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Global Financial Crisis: What's Next?

The new book[1] by Mikhail Ershov, Doctor of Economics, covers one of the most pressing and vivid challenges of the contemporary global economy. Mikhail Ershov, a well-known Russian researcher and banker[2], perhaps as no one else is capable of tracing and analysing in-depth processes which evolve in the global financial system as well as to give substantiated forecasts of their future evolution. These very qualities of the author make the reading of his new investigation so exciting and fascinating for all people who ponder on the fate and fortunes of the today's world at this point in its evolution that can be called a turning point in many respects.

Before we pass to the analysis of the book, we would note that its actual content is much broader and more profound than its title might imply. Alongside with an analysis of causes and nature of global financial upheavals and their potential implications for the Russian and global economies, the author discusses in detail the monetary, currency and general economic policies of the pre-crisis period, gives his recommendations and proposals to prevent similar situations in the future in the context of overall national economic recovery and reinforcement of national positions in the world.

The study by Mikhail Ershov begins with a breakdown of the nature and key causes of the global financial upheavals of 2007-2009. The author analyses changes in the contemporary global economy that resulted in the financial disasters of 2007-2009. He believes that the key changes include the financial bubble blown up beyond measure that, in the globalisation context, started in many respects growing independently of the real economy, which led to distortions and misbalances in individual economies, and in the global economy in general. All this, on the back of globalisation-driven free capital flow between countries funnelled by a system of financial instruments (including uncontrolled derivatives) growing more and more complicated and the lack of any efficient international financial regulation mechanisms, was bound to produce a global collapse, sooner or later. A serious failure in any element of the global financial system

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1 *M. V. Ershov.* Global Financial Crisis. What's Next? M.: Ekonomika, 2011. 295 pp.
2 M. V. Ershov has authored dozens of publications in major research and professional magazines and three individual monographs; he is currently Senior Vice President at Rosbank.

was enough to stagger the whole system, as was evidenced by the US subprime mortgage crisis, though a seemingly local event.

'In the XXI century, the global economy starts facing a fundamentally new geoeconomic and geopolitical situation in its history', says the author of the book (p. 7). The US financial crisis that rapidly spread over to their global economic partners, forced the developed countries to revise the fundamentals of their regulation methods by providing substantial support to economic players. 'The overall situation made possible to speak about the crisis of the contemporary model of financial capitalism' (p. 7).

Apart from drawing such a far reaching conclusion, Mr Ershov also supports it with abundant factual materials that describe key processes in the modern global economy. 144 tables, figures and charts in 283 pages of the book, with most of them being the product of the author's own calculations: this alone shows the scale and quality of the analytical job accomplished by the author. Among other things, we deem it necessary to mark out this particularity of the book as the author does not impose his point of view, but rather invites the reader to verify whether his conclusions are correct.

In analysing the sources of global financial calamities, the author underlines that their 'fundamental causes ... were not the current (although important) mortgage problems, but systemic misbalances piling up in the global economy and the rapid growth of a fundamentally new segment of the financial market – derivatives coupled with its inadequate regulation. In such a misbalanced system, the mortgage market problems only facilitated the issue of all accumulated distortions and prompted the crisis development' (pp. 19-20).

The book demonstrates that the derivatives market recorded a particularly rapid growth with the turn of the century. From 2001 to 2007, its global capacity soared from USD 135 trillion to USD 668 trillion, or almost fivefold, and, immediately before the crisis, exceeded the global GDP by more than tenfold (p. 21). Apparently, the policy of the US Government, which was interested in the expansion of its corporations outside the country, contributed much to such developments.

Among other things, the US authorities directly participated in the overblowing of the global derivatives market by encouraging almost unsecured mortgage loans that then spread across the world in form of various derivatives through financial operations of specialised agencies such as Fanny Mae and Freddie Mac, commercial banks, hedge funds, and other market players. It would be enough to say that, by April 2007, the total mortgage debt created with the help of such financial institutions approached USD 10 trillion, or 75% of the US GDP (p. 26).

Market of financial instruments grew rapidly and became increasingly intricate. In terms of their reliability and coverage it became ever less predictable. Accompanied by its fast internationalisation (the share of foreign ownership of global financial assets equalled about USD 70 trillion, or more than 30% of total assets (p. 35)), the weakness and unpredictability of the whole global finance structure became evident.

The financial instability has been also fuelled by so called global misbalances when many countries, primarily developed nations, such as US, Japan in certain periods, and EU countries, traditionally had and have important deficits of their trade and payment balances, while other countries, especially emerging economies rapidly growing in the recent decades, strike their balances of current operations with sometimes quite high surpluses. As a result, the countries of the first group are short of finances to develop and meet the current needs of their populations, which they cover by selling government securities and raising private investments from countries of the second group. As a result, the latter as if finance the welfare and development of the former and base such financing on their own savings that they were unable to use at home for various reasons.

Such donor nations include Russia, where savings are higher than accumulation. This situation makes it ‘a source of financial resources for countries suffering from financial shortages’, writes Mr Ershov. ‘In practice, a part of our financial resources (located in specialised funds, such as the stabilisation fund, etc., and in gold and foreign exchange reserves) were invested in the US treasury bonds and instruments of other countries thereby financing their deficits’ (p. 39-40). The author supports these conclusions with data from official documents of the Bank of Russia.

In general, the author of the book believes that the inflating the balances by raising cheap money from abroad and fundamentally wrong market behaviour ‘served as important causes that aggravated the crisis... Local problems enhanced the impact of global problems, while the global problems not only remained unsolved, but attempts to mitigate them resulted in new additional risks. This makes the situation extremely unstable in both - long and short terms - and preserves the risk of new problems in the future.' (p. 42-43).

The vicious practices of hedge funds, private banks, investment funds and other commercial institutions contributed a great deal to the creation and aggravation of the crisis situation in international financial markets.

Financial market operators took advantage of the ever growing liberalisation in banking law and the overall weakening of regulatory control over financial flows, as globalisation processes went on, to recur to ever riskier tricks to maximise their profit within ever shorter timelines. Leverage was one of such tricks when a financial company blew up its assets almost entirely through borrowings which oftentimes exceeded its equity by tens of times. Loans were often issued without sufficiently diligent verification (subprime) with quite long maturities, and underlying liabilities were, as a rule, short-term ones (or sometimes simply overdue). This made the crisis even more possible. The bankruptcies of such large 'subprime lenders' as New Century and Nova Star in the US and UK Northern Rock Bank in the UK started as early as in summer 2007, followed by problems with government-linked US mortgage agencies Fanny Mae and Freddie Mack, investment banks Bear Stearns, Lehman Brothers, Merrill Lynch, Morgan Stanley and Goldman Sachs (that were either bailed out by the US Government, or went bankrupt), demonstrated the scale and severity of the issue. The author states that, by autumn 2008, 'the US investment banking systems ceased to be what it was' (p. 47).

An analysis of operations by investment banks and other financial entities that found themselves on the verge of bankruptcy showed that in some cases their leverage was 75 times their equity (Fanny Mae and Freddie Mac) and even 100 times (as it had been before) as was the case of Long-Term Capital Management (LTCM) specialized in derivatives. The financial capital system established in the US and other developed countries in the course of globalisation did not stand the test of time and proved a failure during the crisis.

Taking into account that over the last three to four years, tens of monographs and thousands of research articles on various aspects of financial turbulences of 2007-2009 were published in Russia and in other countries, the author of the book spares us any detailed descriptions of the crisis evolution and its manifestations in different countries. Instead, he focuses on fundamental issues of the phenomenon and its potential implications for the global economy in the coming years and onwards.

Mikhail Ershov believes that one of the issues to trace is a possibility of 'substantial reshuffling of corporate structure of the global financial markets (in the US as a consequence of the world at large)'. (p. 48). Government authorities of leading developed countries started playing an essential role in such revision as they recurred to the large-scale pumping of liquidity into monetary circulation channels and selective assistance to backbone financial corporations, including by taking over control over them, and in some cases even by directly nationalising them. Mikhail Ershov writes: 'The efficiency of a new version of the old formation of state capitalism which took shape in the post-crisis period was put on the agenda' (pp. 48-49).

It is now evident that wide-scale bankruptcies of private financial corporations (and in some cases even potential sovereign defaults) would have been imminent, potentially with subsequent collapse of the entire global financial system, but for the intervention by government and, as the crisis evolved, international authorities. In this connection, the author states that 'The crisis was so huge, and stabilisation efforts applied by regulators, so unprecedented, that all this cast doubts on the fundamental efficiency of the financial model of capitalism (primarily its US version), its survivability and its viability in the global market... As a result, the role of the government in the economy grew substantially which made the talks on models of state capitalism in global environment important again' (p. 11).

We have already noted that, in general, the author positively assesses anti-recession efforts undertaken by governments in some countries, and, as the crisis evolved, by international or (as in the case of the EU) supranational authorities. He believes that these measures, primarily replenishment of monetary circulation channels with liquidity, were dictated by pragmatic considerations and, on the whole, achieved their objectives, i.e. prevented the threatening economic collapse.

However, as any important economic phenomenon involving large financial resources, anti-recession measures have a reverse side: the excessive liquidity accumulated in the monetary market of developed countries may speed up inflation processes. Respective governments prefer combating this risk by pushing the threat outside their national borders, mainly to developing economies.

This trend was reflected by the rapid growth of export of so called 'hot money', or, in other words, speculative capitals that had many times led to financial perturbations in the countries receiving such capital recently. The latter are actually quite aware of this threat and take protective measures against excessive expansion by international financial profiteers. In the recent years, especially at the final stage of the crisis, Brazil, India, the Republic of Korea and some other countries took restrictive measures of tax and other nature against the inflow of short-term speculative investments.

Nonetheless, emerging economies, especially their leaders, do not only defend, but also attack. During the crisis, financial and industrial groups and so called sovereign investment funds of China, India, Brazil, Korea, South Africa, Singapore and some other countries intensified acquisition of rapidly cheapened assets in the 'gold billion' States, which, according to Mr Ershov, forecasts considerable changes in the global balance of economic and political forces. 'From systemic, geo-economic standpoint, he writes, it looks probable that global redistribution of property may well occur, whereas more in-depth interests and centres of power are behind the downfall of asset prices. These tendencies may bring about the situation when the explicit and implicit picture of the world may change significantly' (p. 49).

The above processes are vital for Russia that suffered the most from the financial crisis as compared to most of its partners, but retain opportunities to maintain and even strengthen its role as a leading player on the global economic and political scene.

In the foreword, the author points out that in ancient Greek the word 'crisis' is translated into Russian as 'a trial', 'a decision' or 'a turning point'. I believe that these words most accurately depict the situation of Russia in the today's world. After a sever trial by history during the crisis years, today's Russia faces decisions that may really become a turning point in its future.

In the final chapters of the book, the author discusses in detail the opportunities and outlooks of national development in the context of the lessons learned during the crisis and specific areas of general economic, industrial, monetary and currency policies that, in his mind, should be run by the Russian authorities to protect Russian sovereignty and bring the country to the ranks of global economic and technological advance leaders. Specific recommendations of the author aimed at reaching this objective provide for developing clear post-crisis economic development priorities; preparing an integrated approach to the creation of money supply that would link the policy run by the Bank of Russia to the objectives of the budgetary, industrial and structural policies; exercising thorough control over the capital flows not only out of, but also to the country; working out an exchange rate policy that would facilitate inflow of long-term direct investments in the country and protected national producers from unfair competition and many other, weighted and constructive proposals (pp. 280-290).

Mikhail Ershov concludes his book by saying: ‘Today we face historically unprecedented opportunities for working out fundamentally new approaches and mechanisms to form the basis for sustainable development of Russia for many years ahead by strengthening its international positions and turning the country into an important global centre of economic and political influence.’ (p. 290).

We would like to hope that the new book by Mikhail Ershov will facilitate the creation of a policy aimed at reaching the above goals.

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