

THE PHENOMENON OF FINANCIAL ECONOMICS: RUSSIA AND THE WORLD ARE IN CURRENT GLOBAL TURBULENCE

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Abstract: *The article deals with the analysis of the current situation on the global financial arena, analyzing the chain of cause and effect of the origins of the economic crisis and providing its possible logical outcomes. We are trying to prove here that the way the world economic situation develops will lead to either further growth or stagnation of national economies and define their position in the global business, financial, and social spheres.*

We provide an analysis of the serious transformations financial economics have been undergoing at the end of the 20th and beginning of the 21st centuries. All these changes, such as the development of international fusions on financial markets, the creation of new financial instruments, products and services, and others, have been caused largely by (and also have led to) significant events in the global political arena. However, regardless of the transformations, world leadership remains in the hands of US government and business and that of their closest partners, while those societies that are not willing to support the “Americanized” world order end up on the blacklist of the World Bank, the IMF, and other international financial institutions.

Finally, the article provides our views of the possible ways of dealing with the global economic stagnation. We highlight the importance of the strong and careful supervision of any global as well as national financial activities, the education of the public on the issues of wise investments, and the dangers of living on credit.

Key words: *financial economy, crisis, derivative financial instrument, banks, securities.*

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The problem of the current global financial crisis occupies a central place in the mass media and people’s consciousness of the whole world today. The future way of development of world civilization and the particular national economies depends a lot on how adequately these issues will be realized not only by authorities and financiers of different levels, but also by the major part of the population. This article shows an attempt to solve the problem systematically, to construct the chain of cause and effect for the origin of the crisis, and to logically prove its possible results.

The financial and economic crisis can be compared to a disease. The crisis is an aggravation of contradictions in the system that can finally lead to an explosion.

Nickolay Kondratjev originated a theory of the wave development of economics with long and short wave-cycles. According to this theory, we have a local crisis every 10–12 years and global crises every 40–50 years. In 1998, Russia experienced a local crisis; and in 1987 the same crisis occurred in South-East Asia. Nowadays a tsunami of world crisis is coming on.

Any crisis is an integral part of the market economy. The main contradiction peculiar to it is the contradiction between material and virtual things. A table, a chair, a house, and oil are all material things, while money, bills, stocks, shares, and mortgages are virtual things. The phenomenon of modern world civilization at the end of the 20th century is that financial economics started to dominate in the world. Leadership in the modern economy does not belong to the production of material goods, but to the financial institutions and instruments. It was necessary to develop production constantly, and therefore it was necessary to speed up the flow of finance, i.e., of non-material resources. The financial economics have been undergoing serious transformations—developing international fusions on financial markets, creating new financial instruments, products and services, electronic commerce, securitizing of financial markets, IPO (the Initial Public Offering, a first sale of stock by a private company to the public), venture businesses, fusions and absorptions (Akinin and Akinina 2007).

On one hand, these transformations changed the world greatly, speeding its progress. On the other hand, they led to a disproportion between material and virtual things. All the events happened against the amazing political background of the modern world, creating a unidirectional world.

After World War II, mankind refused the gold standard of money, and the American dollar became the world currency. As a matter of fact, all the international financial organizations became oriented toward the American economy (the International Monetary Fund, the International Bank of Reconstruction and Development, and others). This was determined objectively to some extent, because about a quarter of the world production and a third part of all high technology products belong to the US. However, before we continue explaining the chain of cause and effect, we will pay attention to one more aspect—how and why the financial instruments have appeared.

Like alchemists in the Middle Ages searching for the Philosopher's Stone, the economists today are searching for an instrument to help measure the value of any product. They tested everything: fur, sea shells, precious metals, money (from the most primitive to the modern electronic ones), securities and so on. However, they have not found it yet. How can we measure the products? With the help of money. And how can we measure money? With the help of the quality of products that one can buy with this money. The circle is closed. According to the general opinion, money is the smile of the Cheshire cat from the fairytale by Lewis Carroll. The cat has gone away, but his smile has stayed (Zhirinovskiy and Jurovitskiy 1996).

Financial economics have constantly faced the new problems raised by life. These problems have been solved by steadily embarrassing their institutions and instruments, but they have also caused more new problems.

However, in 1987 when the South Asian countries experienced a local crisis, and there was a danger of its growing into a world one, the credit derivative financial instruments appeared (Zubchenko 1995). These instruments became the basic element of the current crisis. Let's consider the derivative financial instruments in detail.

The fusion of the commodity and stock markets led to the appearance and development of time deals (futures, forward, and option ones). Time deals are treated as derivative financial instruments. They appeared and developed not only on the basis of securities and future contracts for almost all exchanged goods (starting with oil and gas and ending with soya beans and orange juice), but also for exchange indexes, interest rates, currency rates and so on (Ibragimova 1998), and even for derivative instruments. According to the definition of derivative instruments, based on the recommendation documents of the Basel Committee (Krichevskiy 2009), their economic sense lies in the fact that the

cost of all the derivative instruments arises from the cost of the basic assets; in other words, the cost of the derivative instruments in relation to the cost of the basic assets one considers as derived. However, the most characteristic feature of derivative instruments is missing in this definition: The aim of its appearance and use.

The derivative instrument is a deal with the reduction of the possible risks that can be followed by financial losses. If this aim is not achieved, it is impossible to consider any deal as a derivative instrument, even if it has some of its features, for example, realization in the future. Therefore, the deals of REPO and RESO are not considered timed ones, like the buy/sell transactions on open accounts. The main feature of the basic assets which are the basis of the derivative instruments allows us to divide them into traditional commodity and financial instruments, and to define some stages of the origin and development of the derivative instruments through these criteria.

The future of standardized goods and forwards of non-standardized goods are undoubtedly the first generation of time deals. These derivative instruments can be defined as commodities. They continue existing in timed commodity markets, acting out their principle function. Among western and Russian economists, the question about considering derivative commodity instruments as securities is not settled nowadays. Some authors consider them securities; however, there are a great number of arguments against this statement. Settlement of this problem in favor of any argument will impact methods of forward transactions market regulation.

In the second stage, we can refer to the appearance of derivative instruments in financial instruments involved in circulation (stocks, bonds and other obligations). The new instruments were named derivative financial instruments, because they were based on assets of the financial market, including the monetary market. In such conditions, the forward transactions market mainly covered the US in the first half of the 1980s, and the explosive growth in Europe and Japan started in the second half of the 1980s. If the volume of derivative financial market in 1986 amounted more than \$1 billion, in 1994 it was equal to \$20 billion.

The third stage started in the early 1990s with the appearance of "exotic" instruments. This is characterized by the beginning of the construction and production of off-exchange transactions created by young, brilliant Wall Street scientists. They created such transactions under the orders of final customers willing to exchange something into something else, that is, to construct a swap and then to hedge this swap. Their last invention was loan derivatives.

About 800 such securities were introduced onto the Chicago exchange in 1987 and helped to save it. From the middle of the 1990s, the derivatives unob-

trusively, firmly became an important part of the life of every American. Banks gave their clients low-level reliability loans, then took those loans and pressed them into large amounts. After that they issued new bonds originated from those initial loans. Then those bonds were “cut” again and packed. Thus the derivatives of the first, second, and further levels were created.

Finally, the financial egoism of the unidirectional world led to an output of derivatives in the amount of \$516 trillion in the last seven years. At the same time, the world’s GNP is \$50 trillion, the USA GNP—\$15 trillion and the budget of the US—\$3 trillion (Securities Market 2005b). Thus, they inflated a bubble that involved the entire world, and when this bubble burst (the mortgage securities of the companies “Fannie Mae” and “Freddie Mac”), the “domino effect” lashed almost the entire business world. A chronology of the mortgage crisis is presented in table 1 (Khikin and Gorodnova 2008).

People in our country were convinced that our economic situation is favorable and the crisis would not affect us. To some extent this is true. That is why we can hardly call our native economy a market economy. The stock market, in comparison with other financial institutions and instruments, has not developed enough. For example, developed countries’ banks offer about 200 kinds of products, but our banks offer only seven-10; developed countries offer 500 kinds of products in the insurance business, we offer only 50–70. As soon as the Iron Curtain fell, we became a part of the outer economic space. Economic openness, in its turn, means a strong dependence on the following factors:

The first—a change in the world prices of natural resources (oil, gas, metals, timber) accounting for 60% of Russian export. The correlation coefficients of the nations’ stock exchange indexes, reflecting economic conditions and oil prices, are 0.636 in the USA; 0.26 in Japan; 0.067 in China; and 0.96 in Russia.

The second—capital flow to Russia and abroad, the net result of these flows. Thus, the net capital exports of the private sector from Russia were: \$24.8 billion in 2000; \$9.3 billion in 2002; \$1.9 billion in 2003; \$8–9.4 billion in 2004. As a result, in 2005 net capital exports accounted for \$0.5 billion. Before the crisis in 1998, the share of non-residents was almost 80–90%, but nowadays that share is 50%, and on the ruble bonds market—40%.

The third—change of world currency rates, pace of economic development and interest rates with highly developed financial and stock markets.

The interest rate is investors’ required capital profitability. The US Federal Reserve System raised interest rates from 1% to 4%; the European Central Bank also raised rates. Interest rate growth in the USA and Europe is conditional upon the realization of the famous Taylor rule, according to which “in order to stop inflation it is necessary to fix an interest rate one and a half times

Table 1—Chronology of the mortgage crisis in the USA

Time stamp	Description of the situation in the mortgage market	Consequences
October 2005	Inflationary pressure on economy	Average cost of obtaining funds increased 2.25% for 40 days
November 2005	Loans with low interest rates became uninteresting to investors	Folding crisis on the real estate market Overestimation of the clients resources
December 2005	Growth of interest rates Growth of defaults in condition of stagnating real estate market	Growth of the investors’ material losses Decrease of demand for loans Shortening of number of employed persons
January 2006	Investors claims about loans redemption	A number of mortgage companies declare they are closing or bankruptcy
February 2007	Loans’ medium market-value falls to 60% of face-value	A number of mortgage companies declare they are closing or bankruptcy
March 2007	The largest creditors’ announcement of delinquencies	Mass media pays attention to problems of mortgage market
July 2007	Mortgage market leaders declare enormous material losses	Stopping of giving out loans with floating interest rates Growth of mortgage companies’ losses
August 2007	Primary mortgage statements shares fall	Reduction of the rate of mortgage securities two more times
September 2007	Fall of mortgage derivative profit by 50%	Liquidity crises of world-wide banks and plight of investors

in excess of the index of inflation”. Higher rates on the markets of the developed countries attract international capital from developing countries, which affects the condition of the security markets of these countries.

The correlation coefficient of the indexes PTX and interest rate FRX of the USA for 2001–2005 was (–0.61) (Securities Market 2005a). The correlation coefficient of the indexes RTX with indicators of capital value for developing countries taken into account by JP Morgan (put and call of the bond-equivalent yield of developing countries and yield of the US Treasury) was (–0.86). According to the experts, interference will increase in the future.

All the facts once again convince us that, as a part of the world economic system, we are experiencing all the “delights” of the global crisis.

In the last few years, while fighting inflation using monetary methods, we sent huge cash flows to the Stabilization Fund, which in its turn invested them into U.S. securities. Instead of investing in domestic infrastructure, developing the innovative sphere, and strengthening the Russian banking system, we were strengthening the U.S. economy. Certainly, there are some explanations for this. The government had been accumulating resources for a total change, fearing that in Russia, with its unprecedented corruption, the “hydrocarbon” money would be simply defalcated. The government managed to partially exercise its plans. A huge financial reserve has been created, despite partial losses due to the approaching world crisis.

At the same time, private companies have accumulated enormous debts (above \$500 bn) to foreign banks. The reasons for the creation of indebtedness are as follows: Since all the “spare” money had been sent abroad, the nation did not manage to create its own megabank. For example, at the moment there is no Russian bank among the top 20 world banks. To a great extent, all the domestic banks (except for Sberbank) are dwarfs. That is why Russian banks and large companies (Gazprom, Rosneft) had to appeal to foreign organizations for large sums of money at a 4% annual interest rate (Akinin 2008).

Now the national government is seriously concerned about these financial problems. It is going to take the following measures: To finance unfinished construction, first of all housing construction, and to buy back the finished economy-class houses; to increase the authorized share capital of Rosselkhozbank and Rosagroleasing aimed at loans supporting efficient agricultural projects; to enlarge leasing programs in the automobile and agricultural machinery industries; to provide governmental guarantees for defense orders and governmental target programs; to subsidize oil and gas companies clearing their external debts; to subsidize transport infrastructure construction; to raise small business loans from 9 to 30 bn rubles; and to aid dealer networks (Government Will Support Financial System 2008).

The government strongly indemnifies the bank deposits of the population: The rate of insurance indemnity was raised from a recent volume of 400,000 to 700,000 rubles, so to a large extent the bank deposits of the population will not go bankrupt. The quotations of Russian companies’ securities will rebound in a while. In the experts’ opinion, Russian business and its capitalization before the collapse were underestimated.

What other consequences of the crisis can we expect? The risk (venture) capital has left Russia, while direct foreign investments are still working. However, the real estate market has practically stopped. The mortgage market has halted: The initial contributions have been raised, loan requirements tightened, and unaffordable dwellings are becoming even more unaffordable. It is obvious

that the construction industry will come to a halt. A lot of estimators, insurers, and brokers dealing with car credits will also be out of work. Volume car sales will fall. The crisis will hit banks. Many of them have stopped issuing loans, while others have raised interest rates by 2–4%. However, the first Deputy of the Russian Federation government Chairman, Igor Shuvalov, has assured depositors that the Russian Government and the Bank of Russia will never let the banking system situation get worse (ibid.).

To prove this statement, we can list measures of tax and budget policy aimed at overcoming the world crisis (Table 2) (Kudrin 2009).

Table 2—Russian tax and budget policy measures aimed at overcoming the consequences of the world crisis

No.	Measures	Bn Rubles	Bn US Dollars	% GNP
1	Measures of tax and budget policy, total	2,045.3–2,145.3	61.2–64.2	5.2–5.4
2	Measures of tax policy, total	900–1,000	26.9–29.9	2.3–2.5
	4 point income tax reduction	400–500	12–15	1.0–1.3
	Increase of depreciation (capital charges) from 10% to 30%	150	4.5	0.40
	Change of the order of collection of duties on exports of oil	250	7.5	0.60
	Others, including the increase of material exemptions for citizens who buy homes, reduction of the small business tax rate, fisheries support	100	3.0	0.30
3	Measures of budget policy, total	1,145.3	34.3	2.90
	Addition of the authorized share capital	439.0	13.1	1.10
	Increase of the authorized share capital of Rosselkhozbank	75.0	2.2	0.20
	Increase of the authorized share capital of public corporation Rosagroleasing	29.0	0.9	0.10
	Increase of the authorized share capital of public corporation AIZhK	60.0	1.8	0.20

No.	Measures	Bn Rubles	Bn US Dollars	% GNP
	Increase of the authorized share capital of Vneshekonombank	75.0	2.2	0.20
	Material contribution to the endowment assurance agency	200.0	6.0	0.50
	Total subordinated loans, given to:	450.0	13.5	1.13
	Vneshtorgbank	200	6	0.50
	Rosselkhozbank	25	0.7	0.06
	Other banks	225	6.7	0.57
	Subsidizing of interest rates for agricultural sector enterprises	18.07	0.5	0.05
	Airline support	32	1	0.08
	Car manufacturing support	39	1.2	0.10
	Industrial products exports support	6	0.2	0.02
	Small- and medium-sized businesses development	6.2	0.2	0.02
	Taking active measures on the labor market and employment promotion	43.7	1.3	0.11
	Unemployment relief increase	35.0	1.0	0.09
	Defense industry	50	1.5	0.13
	Giving the opportunity to use maternity capital to repay main debts and loan services, including mortgages, buying or building houses	26.3	0.8	0.07

Financial egoism is a feature of the Russian oligarchs too. In the experts' opinion, metallurgic magnate and owner of Nor Nickel O. Deripaska has the largest debts. In the last few years he made a lot of deals using loans. As a result, his debts now exceed the total cost of his empire.

The total debt of the "Metalloinvest" company (Mr. Usmanov's property) amounts to 5 billion US dollars. Steel company "Mechel", controlled by I. Zizulin has the same amount of debt. "Evraz", jointly owned by R. Abramovitch, A. Abramov and A. Frolov, owes 1.8 billion US dollars to Vneshekonombank.

The body politic is now trying to save these and other oligarchic companies, using different schemes of new property redistribution. In particular, R. Abramovitch was given 2 billion US dollars (his debt is 10 billion), and one of the largest diamond companies, "Alrosa", gave him 44 billion US dollars. On November 7, 2008, the second "Action Plan aimed at the improvement of the financial sector and other trades" was published on the federal website. On December 25, 2008, the list of 295 backbone companies was published. 3.5 trillion rubles are required to support them.

100 days of "crisis management measures" showed the incompetence of the Russian government and, on a large scale, of the failure of the Russian state. As V. Jirinovsky, the deputy chairman of the State Duma, said, "We had eight problem-free years at the expense of external market high prices; the funds were not used for economic development. The main problem is that our public administration is organized in the wrong way. There is monopoly rule everywhere. Small-scale business does not develop at all, the laws are created for the benefit of the bureaucracy, and corruption destroys everything. It is difficult to count on success with such a governing system. However, it can be broken by the president. Dmitry Medvedev has a chance. If he takes it and breaks the existing state of things for three or four years, he will be able to provide for the country's normal development".

Here are some figures illustrating these words: The world drop in prices for all product groups led to cuts in retail prices in most countries. However, in Russia the total rise of internal prices has not stopped. According to the latest statistics, there was a price fall in 27 European countries on an average of 0.4% in November 2008. At the same time, there was high inflation in Russia of about 0.8% per month. According to the total statistical information for 11 months, the rise in prices in the 27 EU countries was five times lower than in Russia—2.3% in Europe as opposed to 12.5% in Russia.

US oil retail prices fell to a five-year minimum, falling 9% in the final weeks of 2008. Russia has never had a fall in bread prices even when there was a shortfall in wheat prices. One of the leading Russian political scientists, S. Karaganov, advises, "We should be more careful in future. It will be more useful to concentrate on solving domestic problems. We should develop a new national economy. I remind you that Russia's part in the world's GDP is about 2.5%. That is the limit for our country, and we will not be able to jump higher. We must maintain this level of development by all means, because there will never again be such high oil and gas prices."

On a world scale, despite appeals for changing the world's financial system and forming a multipolar world, the planet still prefers to grapple with the crisis in dollar-centric conditions. The events of recent months have dem-

onstrated that the US and European economic systems resist the crisis much more successfully than the economy in Russia, as well as in Asian and African states.

Russian print media have released quite a lot of analyses comparing and contrasting the effectiveness of financial crisis management in different countries (Nemcov and Milov 2009, Nikitina 2009, Svan 2009). On the basis of these analyses, the following conclusions can be drawn.

First of all, the acceptance of troubles in the financial market and the prerequisites for the crisis was significantly delayed in Russia. Secondly, many measures were not properly worked out. Thirdly, much of the support was given to oligarchic organizations instead of to state institutions or small-scale businesses.

Today it has become quite obvious that almost all the money that was supposed to support Russian banks simply has not reached the banking system at all. While the United States has concentrated on modernization, building new transportation systems and the public sector, Russia turned its attention to the Russky Island, where Dmitry Medvedev has been planning to hold the 2012 APEC summit, and to the Sochi resort, the host of the XXII Olympic Winter Games in 2014. As a result, no resources were allocated to the development of the energy sector of the economy, support for small-scale business, or improving public health facilities.

These and further conclusions are described in more detail in the report by Dr. Vladimir Krichevsky, "Post-Pikalevo Russia: New Political and Economic Reality" (Krichevsky 2009). Krichevsky predicts the year 2009 will be the most difficult in the history of post-Soviet Russia. In the first half of 2009, Russian GDP dropped by 10 percent, output by 15 percent, and investments by 18 percent. The fall was worse than in other countries despite the colossal sums the government poured into the economy (about 10 percent of GDP). At the same time, the rate of the U.S. GDP decline slowed to a crawl in the second quarter of 2009. Moreover, American GDP is expected to rise about 1.5 percent in the third quarter of the year.

Regardless of all the anti-crisis measures taken by the Russian government, not much has been done yet to really help the economy. Financial aid from the Russian government never aimed to modernize the economy or encourage entrepreneurship. On the contrary, the money went to the companies the government singled out as important for the national economy; in other words, into the pockets of oligarchs.

In Europe and the U.S., emphasis was put on increasing the effectiveness of industrial production, technological innovations, support for efficient companies, management training, and ownership changing. In Russia, at the same

time, politicians keep on repeating they are not planning to make significant changes to the economic structure like nationalizing or redistributing enterprises, changes in management, etc. On the contrary, all is done to sponsor Russian oligarchs and improve their well-being. Even though they do return some money to the national economy in the form of foreign investments, this money is a pittance compared to what they received in the first place.

Finally, Dmitry Medvedev had to officially admit that mistakes in the Russian anti-crisis measures could lead to a total economic collapse. In his article "Go Russia!" published on 10 October 2009 on the Kremlin's official website, Medvedev states:

"The global economic crisis has shown that our affairs are far from being in the best state. Twenty years of tumultuous change has not spared our country from its humiliating dependence on raw materials. Our current economy still reflects the major flaw of the Soviet system: It largely ignores individual needs. With a few exceptions, domestic business does not invent or create the necessary things and technology that people need. We sell things we have not produced, raw materials or imported goods. Finished products produced in Russia are largely plagued by their extremely low competitiveness.

This is why production has declined so much, more than in other economies, during the current crisis. This also explains the excessive stock market volatility. All this proves that we did not do all we should have done in previous years, and far from all things were done correctly. The energy efficiency and productivity of most of our businesses remains shamefully low, but that is not the worst part. The trouble is that it seems that owners, directors, chief engineers and officials are not very worried about this." (Medvedev 2009)

However, the global crisis will lead to some positive points and improvements for the world economy. Countries will get rid of spare money, industrial restrictions will take place, the processes of amalgamation and acquisition will start working more actively, and the transparency of the financial system will increase.

In conclusion, we would like to note that, despite the absence of serious change in the world financial system in the very near future, there is a need for connection between the virtual and real aspects, between financial elements and their material equivalents such as mineral and energy resources. That is another question to discuss.

Résumé

This analysis of the global financial and economic tendencies demonstrates that tectonic shifts will not occur in the foreseeable future. Great Britain and the European Union are not interested in the US demolishing the existing financial system. Basically, normally operating financial systems of the modern type, but without “inflated” liquidities, suit most members of this system. For China, the preservation of the dollar as the basic reserve currency and the current volumes of American exchequer obligations in the reserves are favorable. Japan is interested in this as well. Great Britain in general is a “window” in the European Union, and dollar liquidity for them is also very important.

Nevertheless, the termination signs of “the American Superpower” have been designated. The economic realities confirm that there is a new world leader, China, since it is not only the largest supplier of money, but also a necessary partner of Washington. Moreover, today the US dollar monopoly is destroying not only the euro, but also other national currencies. In particular, China has started to advance the currency as the international unit of accounting.

The Central Bank of China and the Central Bank of Argentina have reached an agreement on a currency swap of 70 billion yuan (10 billion dollars). This contract will allow Argentina to pay to import goods from China in Chinese currency. China has already concluded six similar transactions since December 2008. Similar transactions allow them to refuse to use dollars or euro in trade. Soon such agreements will appear in Russia and other countries that are large suppliers of hydrocarbons.

This essential moment in the modern world financial system is overlapping with offshore tax havens. The blacklist of such states includes Costa Rica, Malaysia, Philippines and Uruguay, which legislatively do not support international agreements under taxation. There is still a list of 38 countries which have incurred obligations in conformity to international tax standards but do not sufficiently carry them out. Among them are such countries as Andorra, the Cayman Islands, Liechtenstein, Monaco, the Netherlands, San Marino, and others.

Sanctions will be applied against those states which have been included on such lists but have refused to change their status (such as the introduction of increased requirements to disclose information about people who exchange money there). The tax policy in relation to these states can be reconsidered, and international financial institutions such as the World Bank and IMF can refuse investment projects for the offshores. These sanctions will make the existence of offshore zones meaningless and bring all their advantages to nothing.

The introduction of supervision over activity and financial investment tools, including derivatives, is very prominent. A special International Board will be engaged in this. Control over bonuses for large companies’ top managers will be strengthened.

However, the most important thing, in our opinion, is that the circumstances of the psychology of economic behavior will begin to change for representatives of business and the population. We assume that financial activity will become more moral and the population will realize the danger of living on credit.

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