World Financial Crisis:
Reasons & Consequences

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Financial Derivatives Market

- In 2007-2008, the world market of derivatives, i.e.swaps, forwards, options and futures, remains at the core of the financial crisis. Non-regulated derivatives market volume is $62,000bn. The total market volume is estimated at $1.2-1.4 thousands trln.
- Credit default swaps (CDS), collateralised debt obligations (CDO) issued against US subprime mortgage loans were the main financial instruments to keep investor funds which inflated the "bubble".
- Losses written off by investors, such as investment banks, funds, and commercial banks, have already amounted to ca. $500bn. Write-offs will continue. In a Fannie Mac and Freddie Mac bankruptcy scenario, losses of $200bn to $500bn (CDS market volume) would have to be written off.

Key Role of US Financial Market

- ❑ Bankruptcy of several US financial institutions, such as Lehman Brothers, Washington Mutual, merger of Merrill Lynch, Bear Stearns, transformation of Morgan Stanley and Goldman Sachs investment banks into commercial banks.
- ❑ A visible crisis outcome is in a “credit squeeze” in the economy, caused by loss of trust and inability to assess credit risks.
- ❑ Capitalization drops in 2007-2008 on stock markets located in world’s financial centers:
- ▪ US market capitalization: ca. 40% of global market cap;
- ▪ US: drop by 25%;
- ▪ Russia: drop by 75%;
- ▪ China: drop by 60%;
- ▪ India: drop by 80%.
- ❑ US Administration in general and US Department of Treasury and FRS in particular stick to their interpretation of this financial crisis as a crisis of specific institutions, i.e. investment and commercial banks. This is not enough.

Key Role of US Financial Market

- The modern financial system has become global. All financial centers nowadays are technologically connected by telecommunication links, transactions are executed 24 hours a day.
- Ratio of aggregate balance of payment deficits to global GDP was 2-2.5% in 1980-ies; today it is 5.5 – 6 %. National cash flows to the global market are redistributed among countries. This is the global way to transfer the savings into investments.
- US financial instruments are the institutional foundation of the global financial market.
- **<u>Important!</u> That is why the crisis of US banks and funds is the crisis of the global market itself.**
- At the economic growth stage, financial market globalization made it possible to “raise the money” for a project of any, most critical scale. At the downturn, globalization makes the financial crisis a global phenomenon.
- The global economy has entered a period of falling growth rates and frequent financial crises and recessions, the downward trend of “Kondratyev’s long wave”.

Key Role of US Financial Market

- The current crisis is the second one over the period of 2000-2008. First: the stock market crisis of 2001 which hit hi-tech stocks. Second: the derivatives market crisis of 2007-2008 which hit mortgage loan pools.
- Sequence of events:
- stock market "bubble" inflates, caused by use of forwards and options;
- underlying instrument price growth stops, resulting in loss of yield on derivatives;
- investors fix losses.

Important! **At the "bubble inflation" stage the derivative prices are disconnected from basic asset price. No adequate assessment of financial risk.**

- Macroeconomic consequences of financial crisis:
- Global "stagflation" = recession in national economies + high inflation.
- Outlook: recession in 2008-2009; low GDP growth rates and inflation over subsequent 3 years.
- **Important! Inflation will devalue existing debts. Interest on existing debt will be below inflation. Interest on new debt will be above inflation.**

No Adequate Government Regulation

- Absence of real government regulation on either the derivative market or the financial market, both at the national and international levels.
- Polson's Plan: problem assets buy-out. Acquire stocks of anchor companies to "inject fresh money".
- Nationalization of AIG; Fannie Mac; Freddie Mac , etc. in the US, Northern Rock, Fortis, etc. in EC countries: elimination of consequences and prevention of new bankruptcies.
- **Important! Radical measure:**
  - Legal division of the financial market into elements: transactions with underlying assets and derivatives;
  - Transfer of derivative transactions to offshore zones;
  - Prohibition on secondary derivatives holding for legal entities registered outside offshore zones.
- Real steps: employment of technologies such as Resolution Trust Corporation (RTC). RTC in 1989 – 1991: banking sector restructuring and sanation.

Interplay Effects

- Positive effect of globalization of economy and financial market on the eve of the financial crisis:
- Growth in prices for Russia's main exported commodity groups driven by use of derivative instruments on the crude and metal markets. URALS crude price grew to $130/bbl.;
- Investments in the Russian stock market. Securities market capitalization grew to 85% of Russia's GDP in 2007;
- Russian joint-stock companies launched IPOs and obtained listings on the international markets;
- Russian companies and banks raised loans on the international markets. Net debt grew to $380bn.
- In 2001-2002 GDPgrowth weakened in response to global recession. In 2000-2007 economic growth remained stable as a whole. GDP growth rate was +6.9% on average; in 2007, +8.0%, in 2008 , +7%.
- Accumulation rate in GDP, 15-20 %; investments in the Russian economy grew at above 20% a year.
- Real average monthly wage growth outpaces the Consumer Price Index (CPI).
- Inflation slowed down during 2002-2007. The historical low annual inflation rate was 10%. In 2008, inflation gained pace hitting 15% of CPI p.a.

Interplay Effects

- Russia’s external account surplus in 2007:
  - current account surplus of ca. $130bn
  - capital account surplus of ca. $80bn.
- Money supply was driven by the balance of payments. M2 aggregate growth was higher than GDP growth rate.
- Federal budget surplus max 7.5% of GDP; Extended Government budget surplus, 8.3% of GDP in 2006.
- Government funds built on the basis of the stabilization fund, i.e. National Wealth Fund and Reserve Fund. These in total amounted to 12% of Russia’s GDP in 2007.
- Gold and currency reserves grew to $587bn in 2007 ($560bn in October 2008)
- In 2007-2008, Government permitted federal expenditure to grow by more than 20% p.a. In 2009, growth is expected at 20% in real terms.
- Funding provided to Russian investment projects. For example, Blue Stream is Gazprom’s project.

Crisis Impact Mechanism

- Russian stock market fall caused by foreign capital outflow. Net private capital outflow amounted to $23.4bn in Q1 2008. In Q2, we saw net inflow of $35.7bn. of balance of capital movements. In Q3, net outflow is estimated at ca. $40bn. Bank of Russia forecast was positive ($30bn by end of 2008). Zero balance is more probable.
- Stock market capitalization fell by about 75% in 2007-2008. Another cause was in the market “shallowness”, as almost all transactions are with 5-7 blue chips.
- Margin calls by creditors. Sharp increase in outbound payments.
- Cost of money raised on the global market grew to Libor + 4-5% p.a.
- Russian cost of money raised up to 9.5% for Bank of Russia recourses and up to 20% for corporate credits.
- **Important! Russian financial institutions do not engage directly in derivative transactions.**

Crisis Development in Russian Economy

- In Russia, the financial crisis has reproduced itself, driven by the global crisis
  Important! Russian economy develops as part of the global economic cycle.
- Russian political risks traditionally estimated very high.
- The Russian stock market crisis development pattern is typical of “emerging market” countries: they enter the crisis at a later stage compared to the “center”, crisis depth is greater. The “stability island” failed.
- Cash flows redirected to service external debt of the private sector. Tight “credit squeeze”, credit risks grow.
- Bankruptcies have started among Russia’s Top 100 commercial banks. Bankruptcies of commercial banks and financial companies, i.e. Russian investment banks, loss of trust on the interbank market are threatening.

Economic Trends and Risks in 2009-2010

- **Important! Banking system restructuring is needed.**
- Peak external debt service payments in Q4 2008 and Q1 2009. Need to mobilize resources.
- Companies overburdened by debt, both internal and external, going bankrupt.
- Recession impacts going forward, caused by drop in demand:
- Crude price going down to $70/bbl. ± $10;
- Important! Concerted action taken by Russia and crude/natural gas consumer countries to change the pricing practices on the world market. Practice of crude pricing on forward contract market abandoned. Cooperation with OPEC in pricing matters.
- Commodities and metal prices falling on the international market.
- Risk of current and capital account deficit.

Economic Trends and Risks in 2009-2010

- After 20 years of “cheap money” when interest rates on bank deposits and loans stayed behind inflation, transition to interest rates above inflation, “expensive money” and floating ruble to dollar/euro rates.
- Ruble to dollar/euro rate falling. Need to pay debts in “expensive dollars”.
- Money supply formed by Bank of Russia refinancing banks rather than by balance of payments surplus conversion.
- **<u>Important!</u> In 2009-2010, transition to floating Ruble rate policy. Bank of Russia will migrate to the inflation targeting policy.**

Economic Trends and Risks in 2009-2010

- Inflation rate 15%, GDP growth about 7% in 2008. Economic growth rates fall from 6-7% a year to 2.5-5.0% in 2009-2010 as the result of downturn in investment growth to a rate below 10% a year. Acceleration of GDP growth in 2011-2012.
- Longer-term pension problem aggravating. Difficulties will peak in 2015-2020.
- In 2000-2007, federal revenues grew at 9.2% a year. In 2009-2010, revenue growth rate will shrink. Tax collection rates are falling. <u>Important!</u> Tax reform and tax reductions will be impossible going forward. Only changes adopted in 2008.
- Federal budget may stay breakeven in 2009-2010. Federal expenditure growth rate must be cutten to 2-3% in real terms.

Active Government Interventions

- "Liquidity boost" policy. Experts say: Bank of Russia and Minfin are providing ca. RUR 3trln, which is about 1/3 of total federal spending, in the form of:
  - Minfin deposits;
  - reduced statutory reserve fund requirements;
  - stock buy-outs and buy-back on the stock market (ca. RUR 500bn);
  - Central Bank's refinancing of banks against assets;
  - Central Bank's unsecured refinancing of banks;
  - subordinated loans to banks at RUR 950bn Sberbank, up to RUR 500bn; VTB, up to RUR200bn.
- $50bn provided to Bank for Development (VEB) out of Bank of Russia's gold and currency reserves to refinance Russian banks' foreign debts against share pledges.
- **<u>Important!</u> "nationalization" of Russian economy. Great amounts of private stocks may be concentrated on state-owned banks' and Russian Government agencies' accounts.**

Government Regulation

- First stage: restore banking system liquidity
- Second stage: direct financial assistance to problem banks and debtor companies
- Third stage: rehabilitation and restructuring of the banking system and investment financial companies:
  - Mergers and Acquisitions, such as “Renaissance Capital”;
  - Rehabilitation and bankruptcies, such as “Svyazbank”;
  - Reorganization and reinforcement of the banking system;
- Banking system reinforcement program implementation:
  - Revive ARKO (Lending Institutions Restructuring Agency) on the basis of ASV (Deposit Insurance Agency);
  - Request Bank for Development (VEB) to sell acquired assets or transfer to Property Fund;
  - Request AIZhK (Housing Mortgage Lending Agency) or the Housing Construction Promotion Fund to buy-out mortgages from banks and assets from housing developers. Alternatively, transfer of such assets by VEB to AIZhK.

International Cooperation Challenges and Alternatives

- IMF and World Bank “intellectual bankruptcy”. Strain of ideas and new approaches.
- Lack of intergovernmental real actions.
- Start of broad intergovernmental discussion. Washington Summit in 2008.
- **Important! Real alternatives:**
- Reinforcement of IMF and World Bank as UN finance institutions.
- New
- International effort to support the trust in business cooperation:
- Intergovernmental body of rating of finance institutions
- Intergovernmental supervision body of bank and finance institutions.

Investment Business

Thank you!