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SHAKY STABILIZATION[1]

In late January 2011, the U.S. Financial Crisis Inquiry Commission published a 600-page report on this issue.[2] "Subjective" factor is called a major one, and it is concluded that "this financial crisis was avoidable. The crisis was the result of human action and inaction" (p. XVII). This made possible and aggravated the effect of explosive growth of securitization and subprime loans, unreasonable growth of housing prices, sharp growth of the trading operations of financial companies, unregulated derivatives, etc. (p. XVII).

Important crisis preconditions include the emergence of "shadow banking system."

These risks have been discussed repeatedly. Easier regulation than practiced by traditional commercial banks allowed financial companies, investment banks, hedge funds and money market funds to exercise less costly financial intermediation than the traditional commercial banking system. As a result, financial operations started to flow increasingly into the "parallel" (shadow) banking system.[3]

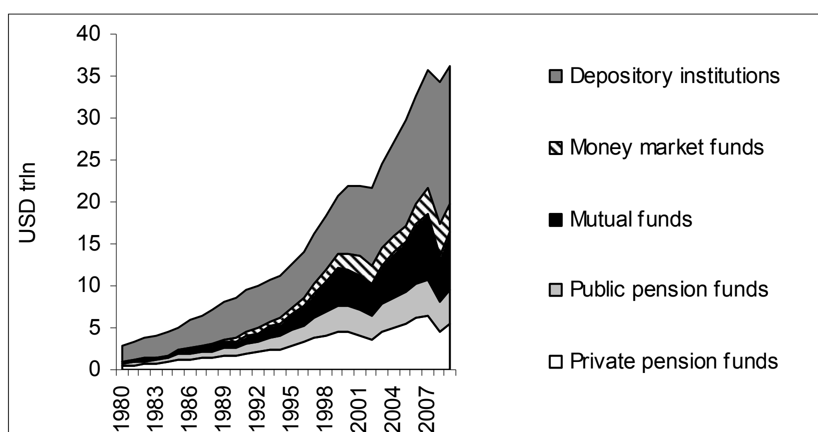


Fig. 1. U.S.: Assets of a Number of Financial Institutions (trln USD)

Source: M. Ershov, Global Financial Crisis. What's Next?. M.: Ekonomika, 2011.

Back in the 1980s, traditional banking system accounted for about 70% of assets of the entire financial sector, whereas by the 2000s their share went down to less than 50%.

[1] The article reflects the personal opinion of the author.
www.ershovm.ru

[2] Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States. Financial Crisis Inquiry Commission. January 2011.

[3] For details, see M. Ershov, Global Financial Crisis. What's Next?. M.: Ekonomika, 2011. P. 295.

Menacing leverage

Easier regulation led to large-scale use of "derivative models," which allowed using the minimum equity and resulted in growing reliance on borrowings (leverage).

This problem has drawn attention for a long time. Back in 1998, Brooksley Born, Chairman of the Commodity Futures Trading Commission, highlighted the risks faced by LTCM (Long-Term Capital Management). It was said that market regulation was such that it allowed the company to raise funding of USD 125 bln - 100 times bigger than its equity! Subsequently, raised funds were used to open derivative positions with a par value of USD 1.25 trln - 1,000 more than its equity!!![4]

For the market in general, leverage indicators (showing asset to equity ratio) adjusted for off-balance-sheet operations in some cases reached the levels of 50-70 times (Fig. 2.). Moreover, sometimes the value of off-balance-sheet operations exceeded the balance sheet value.

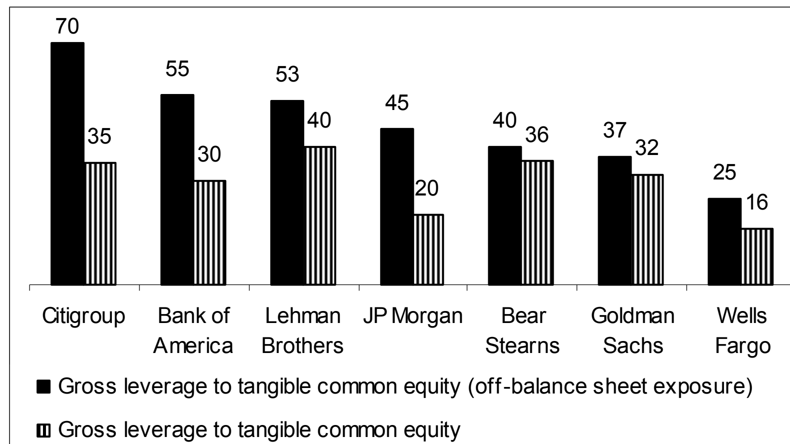


Fig. 2. Leverage of the Leading U.S. Banks in Late 2007 (Times)
Source: FCIC, Jan. 2010.

At the U.S. Financial Crisis Inquiry Commission hearings on the crisis reasons, the President of the Bank of America fairly noted that it was “difficult to understand how markets and regulators could tolerate leverage of 40-1 or even 60-1 in our largest investment banks”[5].

Surprisingly, the risks of so vast deformations were not assessed adequately by the expert and academic community, which "mechanically" relied on "further growth" assumptions.

[4] B.Born. "Regulatory Responses to risks in the OTC derivatives market", November 13, 1998, p. 3.
[5] B.T.Moynihan, Chief Executive Officer and President, Bank of America. Testimony to FCIC, Washington, D.C. Jan. 13, 2010. P. 10.

Crisis of Forecasts

Forecasts of prospective events in the global financial market virtually failed. Speaking at the U.S. Congressional Hearings on crisis-related issues, Alan Greenspan admitted that many things were seen differently and had to be revalued as a result of the crisis. Furthermore (sort of justifying himself), he said that powerful models were created. They were designed to predict such events and the authors of some of these models were even awarded the Nobel Prize. However, the models of such course of events have not even been foreseen. “The whole intellectual edifice … collapsed … because the data inputted into the risk management models generally covered only the past two decades, a period of euphoria”[6].

But why do we need models that fail to accomplish the primary goals of their creation? Certainly, now they say that risk assessment models were poorly justified as such complicated systems cannot be understood in every detail (specifically, this was emphasized by the Nobel Prize winner Edmund Phelps). Indeed, it is difficult to understand so rapidly changing mechanisms and instruments. Yet, simply limiting future outlook by mere extrapolation of visible trends (though clothed in pseudo-scientific model constructions sometimes hardly understandable even to experts) is not what the current economic systems need to asses development prospects.

Failure to view the possibility of unfavorable scenarios as a serious alternative indicates that the economic science and business are **losing their ability to assess realistically the essence of events and** that global corporate interests (and the associated profit generation objectives) are not ready to adopt more reasonable and less profitable (in the short run) business strategies.

There is another less depressive question. What is, basically, the quality of supreme economic award-giving in the modern world? It appears that awards are given to the authors of ineffective models, the "expert jury" is, virtually, unable to assess realistically their quality and everything becomes clear only when the "real practice" puts everything in real and proper perspective.

Deregulation policy, which has been pursued for more than 30 years (in case of the United States), has eliminated the key barriers which could have prevented the disaster.

U.S. Fed: reforms are due

In this regard, it is more often emphasized that the independence of the monetary policy, on the one hand, and the independence of the U.S. Fed, on the other hand, should be

[6] A.Greenspan. Statement during Committee Hearings on the Financial Crisis and the Role of Federal Regulators, US House of Representatives. Oct. 23, 2008.

differentiated. Given that the shareholders of regional FRBs are commercial banks with their commercial interests and the interests of their shareholders, increasing attention is paid to its performance.

Moreover, the U.S. Congress is currently considering the bill providing for the U.S. Fed audit.[7] Until recently, audits have not yet covered crucial areas of its activity such as monetary operations, including discount window loans (which give the opportunity of direct lending to financial market participants); open market operations; operations with foreign governments and foreign central banks.[8]

It is at least bewildering that such crucial functions as monetary policy are not controllable by taxpayers.

How in principal the modern economic system, which declares itself open and transparent and requires openness from others, remains so non-transparent in the key questions of its functioning?

It is fair to say that during the crisis period U.S. monetary authorities proposed some strategic initiatives aimed at systemic reforms of financial sector. These proposals were supported by legislatives.

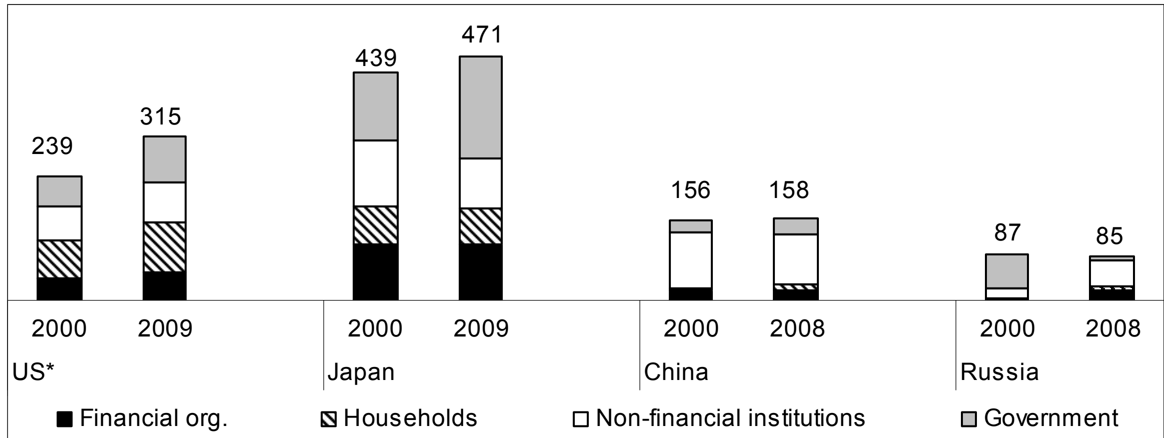
The important adopted initiatives include the imposition of restrictions on the use of client funds for the risky investments of banks ("proprietary trading"). This is critical, all the mores so as many of these funds (deposits) are guaranteed by the government (for protecting the interests of depositors) whereas banks can use them for their, often fairly risky, investments. This restriction was conventionally titled the "Rule of Walker" (former head of the U.S. Fed, who was the author of the above-mentioned measure). Derivatives will have to be traded through special affiliates to be established by banks. For weakening the role of the New York Fed, its head will be appointed by the presidents of countries rather than the Board of Directors of the U.S. Fed.

The Financial Services Oversight Council will be established. It will be led by the head of the Department of the Treasury and composed of managers of the leading economic agencies. It is planned to track thoroughly "leverage" indicators and off-balance-sheet operations. In case of large companies (bank holding companies whose asset value exceeds USD 50 bln and non-banking financial companies supervised by the U.S. Fed), to restrict (in case of stability risks) merger and acquisition operations and the possibility of product offer. It is expected to be recommended that these companies sell a part of their balance-sheet and off-balance-sheet assets to third parties (non-affiliates).

[7] Federal Reserve Transparency Act, HR 1207, February 2009.
[8] US General Accounting Office, Federal Reserve System Audit, October 27, 1993.

History gives no lessons

Although the private sector leverage has somewhat decreased by now, in general, this reduction has been "translated" into the growth of debt burden for other economic sectors.



* net of ABS. In 2009, the total debt to GDP ratio, including ABS, will range between 350% and 360%.

Fig. 3. Debt to GDP Ratio (%)

Source: calculated using data from the Central Bank of the Russian Federation, the Ministry of Finance of the Russian Federation, the Federal Treasury of Russia and the Federal State Statistics Service; Haver Analytics; McKinsey Global Institute.

Furthermore, normalizing their balance sheets, financial companies simultaneously face a decrease in the profitability of their operations, impeding their growth and making it again more "risk-oriented."

This trend became visible during 2010, which saw, first, the growth of demand and issuing of junk bonds and, second, reduction in the yields spread between government securities and high-risk bonds.

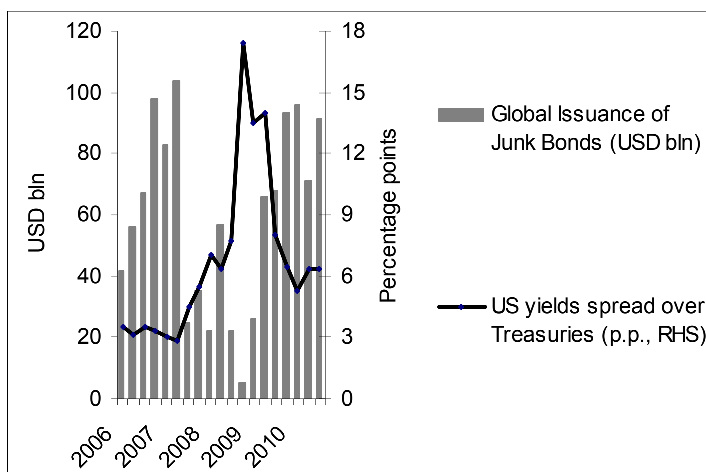


Fig. 4. Junk Bonds Worldwide

Source: The Economist

In other words, the risks preceding the most recent crisis are beginning to reemerge. Naturally, this will be a large-scale and systemic phenomenon. As the head of the Bank of Japan fairly stated, "most financial institutions will find it hard to resist pressures from equity holders to raise the returns on equity under severe competition."[9]

This is even more important in the context of a new phase of "anti-crisis liquidity" injections in the United States as well as in Japan (especially given the need to stabilize the situation after natural disasters) and the outpacing growth of global money supply in relation to GDP (Fig. 5).

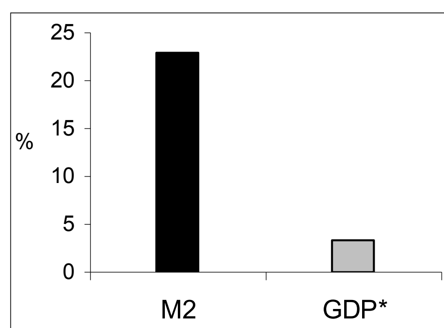


Fig. 5. Increment in the Money Supply (M2) and GDP of Major Economies in 2007-2009 (December vs. December, %)**

* Increment in nominal GDP
** Eurozone, USA, UK, Japan, China, Russia
Source: calculated using data from Eurostat, US Fed, BEA, Bank of England, Bank of Japan, National Bureau of Statistics of China, the Central Bank of the Russian Federation and the Federal State Statistics Service.

The above-mentioned resources, obviously, will search for its niches first by flowing into the markets and warming them up as a result and then leaving the markets, thus creating the risk of collapse. In an environment of free capital flow, this will make the risks of new regional crises more intense and may increase volatility of both financial markets and the entire world economy. This can be accompanied by the aggravation of problems with the U.S. dollar, which, in principle, has entered the phase of long systemic depreciation (Fig. 6).

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

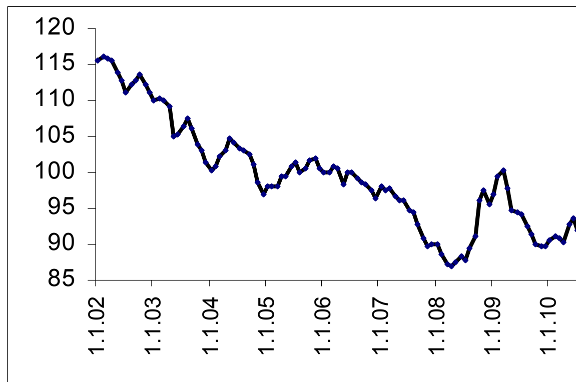


Fig. 6. Real Effective USD Rate (2005 =100)

These circumstances show how fragile the achieved stabilization is and how high the risks faced by the world economy and individual countries are. This necessitates developing the mechanisms of post-crisis development adjusted for new risks and new opportunities emerging worldwide.

Editorial comment: The issues related to global financial crisis, new risks and prospects for post-crisis global development are discussed in the new book by M. Ershov, **Global Financial Crisis. What's Next?**, published by the Ekonomika publishing house in March 2011.