Finance Matters

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Lecture#4

The Financialization of the Economy

Swaps

- It is an agreement between two companies to exchange cash flows in the future
- The agreement would define **when** the cash flows are to be paid and the **which** they are to be calculated
- Usually the calculation of the cash flows involves the future value of an interest rate, an exchange rate and other market variables
- The cash flows exchanges take place on several future dates

Example

- A three-year swap initiated on March 5 2014 between Microsoft and Intel
- Microsoft agrees to pay to Intel an interest rate of 5% per year on a principal value of $100 million
- In return, Intel agrees to pay Microsoft the six-month LIBOR rate on the same principal
- We assume that in the agreement, the payments are to be exchanged every 6 months

Cash Flows to Microsoft

	Six-month LIBOR rate (%)	Floating cash flow received	Fixed cash flow paid	Net cash flow
Mar. 5 2014	4.20			
Sept. 5, 2014	4.80	+2.10	-2.50	-0.40
Mar. 5, 2015	5.30	+2.40	-2.50	-0.10
Sept. 5, 2015	5.50	+2.65	-2.50	+0.15
Mar.5, 2016	5.60	+2.75	-2.50	+0.25
Sept.5, 2016	5.90	+2.80	-2.50	+0.30
Mar.5, 2017	6.40	+2.95	-2.50	+0.45

Use of Swaps

- To **transform a floating-rate loan into a fixed-rate loan.**
- Example: Microsoft borrowed a $100 million at LIBOR plus 0.1%). After entering the swap, Microsoft has three sets of cash flows
- - it pays LIBOR plus 0.1% to its outside lenders
- - it receives LIBOR under the terms of swap
- - it pays 5% (fixed rate) under the terms of the swap

For Microsoft

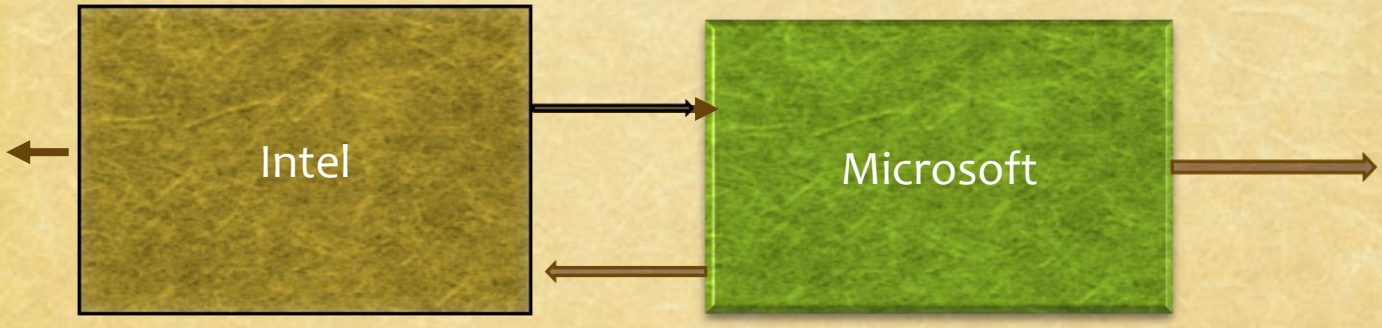
- For Microsoft, the swap transforms the borrowing at a floating-rate (5%+0.1%) into a fixed rate of 5.1%
- it pays LIBOR plus 0.1% to its outside lenders (financial institutions)
- - it receives LIBOR under the terms of swap
- - it pays 5% (fixed rate) under the terms of the swap (to Intel)

For Intel

- For Intel, the swap could transform a fixed-rate loan into a floating-rate loan.
- Suppose Intel has an outstanding loan on which it pays 5.2%
- After the swap:

- It pays 5.2% to lenders (Financial institutions)
- It pays LIBOR under the swap agreement (To Microsoft)
- It receives 5% under the terms of the swap (From Microsoft)

Illustration



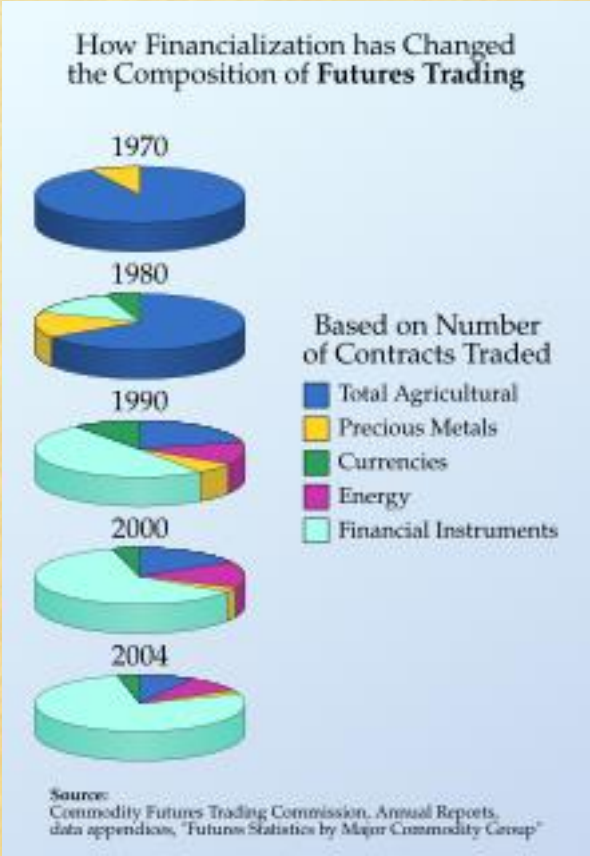
Definition

- Financialization is “a lapse back into the pre-industrial usury and rent economy of European feudalism”, Michael Hudson (Wall Street Analyst, Research and Economic Professor)
- The emphasis is no longer on making things - it is making money from money.

What is “the Financialization”?

- Financialization is the direct consequence of the deregulation of the economy and particularly the financial systems and banking
- It is the direct consequence of the New Deal regulations being dismantled
- Gradually, the financial activities (risk + speculation) became predominant in the economic sectors.
- The employment and total sales of the finance industry grew from 10% of GDP in 1970 to 20% by 2010. The emphasis was no longer on making things - it was making money from money.

The Impact of Financialization on Trading



The New Deal

- The New Deal consisted in a series of programs and projects instituted during the Great Depression by President Franklin D. Roosevelt
- The goal was to restore prosperity to Americans among others : a home for every American
- Stabilize the economy and provide jobs and relief to those who were suffering

Regulations

- National Industrial Recovery Act guaranteed that workers would have the right to unionize and bargain collectively for higher wages and better working conditions;
- Roosevelt had won passage of 12 other major laws, including the **Glass-Steagall Act** (an important banking bill) and the Home Owners' Loan Act, in his first 100 days in office.

- The Glass-Steagall Act, which essentially prohibited the mixing of banking, securities, and insurance businesses. Together these two acts of banking reform provided long-term stability to the banking industry.

Regulations of Finance

- The New Deal introduced regulation in the financial hierarchy in order to avoid a repetition of the stock market crash of 1929 and the massive bank failures that followed.
- The Federal Deposit Insurance Corporation (FDIC) granted government insurance for bank deposits in member banks of the Federal Reserve System
- The Securities and Exchange Commission (SEC) was formed to protect the investing public from fraudulent stock-market practices.

After the Stock Market Crash of 1929

- The government realized that the economy needs to be stabilized and that Americans should invest in the real state market. A house for every one (with the exception of the Black population): the emergence of the private real state market
- Before the crash, no more than 2/5 of Americans were homeowners
- The government became the official guarantor of all these mortgages.

The Democratization of Property

- The Federal government created the Federal Housing Administration
- They created **Fannie Mae** and later its little brother
- **Freddie Mac**
- The federal government underwrote the mortgage market
- The credit became a profitable business.
- Homeowners became stakeholders of the US economy

Racial and Economical Segregation

- Beyond the preexisting racial segregation
- Finance through credit and property became also a tool of segregation
- A prime rate for White people (good credit, good income, not reliable)
- A subprime rate for Black people (bad credit, poor income, not reliable)
- That segregation was reflected in neighborhood: white with houses and black with slums or rental properties

Boring Banking

- Since creation of the New Deal until the 1970s , during that time, the banking sector was described as the era of "boring banking"
- Banks: took deposits and made loans to individuals
- Banks were prohibited from engaging in investments involving creative financial engineering and investment banking: **Glass-Steagall regulations**

- In the 1970s, the financial sector comprised slightly more than 3% of total GDP of the U.S. economy,
- The total financial assets of all investment banks (that is, securities broker-dealers) made up less than 2% of U.S. GDP.

The Change

- Wall Street put pressure on the United States Congress for more deregulation, including for the repeal of the Glass-Steagall Act
- It allowed banks, securities, and insurance firms to form financial conglomerates that could market a range of financial products including mutual funds, stocks and bonds, insurance, and automobile loans.
- In 1982, the deregulation was complete with Reagan repealing the Glass- Steagall Act

The Finance Lobbyists

- Banks started complaining that they would lose customers to other financial companies unless they could offer a wider variety of financial services
- The government responded by giving banks greater freedom to offer consumers new types of financial services
- Then, in late 1999, Congress enacted the Financial Services Modernization Act of 1999, which repealed the Glass-Steagall Act

The New Economic Environment

- As with laws deregulating transportation, telecommunications, and other industries, the new law was expected to generate a wave of mergers among financial institutions

The Ascent of Finance

- In 1978 commercial banks held $1.2 trillion (million million) in assets, that was about 53% of the GDP of the United States.
- By year's end 2007, commercial banks held $11.8 trillion in assets, that was about to 84% of U.S. GDP.
- Investment banks held $33 billion (thousand million) in assets in 1978 (equivalent to 1.3% of U.S. GDP), but held $3.1 trillion in assets (equivalent to 22% U.S. GDP)

The New Economy

Over the last decades, the economy has seen the shrinking of the sectors that were labour intensive to sectors that are money intensive.

Wall Street profits rose from less than 10% in 1982 to 40% of all corporate profits by 2003.

At the same time the manufacturing industry fell from 30% of GDP in 1950 to 10% in 2010. The finance industry swelled as the rest of the economy weakened

Example of “Money from Money”

- During 1980s Michael Milken (former financier and now philanthropist) was the first to use high yield junk bonds for corporate financing of mergers and acquisitions
- He made between $250 million to $550 million per year at the height of his success.
- In 1989 he was indicted for securities fraud and sent to prison for 2 years.

- In 2007, the securities that were so instrumental in triggering the financial crisis of 2007-2008, asset-backed securities, including **collateralized debt obligations** (CDOs) were practically non-existent in 1978.
- By 2007, CDO comprised $4.5 trillion in assets, equivalent to 32% of U.S. GDP

Short Term vs. Long Term

- Since the 1980s, the financial industry has pursued short term financial returns
- Long term goals such as technology and product development investments were gradually dumped to give rise to quick profits
- Many authors and academics argue that the financial industry has played a major role in the decline of manufacturing in the U.S.

- Short term profits over long term profits
- Apprentice type training has been lost in many American corporations
- Everything is measured according to ROI
- Basic research, funding to bring innovation to scale, and diffusion of new technologies to suppliers, have also been dropped or reduced because they are seen by the shareholders as being peripheral to the core competencies of making profits

Online Profits

- Wall Street encouraged and participated in the emergence of companies that would make profit from making money rather than from manufacturing products.
- Investing in the brick and mortar of expensive factories became rather old fashioned
- Companies like Amazon became dominants despite being unprofitable in the long term
- Manufacture in China and sell in America.

The Pre-2008 Financial Crisis

- In 2002, George W. Bush declared that everyone in America should own their home, and that was understood this time to include the minorities.
- Those who were left one in the after New Deal democratization of the property wave.
- Even those who had bad credit, history, with no income, no assets, were targeted to become homeowners

Securatization

- Bad credit, high risk, high returns
- Wall Street came up with a strategy:
- The “Packaging of the mortgages”
- Bundle all the “Bad mortgages” together and then slice with the ones on top being sold as AAA rating assets.
- Sell these new assets to people all over the world (pension funds in places like Nordic countries)

Subprime Mortgages

- Wall Street created some new and novel forms of credit with better returns.
- As regulations slowly collapsed along with oversight of consumer and mortgage lending, Wall Street introduced predatory lending in the form of high interest rate credit cards with fees and penalties, pay day loans and subprime mortgages.
- They conducted massive promotions to scrape more borrowers from the bottom of the barrel. The predatory lending practices "preyed on the poor and made them poorer."

The Crisis of 2008

- Wall Street engineered the Housing Bubble:
- They took advantage of the loose regulation to make more profits
- The big banks began issuing subprime mortgages to people who they knew were not qualified for the loan.
- Then they packaged the junk loans into toxic securities to be sold all over the world.
- When the bubble burst and prices collapsed, lower income home owners found themselves underwater and the foreclosures began.

Ponzi Scheme

- Ponzi Schemes
- Bernie Madoff 2008 – Bernie was turned in by his sons in 2008 for running a Ponzi scheme.
- He keeps borrowing money from clients and paying others with some of the borrowed money.
- Meanwhile, his hedge funds continued loosing money losses
- His fund consistently showed an 11.1% return which attracted a lot of investors. Eventually the investors would lose $50 billion

The Dodd-Frank Legislation

- The Dodd-Frank Wall Street Reform and Consumer Protection Act introduced a financial reform legislation
- It was passed during the Obama administration in 2010 as a response to the financial crisis of 2008.
- Dodd-Frank established a number of new government agencies tasked with overseeing the various components of the act and, by extension, various aspects of the financial system.
- In May 2018, President Donald Trump repealed Dodd-Frank and signed a new law rolling back significant portions of it.

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Your Thoughts