Financial Markets - Where to now?

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October 5, 2008

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The US government has approved the bail-out. Where to now?

The bail-out is a temporary relief to a disorder and malaise brought about by a century of unprecedented economic growth along side growing errors and unrestrained character flaws.

Unless we know the root causes that brought about this disorder, we would be like a doctor providing aspirin to a patient with a severe fever and headache.

The US stock markets may indeed recover by hundred points for a week; a huge sigh of relief are heard from the Chicago Mercantile Exchange to the Philippine Stock Exchange; those in government who have been heavily engaged in financial speculations may now be jumping with joy.

But what next?

What's missing?

Will the bail-out bring about lasting confidence in the economy? Will the economy now grow and employment increase? Will we now experience price stability such as in food, metals and oil? Will we have faith in the implementors of the bail-out program?

Or would we rather say that we may be jumping from the frying pan to the fire with this new law?

What is missing?

This. What are the root causes of the problem and how does the bail-out become the answer to this problem? You may even ask, "Will the perpetrators be found guilty, dislodged from power and punished?"

The big picture

What is the big picture in all this?

There are two sides to the economy.

First, there is the real economy which produces real goods and services to satisfy human needs placed in a hierarchy by Abraham Maslow.

The growth of business in the real economy results in savings. At first, these savings were small

and were hidden under mattresses. As wealth accumulated from all sectors in the economy through the years, banks were formed to serve as depository of these savings as well as as a source of funds for those in business.

The accumulation of wealth from centuries of economic growth brought about the proliferation of all types of banks, insurance services, investment bankers, fund managers, mutual funds, hedge funds, etc. This became the second side of the economy - the financial markets.

As working men created wealth, a purse keeper accumulated and secured their wealth.

The existence of these financial markets had clearly one purpose - to serve the real economy and people by gathering their savings and making this capital available back to the real economy and to people at less cost.

Leaders in the financial markets saw that this purpose was good. And they said, "Let us create more financial services to the real economy and provide capital requirements and liquidity for those in need".

Thus, they conceptualized the idea of the corporation, legislated it as a form of business and developed the concept of shares of stocks, debentures and preferred shares. They also created bonds, treasury notes and bills, foreign exchange as vehicles for moving people's savings.

And they saw that it was good. And they said, "Let us now put up stock exchanges where corporations could raise funds to expand operations and where people with excess funds could invest their savings with greater yield. And they were extremely happy for being of such great service to the economy and for making money in the process.

So long as financial markets operators were focused on this purpose, to serve the real economy, their relationship had symbiotic benefits.

But the 20th century severely changed that focus.

Deviations from the Real Purpose

Deviations started to appear. Instead of serving the real economy, financial markets developed strategies to serve themselves at the expense of the real economy.

The first visible sign of deviation was the collapse of the U.S. stock market that started on October 21, 1929 and continued on till October 29, 1929 - the Great Wall St. Crash.

There are interesting events in this crash that echo in current events. The following data comes from Jeremy Kingston and David Lambert's book, Catastrophe and Crisis, published by Aldus Books Ltd. in 1979.

First, the economy before the crash seemed to be booming, people had easy access to money and people were living in prosperity.

According to the book, "this availability of money was one of the reasons for the boom. Shares in the climbing market could be bought on margin - that is to say, the buyer paid the broker only a small portion of the cost of the share, the difference being made up with money borrowed by the broker from a bank and loaned to the buyer."

Second, the engine of growth was the culture of getting rich quick.

The book states: "It is an unhappy fact of speculative buying that when prices are rising fast, whether the rises occur in land, or shares, or even tulip bulbs, people cease to look for the reason why they are rising. The items may be intrinsically worthless but what counts is that they can be resold at a profit - sometimes a very great profit. In 1928 and 1929 Americans became dazzled by the real possibility of becoming very rich very quickly."

Third, in the initial shake-outs and downturns that happened before the 1929 Crash, the Chairman of the powerful National City Bank, Charles E. Mitchell, offered to lend US$20 million "to avoid any dangerous crisis in the money market".

According to the book, "Mitchell, who was speculating heavily, had strong reasons for wanting the boom to continue, and his words rallied the market. (Five years later, Mitchell was arrested and tried on charges of tax evasion.)"

Fourth, on October 24th, Black Thursday, as stock prices were falling like lead, the Vice President of the Stock Exchange "walked onto the floor as representative of the banker's pool and bought heavily in 20 assorted stocks. Again the volatile market recovered...But Tuesday October 29 was the most devastating day in the history of the American Stock Exchange...Even after October 29 the market went on falling. It reached its lowest level of the year on November 13th".

What happened to the man, Richard Whitney? He was later tried and sentenced for misappropriating Stock Exchange funds.

Fifth, when rich and poor people plant unbridled selfishness, they harvest ruin alike.

The book continues: "Men who had called themselves millionaires a week before were now irretrievably ruined. Large fortunes, small savings, all wiped out...Billions of dollars worth of profit - some real, some paper - had vanished, and the office clerk, the chauffeur, the window-cleaner, the salesman had lost all their capital."

Sixth, note the month and dates of the Crash - October 21 to 29.

Another sign of deviation is the government regulation allowing short selling of stocks.

Shorting is an investment strategy in a declining market when an investor sells stocks he does not own at a certain price and later buys them in the market when prices, he speculates, will fall lower than his selling price. The difference in price is his profit. The lower the buying price turns out to be, the greater will his profit be. He wins when the market goes down in a tailspin.

Another deviation is the creation of Futures Exchange that promotes selling and buying of contracts for speculative purposes and allowing financial intermediaries or their conduits to play the game.

For example, a buyer agrees in April 2008 to buy from a seller an oil contract at an agreed price, say $110 per barrel for future delivery in June 2008. Under this arrangement, the buyer and seller of oil may not actually be in the oil business, have no intention of receiving, delivering or keeping actual stocks of oil and have no actual need for oil.

They are in the business of speculating on the selling and buying of paper contracts - derivatives. The prices that are transacted are based on the volume of buys and sells for the paper derivatives,

not on the demand and supply of the actual oil commodity by mankind.

The same goes for buys and sells of foreign currency futures, interest-rate futures, stock-index futures and many other exotic types of investments.

These derivatives are traded in futures exchanges, the most notable among them are Chicago Mercantile Exchange and New York Mercantile Exchange.

The most recent example of deviation is, of course, the buy and sell of financial papers called collateralized debt obligation (CDO) and collateralized mortgage obligation (CMO) that brought about the subprime crisis in the US property sector and the collapse of Fannie Mae and Freddie Mac.

Media interestingly attributes the cause of the entire present crisis in the economy entirely on the subprime debacle in the property sector.

However, this may not be so and the subprime crisis may just be a cover-up for a grosser fiasco and shame for financial intermediaries - their losses in highly speculative deals in the commodity, currency and stocks futures markets.

The Raison D'etre Of Financial Intermediaries

What is the ultimate purpose of financial intermediaries in the economy?

First, banks, insurance companies, fund managers and investment bankers are fiduciary trustees of savings accumulated by industries from centuries of serving the needs of people.

They are supposed to keep these savings, not lose them.

When Citibank, Morgan Stanley, AIG and hundreds of other financial intermediaries write off hundreds of BILLION dollars for bad investments in a period of less than a year, they have spilled the milk of human endeavour gathered by hundred millions of workers throughout history.

Second, as trustees, financial market operators serve not just the investors who hand them their savings but also the real economy that produced the businesses that resulted in these savings.

The obligation of financial market operators ultimately is anchored to the fundamentals of protecting and promoting the interests of the real economy that brought about their existence in the first place.

Third, the financial markets are NOT the engine of growth in any economy. The engine of growth is the real economy - the world's billions of people, past and present, who produce goods and services to satisfy man's hierarchy of needs.

Believing otherwise would lead people to rush to exchanges and buy and sell paper certificates whose values swing up and down with the varying degrees of exhiliration, hysteria and back-room manipulation in the markets.

Or, this belief may encourage players in the real economy to borrow for projects that will end up in bubble bursting just because interest rates are cheap, as in the 1997 Asian crisis.

Fourth, in formulating investment strategies, financial operators must come back to the original purpose for which financial intermediaries have been created - to serve the real economy and people and to make these savings readily available back to the real economy and to people at less cost.

The fact is, there is decent money to be made in this honorable role, as has been made in at least the past millenium.

Conclusions

These principles inevitably lead us to the following conclusions in bringing back confidence and growth in the economy.

First, the cause of the financial crisis takes its roots in the abandonment by the financial intermediaries of their raison d'etre, their original and true purpose of existence in the economy.

Trillions of dollars of the world's savings earned through centuries of work are placed in the hands of a powerful and brilliant few. They in turn channel these savings in stocks, futures, currency exchanges as well as securitized papers. They may even create separate conduits and entities for this purpose and register them in the Bahamas to escape supervision and taxes.

If the real economy is not directly benefited from these investments and the financial market operators deprive the real economy easy access to funds because they make easier money from speculative investments, then they would be betraying their raison d'etre.

If the increase in the values of these investments depend ultimately on the weather, greed, get-rich-quick culture, human exhilaration or despondency, or mass hysteria, then they would be betraying their cause for being as fiduciary trustees of other people's money.

If financial intermediaries are allowed to place the world's savings in these investments, it would be like allowing your CFO to divert company funds from your usual operations and to "invest" them instead by playing roulette in the casino just because your CFO happens to be outstanding at numbers with a brilliant mind for probabilities.

Well, this is story of the 2008 Financial Crisis. And the magnitude of the losses have been so staggering that US Congress had to enact a Bail-Out law.

Second, the Bail-Out Law of the US Congress must address the abandonment by financial intermediaries of their original purpose of existence and provide sanctions and penalties on violators.

If this is not addressed, it would be like providing a fresh amount of $700 Billion to your same CFO to save the company by playing in the same roullete where he failed miserably.

No one can have confidence in that arrangement.

Third, the specific solutions to the crisis may lay between the theories of John Maynard Keynes who advocated the desirability of government intervention in the economy and of Milton Friedman who argued for the opposite.

In any case, the solution to the crisis need to be insulated from greedy people, both in private and government sectors who will use Keynes or Friedman for their selfish motives. As they say, even the devil can quote the Bible.

It is a wonder how many of those who voted on the issue of the bail-out in the US Congress belonged to the realm of the devil.

Finally, to bring back confidence in the economy and in turn in the financial markets, the real economy in the world must grow, provide employment and control inflation.

It is the real economy that gave life to the financial markets. It will be the same real economy that will bring back life to the financial markets. The financial markets cannot save themselves.

This is a very sad commentary on the recent financial crisis: the financial markets with the wealth of nations, technology and influence in their hands succeeded in engineering securitized certificates and highly complex financial instruments in the exchange but failed to use this same wealth, technology and influence in increasing production, providing innovation and generating aggregate demand in the real economy throughout the world.

The common explanation is this: it is far more convenient, surer and faster to make money on derivatives in the exchange than to make money by putting up factories, research labs, roads, bridges and airports around the world.

The role of the rich in the world economy

And this is the irony of being rich.

When a man gets to be one, he loses his sight of the fact that he became rich by serving people, by making his customers number one and by exploring unchartered frontiers where other customers abound.

As he masters the time value of money, he figures he will make faster money in the exchange rather than in the exchange of real goods and services in the real economy.

He loses his touch of the opportunities that abound in the teaming population of third world countries and underdeveloped economies where the demand for food, clothing, housing, education, infrastructure, transportation, information and communication technology, health and science facilities are boundless.

But people create demand. A billion people means a billion-people demand.

What is needed is to trigger the supply to satisfy this demand. The process of matching supply with demand creates opportunities, employment, income and purchasing power. These are created not just in underdeveloped economies but in the advanced markets where this capital - money, technology and education, machinaries - comes from.

There is no bubble in that demand, no bubble in that supply, unlike the demand and supply of securitized papers.

The new capitalism returning to roots

This is the new capitalism that has just simply returned to its roots - serving the needs of the real economy and people of the third world and underdeveloped sectors of the economy.

Have you wondered, for example, about the role of the Thomasites on our economic development when they introduced American education in the Philippines at the break of 1900s?

Let the financial intermediaries who hold the wealth of nations in their hands apply their brilliance in engineering the development and matching of this demand and supply in third world countries and underdeveloped sectors of economies.

The era of the financial derivatives for self-serving and self-seeking investors has burst in bubbles and must now come to an end.

We have arrived at the new frontiers of capitalism. And there is real money to be made in them for all.