1980s and Japan in the late 1990s).

If other countries do not recourse to protectionist measures and Russia, in turn, will keep its regulation of foreign sphere unchanged, then (taking into account that Russian economy has been liberalized to a great extent and external conditions became much less stable) in order to reduce new external risks, the emphasis should be put on development of anti-crisis mechanisms capable to mitigate the impact of "external shocks".