

MAPping the Future
Financial markets--how large are they?
By Rey Angeles

WE MEASURE the size of a company by its assets, net worth or sales.

We measure how big an economy is by its gross domestic product, exports or foreign reserves.

How does one measure the size of the financial markets?

Fortune's top 500

Here is an interesting series of statistics from Fortune's Top 500 corporations in the United States. (Source: http://money.cnn.com/magazines/fortune/fortune500/2007/full_list/.)

In 1955 Fortune's top 50 included only companies, which produced goods and services in the real economy.

In this list, not a single bank or financial intermediary appears. Neither in the top 500.

Here is a sampling of the top 50 companies in 1955: General Motors, Exxon, US Steel, DuPont, Bethlehem Steel, AT&T, Kraft, Goodyear, RCA, Firestone, Uniroyal, Alcoa, Wilson, United Technologies, American Can, Rockwell Automation, Eastman Kodak, Armco.

Many of these names no longer register in front page news.

The first time a financial markets operator appears in the Fortune top 50 corporations was in 1995 when Citigroup ranked number 37. That is 13 years ago.

Let us consider 2007 records. In this year the list of the Fortune top 50 corporations includes the following 13 financial operators: Citigroup (ranked No. 8), Bank of America (9), AIG (10), JP Morgan Chase (11), Berkshire Hathaway (12), Morgan Stanley (20), Merrill Lynch (22), Goldman Sachs (24), MetLife (37), Wells Fargo (41), Wachovia (46), Lehman Brothers (47) and Freddie Mac (50).

That is 13 out of 50!

Give another 10 years and we will see the figure reversed. Grant another 20 years and the top 50 corporations may likely all be financial operators.

History is truly more fascinating than fiction.

How they became large

How indeed did the financial markets become so large and command such high respect from the governments of the world?

For simplification, let us say that the annual volume of the production of mankind in real goods and services amounts to \$10 million and from this production, mankind generates an annual saving (revenue minus expenditure) of \$1 million.

What happens to the \$1 million savings? Answer: It is kept and secured by financial markets operators.

What happens to the \$9 million net value of production? Answer: It was sold, consumed and done with.

Let us say that every new year brings in a net production of \$9 million and savings of \$1 million that is accumulated in the hands of financial markets operators. Let us stretch our minds further and say that this annual cycle happens for 100 years.

What do we see at the end of 100 years?

We will indeed be seeing that the real economy still annually produces, sells and consumes \$9 million worth of goods and services, but the wealth in the hands of financial markets would now have grown to \$100 million—100 years times \$1 million per year!

What does this concept mean? Well, it means the financial markets could now become bigger than the producers of real goods and services.

Let us assume that financial markets operators earn a mere 1 percent on all the savings accumulated in their purse strings.

That would mean that even as the real economy continues to save \$1 million a year (revenue minus expenditure), the financial markets are now earning at least \$1 million a year—1 percent based on the total accumulated savings of \$100 million plus compounds.

That is very neat, indeed!

What if the financial markets operators became rather weary of earning only 1 percent?

Then they would find a way of engineering paper certificates that would yield not just 1 percent but, say, 3 percent or more per year on the accumulated savings of \$100 million! Then, the \$3 million earnings of the financial markets would greatly exceed the \$1 million of the real economy.

Then, we would start to think that the real economy is simply a poor cousin of financial markets and the real generator of wealth in the economy is the financial markets—mankind's CFO.

And governments, captains of industries and the rich and famous of the world whose wealth are now yielding at least 3 percent in the hands of financial operators would indeed find financial markets operators simply adorable.

Derivatives for nth time

Here is another material for understanding the scope of the operations of the financial markets.

The most commonly known financial instrument is the promissory note. It bears an interest rate. The bank lends to a factory owner and covers the transaction with a PN. Its source of funds are deposits, which are, in turn, covered by a passbook or a deposit certificate promising a minimum rate of return.

But over the years, the financial markets operators engineered and created various forms of marketable financial instruments to attract savings and provide higher yields for investors. These instruments, such as the shares of stocks of a company, can be bought and sold in countless times as often as there are buyers and sellers.

One such financial instrument is called derivatives.

What NYT has to say?

Let me now introduce the definition by New York Times of derivatives in its website, <http://topics.nytimes.com/top/reference/timestopics/subjects/d/derivatives/index.html?inline=nyt-classifier>.

"The most common types of derivatives are futures; forwards, which are futures traded outside of a regular exchange; options, which are the right to buy or sell something at a specified date and price; and swaps, contracts involving an exchange of assets or payments."

The article continues: "In recent years, a bewildering variety of derivatives have been developed. Two types that have played a central role in the recent turmoil are mortgage-backed securities, whose value depends on the value of the mortgages, which depends on how many of them are being paid off, and credit default swaps, which are in essence a form of insurance policy, and whose value swings with the fiscal health of the transaction or asset it is written to cover."

How big is the market for derivatives today?

The NYT article continues:

"The derivatives market today is \$531 trillion, up from \$106 trillion in 2002 and a relative pittance just two decades ago. Theoretically intended to limit risk and ward off financial problems, the contracts instead have stoked uncertainty and actually spread risk amid doubts about how companies value them."

You may not have caught the significance of these figures, so I will compare them with the gross domestic product of nations.

Derivatives vs GDP values

The total 2007 GDP of the United States amount to \$13 trillion. The Philippine GDP is \$0.144 trillion.

The combined GDP of the United Kingdom, Spain, Italy, Germany, France and the United States is \$24 trillion. (Source: IMF World Economic Outlook Database, <http://www.imf.org/external/pubs/ft/weo/2008/02/weodata/weoselgr.aspx>.)

Compare this value in the real economy of all these countries with the total market of derivatives mentioned above—\$531 trillion. It is less than 5 percent!

If our OFWs remit \$15 billion a year to our economy, in how many years would they be able to pay for the value of derivatives transacted today?

Thirty-five thousand four hundred years.

Surely, the value of \$531 trillion derivatives includes notional values and may not reflect the true value of the transaction. That may be correct. Nevertheless, the figures astound.

But one thing is clear from these figures: They explain why governments and central banks are bent on serving the interests of financial operators by funding their requirements for survival with \$700 billion and more of the past, present and future money of taxpayers.

Only a segment of markets

But that is not the end.

There are two other major ways of measuring the size of the financial markets—the annual volume of trade in stock markets and of transactions in bonds in world exchanges. (Source: World Federation of Exchanges website: <http://www.world-exchanges.org/WFE/home.Asp>.)

In 2007, the total value of shares traded in major exchanges in the world amounted to \$101.2 trillion. Of this amount, about 46 percent or \$46.6 trillion was traded in the United States.

In the same year, the total value of bonds trading in major exchanges in the world was \$15.2 trillion.

In all, the values of the three types of investments amount to \$647.4 trillion.

What does this tell us?

The world has generated trillions of savings and most of them are invested in exchanges.

Let us put that concept in an easy-to-understand statement. The world of exchanges are awash with money accumulated through centuries of mankind working in the real economy and that money has no place to go.

This brings to light the reason why financial engineering is one of the hottest careers in the world and financial engineers command highest incomes.

The abundance of capital in the world of exchanges today also explains why derivatives must be invented. If derivatives were not around, financial engineers would create another medium by which the wealth of nations could be attracted, channeled and yield higher incomes.

How ironic it is that the rich and the powerful must lose money for having so much of it in the financial markets!

And how difficult it is to comprehend that while this abundant wealth has no place to go but in an endless spiral of speculative transactions, billions of people in third world countries and underdeveloped economies are wanting of food, clothing, housing, medicine, hospitals, roads, bridges, airports, clean air, clear water and capital to build businesses.

Secretary Henry Paulson Jr., how does one explain this phenomenon?

(The article reflects the personal opinion of the author and does not reflect the official stand of the Management Association of the Philippines. The author is an entrepreneur who wrote the books "The Peso Exchange Rate: Why Are We So Poor?" and "The Philippine Economy: Do Our Leaders Have A Clue?" Feedback at map@globelines.com.ph. For previous articles, please visit .)