What are **DERIVATIVES**?

Derivatives are financial products derived from an underlying commodity such as coffee or wheat.

They are basically BETS on what the price of something will be in the future.

The two basic types are **OPTIONS** and **FUTURES**.

OPTIONS give you the right to buy, or sell, a particular commodity at a specified price on a specified future date.

For example, you spend £500 on an option to buy a hundred tons of chocolate in one year's time at £50,000.

One year later, the market price for a hundred tons of chocolate is £60,000.

You buy your hundred tons for £50,000 and sell it for £60,000, making a £10,000 profit, minus the original £500 cost of buying the option.

But if the market price of chocolate has fallen to £40,000 for a hundred tons, you don't buy it because your option means you would have to pay £50,000 and so you would make a loss. You still lose the original £500.

FUTURES are pretty much the same, except you have committed to buy (or sell) the commodity. So if you buy a future for a hundred tons of chocolate at £50,000 but the market price drops to £40,000, because you are under contract to buy at £50,000 per hundred tons you would lose £10,000 on the deal, plus the original £500.

Because **FUTURES** are riskier than **OPTIONS**, they are cheaper, and so people who guess right can make more money from them. But if they guess wrong, they lose more.

Financial derivatives are the same, but based on shares. Traders, such as Nick Leeson at Barings, continue to lose billions of pounds of their employers' money by betting wrongly on derivatives.

Derivatives can be sold on from trader to trader, always increasing in price, until the value of the derivative is many times the value of the original asset.

You can buy a derivative for anything - even the number of twins to be born in Nebraska in 2020.

The world market in derivatives is "worth" hundreds of trillions of dollars, many times the size of all the world's economic output, which is roughly 66 trillion dollars.

The Big Bang

All the barriers and rules separating different areas of banking, finance and participation in the stock market are simultaneously abolished.

Banks can now take part in pretty much anything - investment banking, retail banking, securitisation (packaging different debts together and selling them on, for example as **CDOs**), **derivative** trading.

There is a huge increase in types of speculative trading.

There is also a massive increase in the amount of leverage allowed - banks only have to hold £2 for every £100 they lend.

Banks are allowed to measure their own riskiness and high street banks can now take part in high risk trading.

Banking conglomerates get bigger and more complex - Too Big To Fail.

The City of London becomes the global centre of the expansion of financial services.

The Washington Consensus:

State enterprises should be privatised
Barriers impeding the entry of foreign firms and investment should be abolished
Finance should be deregulated
Government spending should be cut.

SUBPRIME MORTGAGES AND PREDATORY LENDING

Because high interest subprime mortgages were so profitable, lenders did everything they could to sign people up.

If people's credit rating was nearly but not quite subprime, lenders would class them as subprime and charge them higher interest.

Sometimes the mortgage lender would wait until the buyer was about to sign and then double the interest rate.

Loans given out included '**liar loans**' - where the individual states their income and no one checks; '**no doc**' loans - in which the borrower produced no paperwork; and '**ninja loans**' - no income, job or assets.

By 2006, 60% of subprime applicants were exaggerating their income by 50%

These were just the legal loans - there was also widespread fraud involving false identities and multiple applications for credit.

These mortgages were then bundled up into **CDOs** and rated **AAA** safe investments - as safe as buying a bond from the US government

CANADA

had much tighter banking laws, in particular requiring higher levels of capital reserves. Other features of the Canadian banking system included lower levels of securitisation, very low levels of mortgage-backed securities such as **CDOs**, a law requiring anyone borrowing over 80% of the value of their home to insure the debt, and no tax relief on mortgage interest.

Canada's banks have an average leverage ratio of 18 to 1 and they are rated the safest in the world.

Since 1923 there have been 2 bank failures in Canada. In the US, there have been 17,000.

Since 2004, Canadian incomes have grown at 11% per year, as opposed to 5% in the US.

But what else can you do when a country has massive debts?

In 1994 Mexico was hugely in debt. In response, the Mexican government devalued the peso, which nearly halved in value in the space of a week.

At this point the US, unwilling to let the Mexican economy fail, intervened by buying up pesos on the open market and then giving Mexico $50 bn in loan guarantees.

The peso stabilised and by 1996 the Mexican economy was growing again. Mexico repaid all US Treasury loans ahead of schedule, in 1997.

This appears to be the last time in recent history when a country with a debt crisis received an emergency loan without massive and disadvantageous conditions attached.

It wasn't all altruism...

The Mexican bailout attracted criticism in the US for the central role of US Treasury Secretary Robert Rubin, former Co-Chairman of **Goldman Sachs**, a key distributor of Mexican bonds which stood to lose several billion dollars if the country wasn't bailed out.

By the end of the crisis, the US had made a $500 million profit on its loans.

So, does free market economics do what it's meant to do?

1. Free market economic policies - deregulation, privatisation and low government spending - are meant to foster economic growth.

Between 1950 and 1987, the US economy grew more slowly than European economies, in spite of having a much smaller welfare budget.

Since 1990, Scandinavian countries such as Finland and Norway, which have maintained a high level of regulation as well as high government spending, have experienced higher economic growth than the free market economies of the US and UK.

In addition, Scandinavian countries have more social mobility and less social inequality than the US and UK, and as a consequence lower crime rates, better life expectancy, lower rates of mental health problems and a generally better quality of life.

2. Free market economic policies are meant to keep inflation low and the world economy more stable.

Between the end of World War II and the mid-70s there were virtually no banking crises, even though inflation was much higher than it is now.

Between the mid-70s and the late 1980s, as free market economics became dominant, 5 to 10% of countries had banking crises.

In the mid-90s, when inflation was very low, 20% of countries had banking crises.

After 2008, 35% of countries had banking crises.

3. Free market economic policies are meant to make everyone richer.

Social and financial inequality has increased markedly since free market policies became dominant, and continues to do so.

Over the past three years, the richest 1,000 people in the UK increased their wealth by £155 bn, enough to pay off the entire current UK budget deficit and still have £30 bn left over for yachts. However, the government is "balancing" 77% of the deficit by cutting spending and benefits, and not aiming any tax increases specifically at the super-rich.

The total wealth of these 1,000 people now comes to £414 bn, equivalent to over a third of the national debt.