Finance Matters

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Lecture Series

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Lecture#1

Introduction

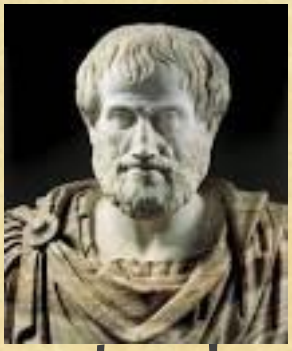
Finance, Money and Banks

- The history of finance is intertwined with the history of money
- Money as a medium of exchange but also a store of value
- Examples: grain-money and food cattle-money
- Trade with Anatolian obsidian was common in 9000 BC as an exchange tool and later in 3000 B.C.E was replaced by copper and silver
- Evidence of banking practices were found in Mesopotamia region

Ancient times

- Finance didn't exist as a special field of study in Ancient times
- Economics (Oikonomos: manager of the household) did exist but more as philosophical and metaphysical questions
- However, several ancient Greek thinkers made various early financial observations, especially **Aristotle and Xenophon**

Aristotle
died 322 B.C



- Aristotle used the labels of **natural** and **unnatural**
- **Natural** transactions were related to the satisfaction of needs and yielded wealth that was limited in quantity by the purpose it served
- **Unnatural** transactions aimed at monetary gain and the wealth they yielded was potentially without limits. He explained the unnatural wealth had no limits because it became an end in itself rather than a means to another end—satisfaction of needs. This distinction is the basis for Aristotle's moral rejection of usury

Xenophon
died 354 B.C

- Xenophon analyzes and compares the subjective **personal value** of goods with **exchange value**
- Xenophon uses the example of a horse, which may be of no use to a person who does not know how to handle it, but still has exchange value

India

- In the period of (321 to 185 BCE), an instrument called ***adesha*** was in use, which was an order on a banker desiring him to pay the money of the note to a third party
- This corresponds to the definition of a bill of exchange as we understand it today

China

- In ancient China, (221 to 206 BCE), Chinese currency developed with the introduction of standardized coins that allowed easier trade across China, and led to development of letters of credit
- These letters were issued by merchants
- Merchants were the ancestors of banks

Middle Ages

Trade and Money Changers

- The increase of the economic activity created the the need for more for money exchange and the conversion of coins
- Money changers served several purposes: holding, transferring large sums of money and extending loans to merchants
- First, the “Money changers” served to finance long trading journeys, later they applied these methods to finance grain production and trading transactions

A Technical Problem

- Europe used the Roman numbers until 1300s
- They were not practical for computation, percentage and large and complex calculations
- Fibonacci introduced Arab numbers in Pisa, then to many European countries and from there was the birth of pre-modern Finance

Money changers

The Moneylender and his Wife. Quentin Massys, 1514.

- Common financial activities included: granting loans, investing, deposit, credit and fund transfer
- First, the formal position of the Church on prohibition of usury and charging of interest on loans was an obstacle
- Most of the Money changers were Jews. Since, they couldn't own land in Italy, they set up their benches to trade in crops (bench, bank)
- Shylock: the Merchant of Venice by William Shakespeare in the 16th century

A Banking Scene

- By the end of the 13th century, Florence became the Banking Centre of Europe
- By 1338, there were more than eighty banking houses in Florence with operations across Europe
- Many of the loans were granted to European monarchs to **finance their wars**
- The risk was elevated and monarchs were ready to pay high rates of interest sometimes as high as 45 to 60 percent

- The Bardi and Peruzzi Families dominated banking in 14th century Florence, establishing branches in many other parts of Europe.
- The Bardi and Peruzzi banks suffered greatly when England's monarchs refused to pay for loans acquired to finance the Hundred Years' War.
- The Medici family (The wealthiest family of Europe) established a bank in the 15th The **Medici Bank** (1397–1494) Florence, Italy.

Foreign Exchange Contract

- Two brothers borrowed 115 Genoese pounds and agreed to reimburse the bank's agents in Constantinople the sum of 460 bezants one month after their arrival in that city
- The following century the use of such contracts grew rapidly, particularly since profits from time differences were seen as not infringing canon laws against usury

The Conquest of the Americas: The Finance of Gold

- Before European exploration and colonisation, Arab merchants traded with the countries in the East
- The Arabs had a monopoly or complete control over the overland trade routes across the land to the East
- The Arabs charged high taxes on all the trade that passed through the overland routes they controlled. These high taxes made the price of products like gold, silk and spices that Europeans wanted, more expensive for them to buy
- Europeans wanted to find their "own sea route" to the East that did not cross Arab lands

Spain and Portugal

- Spain and Portugal started the conquest of the Americas by sending several ships to the New World
- Both became very rich by taking back on their ships unprecedented quantities of gold and silver. These were stolen from the Incas and the mines that the Spanish came to control
- Both Spain and Portugal raided entire South American communities, took their treasures, took control of their land with its gold and silver mines, and becoming extremely rich.
- For instance, 20% of the wealth had to be sent back to the Spanish King, but that still left plenty for the Spanish conquistadores

Spain 1566 to 1790

- The gold was used by the Spanish monarchy to pay off its debts and also to fund its “religious” wars.
- Gold started to trickle out to other European countries who benefited from the Spanish wealth
- The Spanish were able to purchase an unprecedented quantity of imported goods from around the world – including Europe and China

- Spain became the richest country in Europe by the end of the 16th century
- Much of the wealth from this trade was used by the Spanish kings (the Habsburgs) to finance armies to protect its European territories in the 16th and 17th centuries against the Ottoman Empire

From Americas to Europe

- A single ship might carry 2 million pesos. The modern approximate value of the estimated 4 billion pesos produced during the period would come to $530,000,000,000 or €470,000,000,000 (based on silver bullion prices of May 2015)

Failure of Spain

- The increase in gold and silver on the Iberian market caused high inflation in the 17th century, affecting the Spanish economy
- As a consequence, the Crown was forced to delay the payment of some major debts, which had negative consequences for its lenders, mostly foreign bankers
- By 1690 some of these lenders could no longer offer financial support to the Crown
- The Spanish monopoly over its West and East Indies colonies lasted for over two centuries

Consequences

- In the 16th century, Spain accumulated a very large trade deficit – financed by capital inflows (the gold taken from America).
- This created an unbalanced economy – consumption enables high current living standards, but when the gold dried up, Spanish business and industry had been left behind other European nations.
- Nations without a windfall of gold had a much greater drive to create wealth rather than just consume it. Example: the British Empire

- Some economists argue that prices in Spain rose 300 percent between 1500 and 1600.
- One reason was the rapid increase of the money quantity (then silver and gold) targeting a fixed amount of goods
- The consequence was that Spanish exports became uncompetitive in Europe. Instead, the wealthy Spanish imported goods from abroad

The Emergence of Great Britain

- Great Britain, had a different story with gold
- For some, Francis Drake was a British hero.
- For others, he was a pirate who attacked Spanish ships and took some of their gold. (It is estimated about 10% of Spanish gold was lost to piracy).
- Francis Drake gave a good portion of his stolen gold to Queen Elizabeth I – who used it to pay off the UK national debt

Consumers vs. Producers

- In Britain, the prospect of gold was the engine behind a rapid expansion in naval technology.
- Navy and shipbuilding capacity expanded and improved
- The Empire was being built
- It was not an Empire built solely on gold but on coal, textile, spices and colonizing far away lands: India
- These factors helped with the industrial revolution
- 1694: Bank of England is established as a quasi-central bank.

The Renaissance

- In the 15th and 16th century the concept of banking moved to northern Europe. The rise of Protestantism and the weakening of Catholic Rome's influence
- In the 17th Amsterdam became one big financial platform (the tulip bulb crisis)
- Then in 18th century, London became another financial hub until today

The Rothschilds and the Foundation of Modern Finance

- The Rothschild family provided loans to the Bank of England and purchased government bonds in the stock markets
- For instance, one of the sons, Nathan, started to trade in the London Stock Exchange financial instruments such as foreign bills and government securities.
- Later, he began to deal in gold bullion

- The same Rothschild undertook to transfer money to pay the Duke of Wellington's troops, on campaign in Portugal and Spain against Napoleon
- The family of bankers sent subsidy payments to British allies when these organized new troops after Napoleon's disastrous Russian campaign
- They helped wit the construction of the Suez Canal

- Major businesses directly founded by Rothschild family capital include

- Alliance Assurance (1824) (now Royal & Sun Alliance)
- Chemin de Fer du Nord (1845) (one component of SNCF)
- Rio Tinto Group (1873) (British-Australian, mining)
- Société Le Nickel (1880) (now Eramet, French Multinational);
- and Imétal (1962) (now Imerys) (French mutilnational)

The Rothschilds financed the founding of De Beers, as well as Cecil Rhodes on his expeditions in Africa and the creation of the colony of Rhodesia


Chemin de Fer du Nord
Service Direct
Paris-Nord
Chemin de Fer
Ceinture

Finance of war and Finance of projects

- Paris had emerged as an international center of finance in the mid-19th century second only to London
- It had a strong national bank and numerous aggressive private banks that financed projects all across Europe and the expanding French Empire
- The Rothschild banking family of France funded France's major wars and colonial expansion
- The Banque de France, founded in 1796 helped resolve the financial crisis of 1848 and emerged as a powerful central bank.

The 20th Century

The Great Depression

- More than 2000 of the banks that closed during that week of 1933 never opened again
- Nearly 11,000 banks failed between 1929 and 1933 and the money supply dropped by over 30%
- Unemployment rose to 25%
- It took more than 25 years for the Dow to reclaim its peak of 1929

- The stock-exchange speculation had led hundreds of thousands of Americans to invest heavily in the stock market. A significant number of them were borrowing money to buy more stocks
- The wheat prices: the link between the drought (grain price fall) and the stock market.
- If people expect there will be a good harvest next season the future prices will go down as the supply will be more than the demand and the investor won't receive the high prices they were promised and they won't have enough profit to invest in the stock market

The failure of the Banking System

- By the inauguration of Franklin D. Roosevelt as president in March 1933, the banking system of the United States had largely ceased to function
- Depositors had seen $140 billion disappear when their banks failed.
- Businesses could not get credit for inventory.
- Cheques could not be used for payments because no one knew which cheques were worthless and which were sound

Financial Consequences

- Roosevelt closed all the banks in the United States for three days - a "bank holiday." Some banks were then cautiously re-opened with strict limits on withdrawals. Eventually, confidence returned to the system and banks were able to perform their economic function again
- To prevent similar disasters, the Federal Government set up the Federal Deposit Insurance Corporation, which eliminated the rationale for bank "runs" - to get one's money before the bank "runs out"

The Crisis of 2008

"I THOUGHT WE WERE JUST BUYING A HOUSE."

The Historical Context

- In 2001, the U.S. economy experienced a mild, short-lived recession
- The terrorist attacks of 9/11, 2001
- The burst of the dotcom bubble in 2000
- Accounting scandals (inflated revenues, falsifying results, Enron, Xerox…)
- The fear of recession really preoccupied everybody's minds

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Consequences

- Cheap money resulted in:
- More home loans offered by all sorts of banks
- All sorts of home buyers
- More “appreciation” in home prices

Financial Engineering

- But the bankers thought that it wasn't enough to lend the cheap money
- They decided to repackage these dangerous loans into collateralized debt obligations (CDOs) and pass on the debt to other banks who were looking for better returns
- Those CDOs became toxic assets in many financial institutions and that eventually led to the collapse of many banks and the whole economy

Bailout plan

- $700 bailout Plan was put in place to save the American Economy or rather the American banks.
- Too big to fail, was the reason behind this bailout
- The US government was given the permission to buy out all the “toxic assets” on the financial sheets of the failed financial institutions:
- mortgages
- auto loans
- college loans
- "other" (which allows for broad interpretation)

And the story continues…

Your Thoughts