The Global Financial Crisis: Open the Gates

Vremya Novostey
#189, October 13th 2008
http://www.vremya.ru/2008/189/8/214692.html
Leonid Grigoriev
Marcel Salikhov

A global crisis always arrives unexpectedly and at the end of a cycle of economic growth. The question then naturally arises whether this is a single global financial crisis originating in the United States, which subsequently pulls in the European Union, Russia and other countries, or whether this is a collection of several little messes. Any modern analyst from any country would answer that this is an American crisis and that the other countries are the victims. It is politically convenient that no one is even discussing that everyone will be able to write off their economic mistakes in the "general" crisis. Although in the chaos of the crisis, "national mines" explode set off by the financial bomb from the U.S.

Historically, a financial crisis on developing markets includes a liquidity crisis, a credit paralysis, stock market drops and bankrupt banks, but the drop in trust only lasted for days, and not weeks, and was not all-encompassing this time. The transfer of negative impulses, such as what happened during the Great Depression, went slowly. One can point out several boundaries or stages of the current crisis and designate a future "threat boundary." These crisis stages did not start equally in all countries – they moved from the U.S. to Russia, then gradually sucked in other countries – both in the East and in the West.

10 Crisis Stages

The first stage is the U.S. housing crisis, the use of vast resources to write off bad mortgage loans from banks and the first bankruptcies that took place in the year from August to August.

The second stage is the liquidity crisis that has taken place in waves, but the most recent stage has not abated since mid-September. Banks are only using "outside" money from central banks, and do not trust their own money, which is why they can not get out of this crisis. One of the biggest mistakes was to let Lehman Brothers declare bankruptcy. One of the correct theoretical arguments was to avoid moral hazard, i.e. not to take away complete responsibility from market players. This shows that there is a lack of understanding of how deep this current crisis actually goes – the Lehman Brothers' bankruptcy has scared everyone because it showed that there are no more reliable brands.

The third stage is credit paralysis, which has leaked out from the liquidity crisis. The longer this lasts the more harm it will do to current economic activity, but most specifically to future capital investment.

The fourth stage is growing mistrust and the transfer of panic signals through the collapse of stock markets. Even though the U.S. Congress approved the plan put forth by Treasury Secretary Henry Paulson and seven central banks immediately lowered refinancing rates, the world is trying to treat the plague with medicine for anorexia.

The fifth stage is the "soft privatization" of key banks and risk insurers. Even if this is a temporary phenomenon – one can only hope that the injection of hundreds of billions in government resources into private business in liberal economies is really temporary – it is something earth-shattering, since the neoconservatives have started to nationalize banks. For

example, German Finance Minister Peer Steinbrueck even mentioned Marxism in an interview with *Der Spiegel* when he said that one could say that several tenants of Marxist theory were right.

The sixth stage is the crisis boundary and it seems that this can be avoided for now. If one does not take into account the conflict between Iceland and its banks in Britain - which initially attracted half a million clients in Europe, then went bankrupt, which pushed the British to arrest Icelandic bank accounts – the world's monetary authorities have shown a spirit of solidarity in their statements and in fighting this crisis. The authorities understand how protectionism destroyed the world economy in the 1930s.

The seventh stage is trust in personal savings and this boundary must never be crossed under any circumstances. We are witnessing a universal increase in government insurance guarantees for personal bank accounts. However, this could turn into a danger as the temptation should never be created that one can take their money home from banks.

The eight stage is resolving the problems in the real sector of the economy. The U.S. and a number of European countries are threatened with recession. Russia is concerned about its growth rates and programs, although a slowdown is unavoidable.

The ninth stage is regaining trust, although it is a long time until that will happen. It requires certain international agreements and real steps that the U.S. needs to take.

Finally, the tenth stage envisions real reform of the global financial system. Another Joseph Kennedy – the patriarch of the Kennedy clan, an alcohol tycoon and chairman of President Franklin D. Roosevelt's commission to reform the U.S. financial system in the 1930s - is needed now to rebuild the world's financial and economic system in the 21st century.

The Payment For Growth and Illusion

The most recent global economic growth took place from 2003-2008, and according to the International Monetary Fund (IMF), real global GDP grew 33% over the past six years and increased 42% in the previous 12 years. This is the best result for the world as a whole in the past 60 years. However, such a growth on the market does not take place without leaving any traces behind; a Marxist would say that "contradictions have built up." It is true that the growth had some very positive characteristics – emerging countries posted independent growth of 60% and this has made these countries less dependent on cyclic processes on emerging markets (18%). However, prices have soared for energy and other raw materials.

Table 1 shows that there has been a movement of economic power to China, India and to developing countries on the whole. Revenues and foreign currency reserves have also shifted to China and oil exporters. OPEC countries received a total of $100 billion in 1998 and Russia got $30 billion, while this soared seven-fold in 2007 to a respective $700 billion and $210 billion. This energy imbalance has created problems for transport and many other sectors of global industry; as well as for citizens in many countries and has not contributed to stability. The U.S. posted a budget deficit and a current accounts deficit of 4%-6% of GDP in the past few years because of the Iraq war. These U.S. deficits stand in contrast now to the European Union's tough fiscal guidelines stipulated in the Maastricht Treaty and to surpluses in China and for oil exporters.

All of this was within the limits as long as there was general stability around the world. But amid low inflation and low interest rates up until 2006, the growth created the false illusion that everything was permitted. The financial sector bred trillions of pyramids of secondary securities

and exotic derivatives based on relatively flimsy assets in the housing sector. Wall Street had the widest possibilities to create hybrid instruments over the span of an entire decade. The pressure of quarterly reports for control of profitability pushed managers to compete for bonuses. Strictly speaking, manager assessments of quarterly success are an old problem for U.S. business. Large projects cannot be successful in all quarters and this is where the threat is greater that banks will take on extraordinary risks. It turns out that there was not enough regulatory control over banks, just as there was not enough control over non-financial companies in 2001. This is where the most "toxic" assets built up and individual instruments to redistribute risks – credit derivatives markets, CDS and CDOs – turned out to be a source of systemic risk. All financial instruments are new, but the people are new, as well as alarmists and it is easy to talk onself into depression. Non-critical science has taken dangerous financial innovations for progress. The regulators were late again by exactly one crisis, and incorruptable auditors, wise analysts and rating hawks missed the mark. We even proposed last spring that we would manage to avoid this.

Systemic Collapse

History then continued onward like in a disaster movie. Fires began in peat bogs in August 2007 and continued for the entire year, and individual banks began disappearing by that winter and the spring of 2008. Several large financial institutes collapsed first through bankruptcy and mergers. Then there was a summer lull, in which even skeptics believed. Regulators managed to go on vacation without worries during the relatively calm period of May-August. There was a lot of talk about an upcoming crisis and commentators started mentioning a "Great Depression," but no one was ready for any of that. Approximately $600 billion in bad assets were written off in the U.S. over a year, more than $200 billion in the EU and around $25 billion in Asia. But that is hardly even half of the total amount of dangerous securities. Experts suggest that there are still a lot of "toxic" assets out there.

It was during this period that there was a colossal systemic collapse of all supervisory, analyst and control agencies over financial markets. The heart of the problem was the failure of institutes and markets to adequately assess total risks. It turned out that they could follow only part of the risks, but could not recognize systemic threats. The loss of confidence in the wisdom of regulators and the financial authorities is already a dangerous result and a factor for a subsequent general loss of trust. This could be why the appearance of serious men in ties on television – finance ministers and central bankers – who have talked about joint actions for several weeks already is not fueling much of a positive reaction among investors. But this time there is not any confidence in anything. They did not notice the bad mortgages and it took them a year to notice that the fire had reached the surface. Now the question is what do they think about the next threats.

If there are more strikes then even the most various types of assets could be hit: prices are falling on the U.S. housing market and it is still under threat. There is $2.2 trillion in commercial papers, including ABCP mortgage bonds; $2.5 trillion in repo-reverse repo deals; $4 trillion in brokers' assets and $1.8 trillion in hedge funds. Also under potential threat are insurers from defaults on loans and hybrids (CDS and CDO) up to $60 trillion.

One Crisis, But Different Strategies

This is a general crisis, although it has produced various reaction strategies in the U.S., EU and in developing countries. It looks like there were three different regulators in these three areas – self-regulation prevailed in the U.S. and the EU, while international institutions such as the IMF and others looked out for the rest. The U.S. used fear in the country in the first three weeks of the crisis. President George W. Bush was forced to frighten Congress and the public about panic and unemployment. It is hard to contemplate a worse time for a financial crisis in the U.S. than now.

Winston Churchill once said that Democracy is a great thing, but only after elections. The U.S. Congress rejected Paulson's bailout plan on September 29 and almost pushed the U.S. economy into a tailspin. One can imagine Paulson's disappointment, as unlike other politicians, he understood who was at risk, what business was waiting for him to do and what historians would say. It is understandable at this stage that no one can say just what Paulson's plan will be – a vortex or a ford. The bailout package that Congress finally approved contained a number of additional lobbyist details for $150 billion in various presents – half a billion for movies and $10 billion for bicyclists – that will come in useful for the upcoming elections and for Christmas.

In general, we see the U.S. strategy for fighting the threat of panic as made up of intimidation and packages of measures. The thing that we do not understand most of all is what will happen with the issuance of dangerous securities and how does one overcome contradictions between minimizing payments for business on securities – the economy of government spending – with the need to hand over liquidity to banks.

The crisis is softer in continental Europe where business is much more traditional. The biggest losses were seen by those banks that decided to increase their profits using innocent securities on the American market. However, a sharp slowdown in credit in a number of European countries is likely proof that a recession is beginning. European G8 members met in Paris, but did not discuss a 400 billion euro fund for all EU countries. There are too many domestic problems in the 27 EU countries and it is impossible to make an assessment because of the various kinds of "mines". The French wanted to play the "good investigator," but the wisdom of German Chancellor Angela Merkel simply saved the EU from ambiguous commitments to help all banks in every area. The Europeans are still hoping to wait it out. If Paulson's plan works, then it might be possible to do away with national anti-crisis resources and move over to reform already this winter.

The huge resources of exporters, including Russia, went to the U.S. and the EU as low-interest, reliable (government) securities. Not so many "toxic" assets accumulated in developing countries; Western funds and banks tried to take high-yield risky assets in developing countries to increase profit. Investing in these markets always gave slightly higher yields for Western banks and investors, but the risks were limited. The risks turned out to be localized – they were at home, but things are not easier for emerging markets because of this. Waves of portfolio capital come and go from emerging markets not only when problems arise there. The possibility of getting investments from the international financial system not only depends on the climate in the target country, but from cycles and tensions in the financial system itself. If things are bad there then you could find yourself as the guilt-free, suffering good student of financial markets.

The Russian Approach: "Strength and Calm"

Criticism, like analysts and the populist actions by the U.S. (or Russian) government, is very explainable in this crisis – nothing indisputable ever takes place. On the one hand, the Russian approach is similar to that of the U.S. – the use of maximal efforts to fight the problems, but the other approach contradicts the U.S. one – instead of intimidation, quietly tackle the crisis at home and show the world an example of calm.

Russian has shown that it needs a calm market in the developed world so that it can sell its energy and equipment for the country's modernization. Russia kept pace with the crisis this fall and by October had even moved slightly ahead of developed countries. In order to increase the stability of banks, the government injected a huge amount of liquidity into the system and several banks made it through without any losses for investors. Since one of the threats was securities that used foreign debt as collateral, the Russian State Duma quickly approved a law that made $50 billion available through Vnesheconombank (VEB). The alternative looks

relatively depressing – buying up collateral (packages of leading Russian companies) cheaply from collateral holders not because of the collapse of Russian borrowers themselves, but because of existing conditions. The financial resources that Russia has accumulated have not yet been used for capital investment. But if Russia guards its oil revenue in a crisis, then this is already a kind of “sickly greed” – to die from a shortage of liquidity when sitting on a trunk of half a trillion dollars. Of course, this does not mean that the government should not act by analyzing its goals, instruments and the consequences with a clear head.

In any case, one must act keeping in mind that the foreign environment in the next few years will not be favorable for Russian development. The small amateur Russian investor has already become a victim of the stock market. In this case Russia has already repeated its experience of 1998 – yet another layer of new entrepreneurs were disappointed in the possibilities of the market. But Russia’s main problem is to get out of the crisis and to modernize its financial institutes. As a country perched on the verge of a massive modernization, it is important the Russia make it through the global financial crisis and use its national savings for investing up to 25%-27% of GDP.

Developing countries do not have a forum or a mechanism to discuss their problems – they can only go to the IMF or to “expanded” G8 meetings. It is true that a number of energy exporters have emerged that have accumulated foreign currency resources. However, both Russia and OPEC have experience in working in energy, but they do not have a base or the instruments to use their financial resources for stabilization. The most reliable wisdom so far has been to invest some reserves in reliable securities in the West and borrow with the aid of “former investment” banks for projects. It would also be prudent to think about an initiative to organize monitoring and analyst agencies, and to look for solutions for future problems. Russia has its own interests and they need to be grounded.

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The crisis on Wall Street has given new life to the discussion about the death of liberalism. However one needs to be careful in terminology here. The ideological approach of “liberalism without institutionalism” is in crisis as one of the world’s economic theories. Entrepreneurial capitalism, which French President Nicolas Sarkozy has talked about, remains the main path of development for an effective economy. The government is now interfering in the economy in order to fight the potential danger of a market collapse, and this is extremely important. The basis of the economy is not changing, but there is a sobering mood to move away from the possibility of developing without regulation and without adequate institutions. It has become obvious that institutional collapses are possible not only in developing countries as market democracies are established, but in developed countries as well.

The crisis brings up the question of the American business model and on the style of regulators. The transformation of the landmark investment bank Goldman Sachs into a commercial bank basically already means the collapse of the old model of distributing risks with unknown consequences. The financial system has already cracked and this is going on without any conferences or decisions. But this brings up a critical question – who in the world is looking after systemic risks in the world economy. The IMF is trying, but as usual within the framework of traditional macroeconomic problems and in the “American style.” The annual session of the IMF and the Moscow Bank for Reconstruction and Development, which is taking place now, will show whether they will be able to come up with some conceptual proposals. So far France and the European Central Bank, chaired by Jean-Claude Triche, are ready to play a leading role not only for the EU, but for the entire world. In the end, solving the problem of reforming the financial system will quickly move over - forgetting political squabbles - to the “very big G8,” which will expand to 14 countries with 80% of world GDP.

Table 1 GDP Trends in Major Countries and Regions: 1990-2008

	1990-2002 (12 years)	2002-2008 (6 years)
World	42.3	33.9
Developed countries	37.2	17.6
EU-27	29.5	17.0
U.S.	41.7	18.3
Japan	19.3	12.1
Developing Countries	51.3	59.7
Brazil	24.7	30.3
Russia	-33.0	59.2
India	89.4	70.5
China	203.0	99.9
Source:	IMF WEO (October 2008)	

Table 1 Major Stock Indices Trends: 2007-2008

	31.07.07	31.08.07	30.09.07	31.12.07	31.01.08	29.05.08	29.08.08	29.09.08	10.10.2008
S&P 500 (U.S.)	1455	1473	1526	1468	1378	1400	1300	1164	899
Bovespa (Brazil)	54789	54714	61054	64123	57886	71694	55680	49541	35609
Nikkei 225 (Japan)	17248	16569	16785	15307	13592	14338	13072	11259	8276
FTSE (Britain)	6360	6303	6466	6456	5879	6053	5636	4902	3932
Shanghai Comp (China)	4471	5218	5552	5261	4383	3433	2397	2293	2000
RTS (Russia)	1961	1919	2071	2290	1906	2459	1646	1211	844
31.07.07 = 100									
S&P 500 (U.S.)	100	101,2	104,9	100,9	94,7	96,2	89,3	80,0	61,8
Bovespa (Brazil)	100	99,9	111,4	117,0	105,7	130,9	101,6	90,4	65,0
Nikkei 225 (Japan)	100	96,1	97,3	88,7	78,8	83,1	75,8	65,3	48,0
FTSE (Britain)	100	99,1	101,7	101,5	92,4	95,2	88,6	77,1	61,8
Shanghai Comp (China)	100	116,7	124,2	117,7	98,0	76,8	53,6	51,3	44,7
RTS (Russia)	100	97,9	105,6	116,8	97,2	125,4	83,9	61,8	43,0
Source:	RBC, IEF calculations								

Leonid Grigoriev is president of the Institute for Energy and Finance and dean of the Management Department at the International University in Moscow.

Marcel Salikhov is deputy director of the Institute for Energy and Finance.