Part V - Reorganized

- Lectures 17 & 18 have new names
  - Elements of Finance
  - Global Finance

- Lectures 19 & 20 the same
  - Finance & development
  - Financial Frenzy
Lecture 17
Elements of Finance:
Money, Banks & Securities
KEYS

- Basic vocabulary of finance
  - Kinds of money
  - Loans vs. securities
  - Banks vs. capital markets

- Key puzzles
  - What is money?
  - What is capital
  - What does finance do (for you)?
  - What are financial assets?
Elements of Finance

I. Money
II. Banks
III. Securities
I. Money

A. • Functions
B. Types
C. Money & Capital
D. Monetary Returns
What is Money?

- Mystery of Money
  - Money veil
    - Vs. ‘real economy’
    - Standard economics
  - Money as mover
    - Keynes, Marx
  - Money as a good
    - Gold fetish of classical P.E.
  - Money as a service
    - Business populism
What is Money?

- Money as flow
  - Means of exchange (payment)
  - Measure of value (prices)

- Money as asset
  - Vs. money as flow
  - Store of value
  - The mystery of ‘value’
I. Money

A. Functions

B. •Types

C. Money & Capital

D. Monetary Returns
Everyday Money

- Metallic money (specie)
  - Gold & silver
  - Earthly (tangible) money
  - Limits of earthly money
- State money (currency)
  - Coins & paper
  - State guarantee
- Bank money
  - Checks & Cards (M1)
  - Time deposits (M2)
Behind the Veil

What’s behind everyday money?
- Practical money vs. abstract money
- Money of account or ‘value’

Foundations of value
- Circulation/exchange of commodities
- Credit/debt (borrowing & lending)
- States
I. Money

A. Functions
B. Types
C. Money & Capital
D. Monetary Returns
Money & Capital

Money as flow & stock
- Flow = ‘currency’
- Stock = assets (store of value)

Capital = money used to make money
- Flow = investment
- Stock = assets
- Circulation of capital = flow + stocks + return
Capital Assets

- ‘Real’ assets = factories, machines, land, etc.

- Financial assets = values on paper
  - E.g., stocks & bonds
  - Claims, representations, etc.

- Capital value = ?
  - Another mystery, both for real & paper assets
I. Money

A. Functions
B. Types
C. Money & Capital
D. Monetary Returns
Money Making Money

- Lending/credit
  - Interest – the ‘price’ of money
  - Where does interest come from?
    - Surplus value

- Capital/investment
  - Profit
  - Where does profit come from?
    - Surplus value
Banking & Finance

I. Money
II. •Banks
III. Securities
II. BANKS

A. Banks & Money
B. Banks & Credit
C. Bank Services
D. Bank Regulation
Commercial Banks

- Basic banks
  - Unit & branch forms

- Inter-bank system
  - Settling accounts
  - Check clearinghouses
  - Federal Reserve Banks
Money Circulation

- Money storage
  - Accounts (balance)
  - ‘Savings’ (what’s left)
- Money inflow
  - Deposits
- Money outflow
  - Spending/purchases
- Banks as utilities
  - Like water & electricity
  - ATMs = faucets & plugs
I. BANKS

A. Banks & Money

B. •Banks & Credit

C. Bank Services

D. Bank Regulation
Bank Lending

- Business of banks is lending
  - Bank ‘assets’ = loans

- Banks are key lenders
  - Business & consumer loans

- Bank loans = new money
  - Checks
  - Debit cards
  - Credit cards
Consumer Loans

- Bank credit cards
  - VISA, Mastercard, Diners Club, etc.

- Bank consumer loans
  - For major products
    - Car loans & home mortgages

"We have a cash flow problem too. Our problem is that your mortgage payments aren't flowing our way."
Business Loans

- Long-term loans
  - Capital investment

- Short-term loans
  - Commercial paper
  - ‘Bridging loans’

- Credit for investment = new capital
  - Essential to growth

- ‘Fictitious capital’
  - All investment is speculative
Inter-bank Loans

- Settling accounts
  - Time delay

- Bridging loans
  - Inter-bank market
    - LIBOR rate
  - Almost froze, 2007 & 2008
I. BANKS

A. Banks & Money
B. Banks & Credit
C. Bank Services
D. Bank Regulation
Banking ‘Products’

- Money ≠ good or service
- Commodifying banking
  - Packaged services
  - Fee for service
- Marketing services
  - Decline of traditional banker & personal service
Bank Fees & Profits

- Bank resurgence in 1990s -- on our backs

Financial Sector Profits as a Proportion of Total Corporate Profits, 1945-1999

Direct, and to the point - I like that in an advertising campaign, Jenkins
I. BANKS

A. Banks & Money
B. Banks & Credit
C. Bank Services
D. •Bank Regulation
Basic Oversight

- **Charters**
  - State Banks
  - National Banks

- **Accounting**
  - Reporting & auditing
    - Like all corporations

- **Agencies**
  - US Treasury
    - Comptroller of Currency (1863)
  - State Financial regulators
State & National Banks

- **Jacksonian System**
  - 19th century
  - Regulation by states
  - US the most decentralized

- ‘National’ bank system
  - Circa 1880s
  - Branch banking > 1900
  - Bigger state-based banks
Federal Reserve system

- ‘The Fed’
  - Central Bank
  - Created 1913
    - After 1907 crisis

- Bank for banks
  - Reserve requirement
  - Lends to banks

- Regional Feds
  - Bow to Jacksonians
  - NY Fed the key bank
New Deal System

- 1930-33 bank collapse

New Deal
- FDIC – deposit insurance
  - Stopped bank runs
- Glass-Steagall firewall
  - Split commercial & investment banks (securities)
- Mortgages
  - S&Ls
  - FHA guarantees
  - FNMA
Neo-liberal System

- **Bank deregulation**
  - End interest & fee limits
  - Interstate banking
  - End firewall
  - Expand secondary markets

- **Bank Concentration**
  - Number of banks halved > 1980
    - Worse > crisis of 2008
  - 10 top banks dominate
    - from 30% to 50% of assets, 1997-2007
  - ‘Too big to fail’?

- **Results**
  - Higher fees & bank profits
  - Bank concentration
  - Tighter link to securities/capital markets
Elements of Finance

I. Money

II. Banks

III. • Securities
II. SECURITIES

A. •Securities
B. Markets
C. Investors
D. Triumph of Securities
Basic Securities

Stocks
- Corporate
- Claims on corporation (ownership)
- Claims on profits (dividends)
- Types of shares

Bonds
- Corporate & government
- A type of loan
- Set life-span (maturity)
- Face value & interest
- One-time & continuous interest
New & Old

- New securities
  - Raise capital for companies, governments
- Old securities
  - Continue to circulate (primary markets)
  - Yield (interest, dividends, etc) & capital gains
Securitized Loans

- Convert loans to bonds
  - Mortgages
  - International loans
  - (also insurance policies)

- Banks sell to investors
  - Injects new capital into bank
    - Which can issue more loans
  - Interest goes to new owner

- Trade in secondary markets
Bundled Securities

- Mutual Funds
  - Sets of stocks & bonds
    - Variety of ‘products’
  - Traded like regular stocks & bonds
    - In primary markets

- CDOs and all that
  - Rebundling securities
  - Tranches & pieces of securities
Derivatives

- Contracts on securities
  - Not assets
  - Profits from price changes of assets

- Types
  - Futures, options, calls, etc.

- Functions
  - Speculation, hedging & arbitrage
II. SECURITIES

A. Securities
B. •Markets
C. Investors
D. Triumph of Securities
Primary markets

- **Stock Markets**
  - Open floor
    - NYSE, LSE, Hong Kong
  - Fully computerized
    - NASDAQ first, now all

- **Bond Markets**
  -Handled by big commercial banks
  - Trading rooms & computer networks
Secondary Markets

- Secondary mortgage market
  - Mortgage repackagers
    - FNMA, GNMA (~50%)
    - Investment Banks (~50%)
  - Sold to investors
  - Special markets
    - Bank trading rooms & computer networks

- Derivatives markets
  - Specialized institutions
    - CBOT, LIFFE, Euronext
  - Trading floors & computer networks
Bankers & Brokers

- **Investment Banks**
  - Handle new issues (for corporations)
  - Solomon Bros, JPMorgan, Goldman, Lehman Bros, etc.

- **Brokerages**
  - Handle trades of existing securities
  - Members of exchanges

- **Mutual Funds**
  - Specialized firms
  - E.g., Franklin-Templeton, Dodge & Cox, Vanguard, etc.
Functions of Capital Markets

- Gather savings -- with a return
  - Dividends, interest, etc.
  - Capital gains

- Raise capital
  - With new issues

- Price regulation
  - Measures worth of corporations
  - Adjusts with changing fortunes
Failures of Capital Markets

- Generate little new capital
  - Only new issues, like IPOs
- Parasitism
  - Rich investors skim off dividends & interest
- Speculation
  - Just a Casino?
Markets & Risk

- ‘Risk society’
  - Language of risk comes into vogue
  - ‘Risk’ takes moral bite out of greed
  - Finance’s new function:
    - Eliminate risk

**Greenspan sees no derivatives problem**

By Martin Chuestinger

WASHINGTON - Federal Reserve Chairman Alan Greenspan, taking issue with the warnings of billionaire investor Warren Buffet, said Thursday that the growing use of complex financial instruments known as derivatives does not pose a threat to the country’s financial system.

Greenspan said that financial market participants who purchased derivatives, including banks, had been able to spread their risks and that this had helped to lessen the severity of the 2001 recession.

“From the largest corporate defaults in history - Argentina, Worldcom, Enron - and the recent sovereign debt default in Greece, we have seen that the capital of any major financial secondary,” Greenspan said.

Greenspan said that to warn about the use of derivatives issued by Buffet, the president of Berkshire Hathaway Inc, in March in his annual letter to shareholders.

In this year’s letter, Buffet contended that derivatives were “financial weapons of mass destruction” fearing that they posed grave risks to the financial system.

“Financial weapons of mass destruction,” Greenspan said.

**HEDGE FUND REDEMPTION**

**Goldman Sachs**

**Special Appearance by ALAN GREENSPAN**

**Ben Bernanke**

**THIS FALL**
II. SECURITIES

A. Securities
B. Markets
C. Investors
D. Triumph of Securities
Capital Investors

- Capitalists invest in banks (stocks) & securities (capital assets)
  - Invest for returns
  - Interest & dividends
  - Asset values (rising prices)

- 90% of investment is wealthy & institutional investors
  - Small investors are minor players
Generalists

- Wealthy people, corporations & banks
- Trust funds & investment advisors
Pension Funds

- Biggest institutional investors
Private Equity Funds

- Specialized financiers
- Large risk-taking funds
- Buy & sell whole companies
Hedge Funds

- Deal in derivatives
  - Play against the markets
  - About 1/3 of all derivative trades

- Risk management?
  - Mostly US investors, who are risk takers

- Unregulated
  - No one knows how big they really are

Chart 1: Global hedge funds

Source: Hennessee Group LLC; IFSL estimates for 2005
Sovereign Wealth Funds

- National investment funds
  - Began in Persian Gulf
  - Now China, Russia, etc.
II. SECURITIES

A. Securities
B. Markets
C. Investors
D. •Triumph of Securities
Rise of Securities

- Origins (c. 1700-1800)
  - Bank of England (1688)
  - NYSE (1810)

- Railroad era (1850s-70s)
  - RR's & NYSE
  - Mining & SF exchange
  - Crisis of 1870s

- Corporate era (1900s-1920s)
  - Rise of investment banks
    - JP Morgan & mergers
  - Regional exchanges

- Crisis of 1929
  - Stock market collapse
  - Severe blow to securities

- New Deal era (1930s)
  - Reform of banks & securities
    - FDIC – deposit insurance
    - Bank Firewall (Glass-Steagall)
      - between commercial & investment banks
    - SEC – exchange regulation
    - FHA – mortgage guarantees

- Postwar era (Golden Age)
  - Securities contained
  - Little rise in stocks
  - Banking in command
New Financial Era > 1975

- Low-cost trading
  - Schwab et al.
  - Depersonalized & popularized
- Secondary markets
  - Esp. mortgages (GNMA).
  - End of S&Ls
- Derivatives
  - Invented in Chicago
  - Taken up in NY & London
Neoliberal Finance

- **Deregulation**
  - SEC weakened
  - Commercial banks
    - Interest & fees
  - End of firewall
  - Derivatives
  - No regulation of hedge funds (2004)

- **Attempt to slow the train...**
  - Oxley-Sarbanes (2004?)
    - After crash of 2000
    - Accounting scandals
Explosion of finance

- Growth of financial sector
  - > 20% of US economy
  - K. Phillips, *Mad Money*

- Securities trading > bank lending
  - By 2003

- Derivatives market balloons
  - ~ $480 trillion in 2007
  - 15+ times its value in 2000.
  - 12 X size of world economy

- Equity & Sovereign funds
  - Trillions upon trillions
Banks & Securities

- Bank-Securities link
  - Back with a vengeance

- Leverage
  - Banks playing the markets
  - Bank lending to play the markets

- We see the results today....