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Financial crisis: False number games

On the topic of the so-called financial crisis, starting with the proponents of the market economy right across the camp of left-wing critics, there exists an uncanny unity with regard to the dominance of financial capital. In their opinion, what has happened since the middle of 2007 on the world financial markets, was a crisis of confidence of finance capital which follows *purely as a result* of its capital-accumulating occupation *with itself*, but whose effects are not limited only to that. Financial capital, whose business consists of the profit-creating circulation of money and debts, is thought to have radically divorced itself from the organisation of credit-financed production and circulation of commodities. The services which financial capital provides to make more money in the process reached the gigantic sums which people are happy to quote, which were supposed to bear no relationship to money lent to expand business or rationalisation, nothing to do with postponed payments in trade and consumption based on credit. The question everybody is asking is: Where do the incredible sums of money that the financial markets move come from?

The worldwide trade in derivatives...

" ... in December 2007 the volume of credit derivatives traded over-the-counter came to 596,000,000,000,000 US Dollars ... If one could have turned the total amount of these loans into cash, one would have been able to buy ten times over all the goods and services which the human race created in 2008!"¹

Unfortunately one cannot have these astronomical sums paid in cash because they are not loans at all and so they are not assets, but merely the addition of the notional amounts of financial contracts. Credit insurance known as Credit Default Swaps (10% of traded derivatives), as well as interest insurance and currency insurance contracts (75% of the global volume of derivatives), are often falsely equated with assets, just as if someone could double the value of his house by means of a fire insurance, or his monetary assets by a forward currency contract² The huge notional amounts overstate the actual payment obligations which result from the trade in derivatives. In the case of an interest rate swap for instance, the reference value is 100 million €, whilst the two parties to the contract merely accept the obligation to pay the other party the difference between a fixed and a variable interest rate linked to the notional amount of the contract. At a difference in interest rate of one percentage point the resultant payment obligation is then a mere one million Euros. The Bank for International Settlements (BIS) accordingly estimates what is known as the *gross market value* of derivatives trade for 2007 at 15.8 trillion US \$, i.e.: 2.7 per cent of the notional amount.

Beyond this, the derivatives business is usually inflated by a chain of transactions in interbank trade by the fact that the original deal entails a second or often even several re-insurance deals of the same magnitude. "Let's assume a bank offers a trading company a forward foreign exchange contract. If the bank has no other customers who want to take on the offsetting transaction, it will hedge the forward contract by spot and swap deals. Each customer order follows a chain of transactions in interbank trading, because the bank wants to pass on an unwanted position which does not fit in its portfolio. Without a large discount the bank is unlikely to find a counterpart

¹ Peter Wahl (Attac), *Entwaffnet die Märkte*, VSA 2009, P. 7 and following

² According to figures from the Bank for International Settlements (BIS), the 596 trillion Dollars – the total volume of outstanding derivatives contracts in over-the-counter (off exchange) trade – is made up as follows (in trillion US \$): interest rate derivatives 393, credit insurance derivatives 58, currency derivatives 56, shares, raw material and miscellaneous derivatives 89. Bank for International Settlements, OTC derivatives market activity in the first half of 2009, November 2009, <http://www.bis.org/statistics/derstats.htm>

straight away who will take on all of this position and hold it. But with many participants in interbank trading it is however advantageous for another bank to accept the position at a slight discount, to keep part of the currency acquired at an inexpensive rate and to pass on the rest. This "hot potato trading" represents individual risk diversification and ensures that the risk of the original customer order is efficiently distributed over several participants in the currency market. Let us assume that we have several traders who at the moment are holding their optimum portfolio. A customer order from a trading company for 1 million foreign currency units increases the exposure of the first foreign exchange trader who consequently keeps only 10 per cent of the original position. The rest he passes on. Each dealer keeps only 10 per cent, until a dealer is found who accepts all the rest for his portfolio. Assuming that the fourth dealer takes on the remainder of the position ... the entire trading volume as a result of this order is thus 3.439 million units of foreign currency."³ Since the main actors in the derivatives trade, what are known as market makers, can offset one type of reciprocal contract concluded through their transaction chains with their opposites, the BIS estimates the *net volume* in this market at the end of 2007 to have been only 3.9 trillion \$, in other words 0.7 per cent of the notional amount.⁴

What's more, for every contract in the derivatives trade there is a buyer and a seller, so that in these deals every profit is matched by a loss of exactly the same amount; thus no value is created, what takes place is a "zero-sum game". This of course does not mean that not a few participants make enormous profits and can use this success in order to generate new capital by issuing securities on the capital markets and by this means expand their businesses. The question is only, who are then their counterparts, who with their corresponding losses make the profits possible and also the increasing financial power of the winners in the trade in derivatives which has been growing strongly since the early 1990s? According to the BIS, at the end of 1999 the notional amounts of the worldwide trade in derivatives came to 88 trillion US \$, of which 91% consisted of contracts between financial institutions and 9% contracts between the financial sector and the non-financial sector. By the end of 2007 – with just under a seven-fold notional amount of the worldwide trade in derivatives to a value of 596 trillion US \$ – the percentage of contracts with the non-financial sector has grown above average to 11%. The above average growth of the non-financial sector in the derivatives trade thus does not testify to a "decoupling" of the financial sector. Since the beginning of the 1990s it is indeed the case that, in the wake of the advancing globalisation of the market economy with the exponential increase in cross-border payment flows, the need for currency and interest rate insurance contracts and thus the willingness to pay a fee for this has grown strongly on the part of companies producing and acting on a worldwide scale. According to McKinsey, global cross-border payment flows increased from 5 % of the world domestic product (1.1 trillion US \$) in 1990 to 20.5% of the world domestic product (11.2 trillion US \$) in 2007.⁵ Assuming that the volume drivers as a result of the transaction chains have a factor of between 3 and 5, then 30 to 50 per cent of the derivatives trade would be paid for by the non-financial sector (hedging) and so provide the basis for speculative trade in derivatives as well as the arbitrage business specialising in exploiting market price differences.⁶

Worldwide financial assets...

»The financial sector has become *too large* in comparison with the real economy, its *disproportionality* is shown in a multitude of ways.«⁷ For example in the well-loved observation that the entire global financial assets in 2007 at 196 trillion Dollars are four times as large as the world

³ Markus Haberer, Regulierung internationaler Finanzmärkte durch Transaktionssteuern: Die Wirkung einer Tobin-Steuer auf Handelsvolumen und Wechselkursvolatilität, 2006, P. 20 and following

⁴ The Deutsche Bank reports in its 2008 balance sheet as the market value of the position of all derivative financial instruments a positive figure of 1,224 billion € and a negative figure of 1,181 billion €, thus in net terms, assets of 43 billion €. By comparison: the accounts receivable of the Deutsche Bank from the credit business amount to 270 trillion €. Deutsche Bank: Geschäftsbericht 2008, Anmerkung 9.

⁵ McKinsey Global Institute, Mapping global capital markets: fifth annual report, October 2008

⁶ According to the Hong Kong Exchanges and Clearing the trade in derivatives during 2007/08 was distributed as follows: 40% pure trading, 39% hedging and 21% arbitrage. <http://www.hkex.com.hk/research/dmtrsur/DMTS08.pdf>

⁷ Lucas Zeise, Das Ende der Party, PappyRossa, 2008, P. 42 and following

domestic product.⁸ »We are not simply confronted with the consequences of somewhat larger speculative transactions. In fact, for quite some time now, the financial system has become *decoupled* from the real reutilisation process of capital. ... Its owners are entitled (in the form of interest) to the results of overall economic performance. The forms of income without productivity had reached a figure many times that of the distributable annual results of the real economy. Before the beginning of the crash in early summer 2007 the financial sector was worth almost four times *too much*.«⁹

Just as when comparing apples and pears, when comparing the entire global financial assets with the world domestic product, things with different qualities are being compared. Since the world domestic product represents the turnover of one year and the assets refer to a stock of money accumulated over years, the statement that the financial sector was almost four times *too much* or asserting that it is *disproportional* as a result of quicker growth is unfounded. If for instance, 20 units are saved in the following year from an income which remains unchanged, the assets grow by 20 whilst the income remains the same. In addition to the increasing assets in connection with surplus or profit, the total amount of financial assets increases with the creation of money and of capital. If for instance an enterprise takes out a loan or sells a bond on the capital markets to build a factory, the debts are capitalized as receivables in the financial sector. In the USA with indebtedness, financial assets increased between 2000 and 2007 by 21.5 trillion US \$ (from 26.4 to 47.9)¹⁰ The indebtedness of the financial sector – which provides the capital basis for business *within the financial sector* just as for business *with the non-financial sector* – only had a 37% share in the entire growth of indebtedness.

- Private households from 7 to 13.8 trillion US \$
- Non-financial sector from 6.6 to 10.6 trillion US \$
- The state from 4.5 to 7.3 trillion US \$

Total amount of 1-3 from 18.2 to 31.7 trillion US \$

- Financial sector from 8.2 to 16.2 trillion US\$

Next to the booming securitization business, what are known as the developing countries, including China, India and Brazil, also contributed increasingly to the growth of global financial assets. From the beginning of the 1990s, the main driving force here were the stock market flotation's following the privatisation of former state enterprises.¹¹ Consequently, neither the comparison between world domestic product and global financial assets nor the rapid growth of balance-sheet assets in the financial sector testify to a »decoupling« or »disproportionality« in the financial sector. The worldwide financial assets grew disproportionately on the basis of anticipated growth of the non-financial sector (i.e.: not yet achieved as a result of successful business) financed by credit taken out during economic boom. What is called the depth and breadth of the financial sector in its turn encourages the growth of speculative deals in the non-financial sector on a worldwide scale by the improved opportunities for capital and risk allocation. Creditworthiness comes with business success and becomes itself a successful business for the credit or capital provider and through this provide opportunities for his own refinancing with the aim of diversifying his own business. As part of their speculation on future successful deals, carried out by means of loans and securities, in fact both productive and financial capital realise a kind of liberation: productive capital frees itself from imposed circulation by being able to be invested again for the purposes of business diversity even before the money has returned in the form of successfully completed sales; financial capital frees itself from being diverted to create value by

⁸The global financial assets for 2007, calculated to be 196 trillion US \$ are made up as follows: 33% shares, 14% government bonds, 26% private sector bonds, 27 % deposits. McKinsey Global Institute, Mapping global capital markets: fifth annual report, October 2008

⁹ Joachim Bischoff, Jahrhundertkrise des Kapitalismus in: Sozialismus, Nov. 2008

¹⁰ <http://www.federalreserve.gov/releases/z1/current/coded/coded-2.pdf>

¹¹ McKinsey Global Institute, Mapping global capital markets: fifth annual report, October 2008

exploiting labour, by being transformed directly through investment in interest-bearing debts from money into capital – a case of value revaluing itself. The scope of this freedom determines the trust in the success of future business. Not just blind trust, but rather with reference to indicators of the business sector in question. It is hardly surprising that measured by GDP the financial sector – as the smaller economic sector of the two, when compared to the non-financial sector – is growing disproportionately in the wake of the credit-financed market economy upturn.

and circular deals ...

»In fact such an explosive growth of the financial sector and of financial assets was only possible because today's financial markets have the characteristic of being able to generate income, profits and wealth by their own energy and to a practically unlimited extent, which are not based on any purchases or sales of real goods but which rather, when examined closely, are purely fictitious transactions.«¹²

The idea of »purely fictitious transactions« is illustrated e.g.: by the acceptance of mutual equity trades. In a simplified example, A buys Microsoft shares from B for 1.1 million. B now takes out a loan and buys back the shares from A for 1.2 million. Now A, looking at the price gain from the sale of the shares, also takes out a loan and buys back the shares from B for 1.3 million. »This game can be played on for ever without end... It is simply that the same share package is being moved hither and thither... The above example may seem trivial and over-simplified but it describes the essentials of the mechanism which a *large part* of global monetary assets have to thank for their existence.«¹³

If the world were as simple as implied in the above example, if the value of shares was *completely* decoupled from the underlying business as a result of supply and demand, then the growth of global monetary assets would be reflected in a corresponding increase in the price-earnings ratios or a drop in dividends. In contrast, reality shows for the boom years from 2000 to 2007 falling price-earnings ratios and a clear correlation between share price and the evolution of dividends.¹⁴ Equally puzzling would be why legions of financial analysts crosscheck on a daily basis key data on turnover, profit and cash flow with current information about company strategies, competitor analyses or general market data in order to speculate by doing so on future business developments or the conclusions drawn by other market participants. If »purely fictitious transactions« were the essentials of share values, the constant efforts of managers to sell the prospects of business development by using elaborate business and quarterly reports, including conference calls and worldwide road shows, would be an incomprehensible waste of time. On the other hand, the share value in fact cannot be simply computed from the results published by the firm. The share valuation *is thus divorced* on the one hand from the underlying business success of the joint-stock company, but on the other hand not *entirely*. Along with the share, the issuing enterprise sells, without any obligation to take it back, a property title to the enterprise which is furnished by way of a dividend with a claim to a financial return. In contrast to a bond, this claim to a financial return is not linked to a fixed interest rate on the capital invested, but rather holds out the prospect of an undetermined fraction of the future success of the company. Because there is no obligation to take it back, there is another difference with bonds: the share price performance is not linked by a maturity date to the issue value. In the course of stock exchange dealings, investors evaluate the share by the yield resulting from dividends *and* price changes in comparison with alternative investments. The final share valuation, decided by buying or selling, in the process becomes *divorced* from the course of business of the company itself, since both evaluation criteria are not directly linked to concrete business success: dividend expectations speculatively anticipate future income, the speculation on the share price evolution has to do with guesses about the way the economy will develop, changes in interest rate levels and as many additional

¹² Sahra Wagenknecht, *Wahnsinn mit Methode*, 2008, P. 129

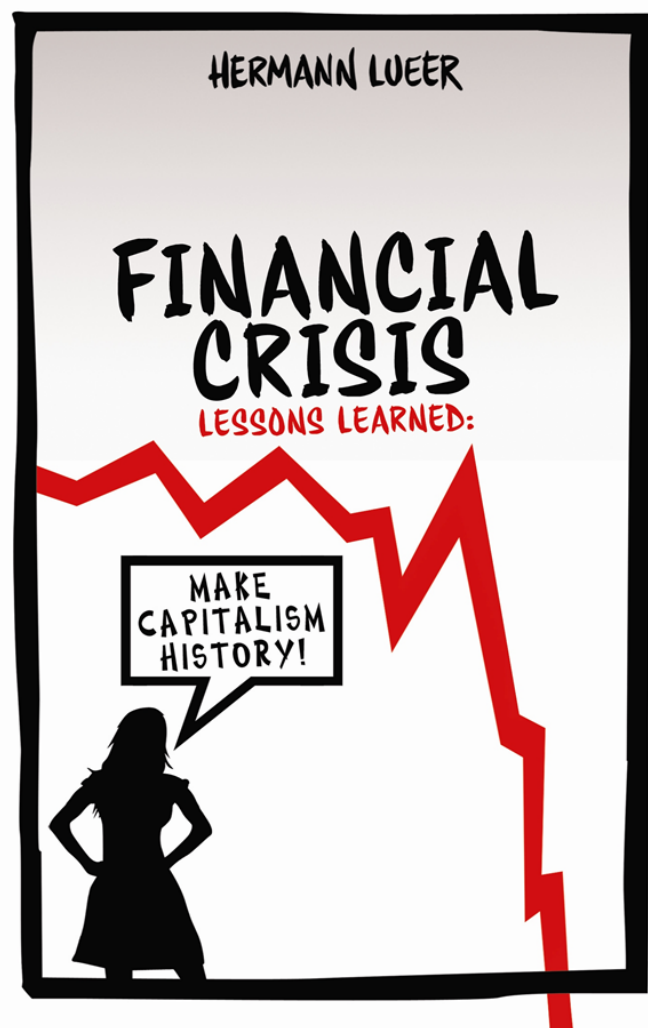
¹³ Sahra Wagenknecht, *Wahnsinn mit Methode*, 2008, P. 131 and following

¹⁴ Cf. on this matter: http://www.econ.yale.edu/~shiller/data/ie_data.xls, 04.12.2008 and: Evolution of share prices, company profits and dividend payments since 1991 in: Deutsche Bundesbank, Monatsbericht Juli 2009, P. 15 and following

factors affecting the company environment as you like, besides the comparative estimation of the company's profit prospects. However much share capital may be capable of acquiring a life of its own by this means apart from the financial performance of the company, speculation constantly reflects on the substance of the speculation in the reality of the assumptions made. An increase in value completely separated from the company's business environment caused by a circular succession of share purchases and sales is therefore quickly identified as implausible and devalued accordingly.

If the bank sector has not become decoupled due to circular share dealings, then perhaps it has done so due to circular bond issues? »Any one bank procures liquidity by taking on credit from other banks, and does so by selling them securities, interest-bearing promises to return payment which they issue on the prospective success of their business. And it gives other banks credit by buying securities issued by them. By the use of this *circle* the financial institutions create ever new opportunities for investment and at the same time the investment means needed to make the most of these opportunities. They give each other credit and take credit from each other, book ever greater assets to their account, and pay and receive ever more interest and similar revenue on these credits. What for one single bank on its own would be a swindle, with the mountain of credit which the banking sector has heaped up becomes an honourable business: the credit system gives credit to itself.«¹⁵

Of course in theory the banks could inflate the amount of capital to a limitless extent by mutually buying and selling debt instruments, but why should they do so? The purpose of issuing securities is not to increase the balance sheet but to make a profit. If bank A buys a bond bearing 5% interest from bank B, let's say for 100 million €, and in return sells one of its own bonds to bank B, with this transaction admittedly 200 million € of additional capital has been created but no profit, and therefore equally no reason for circular business within the financial sector. The same decoupled transactions between 50 banks still do not create this essential reason. The capital inflated by bonds has to be invested somewhere in the source of wealth in the market economy: the use by business of the difference between the price of labour power and the values created by using it in the non-financial sector. Or is the entire financial sector maybe just "a kind of pyramid-selling scheme"? Why then was Bernhard Madoff the only one to be arrested but not the head of the Deutsche Bank, Josef Ackermann, too or the CEO of City Bank, Chuck Prince?



Amazon Kindle ebook \$ 4.60

¹⁵ Peter Decker, Junge Welt, 29.09.2008