IS ECONOMY MAKING ITS WAY AGAIN?

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INTRODUCTION:

In 2007, the world started to face what is considered as the strongest economic crisis after 29´s: mortgages subprime crisis. To understand the context, it is important to say that in 2001, in the United States and after the 11S attacks, Mr Alan Greenspan (former chairman of the Federal Reserve) had to find a way to keep the economy strong by **lowering interest rates, tax cuts and by deregulating markets**. According to this, it was easy for banks to give housing mortgages to people, so the banks could make money asking for it to Federal Reserve thanks to the low interest rates. The more housing mortgages they could give, the better, as interest rates were so low. Banks found a way to make business by giving loans and, in case the people would not pay back loans, bank would sell houses because it was thought that the real-estate market would increase and there would always be profit.

In these circumstances, the Federal Reserve **did not allow banks to outnumber a determined number of mortgages**. So, to keep on the business, the **banks began to securitize mortgages** by selling them at the same time. That grew as a practice and the US banks kept on giving mortgages with low, medium and high risk of default. Wall Street appeals to use derivatives by using **famous CDO´s (Collateralized Debt Obligation), which was a mix of low, medium and high risk of default the mortgages at the same bond**. Moreover, the credit rating agencies gave good qualifications to that CDO´s, however, the buyers did not know what they were getting, so banks, pension funds… got them and spread them all over the world.

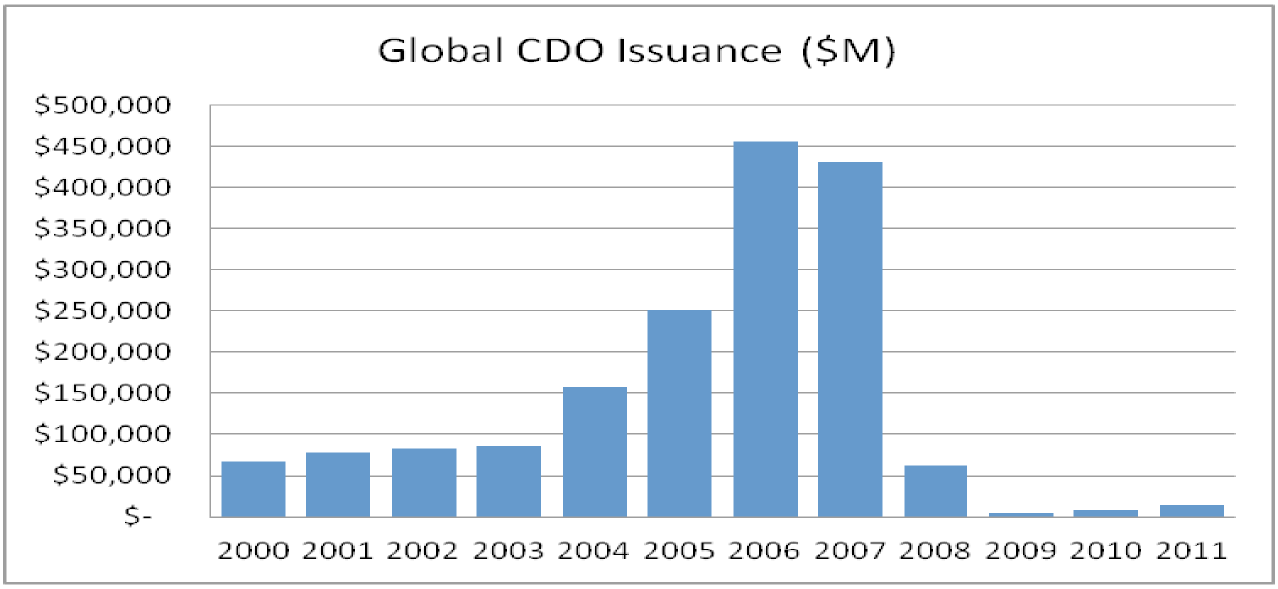
After a while, defaults began to grow and the actors realized that they could not trust each other because they did not know how many banks had toxic assets. Great many banks around the world were full of CDO´s and other financial products, so business went down. **The governments started to**

restructure their banks economy, usually by taking high default risk assets and trying to sell them using their state´s power.

As The New York Times argues: “More than five years later, there is still no answer to perhaps the most critical question raised by the man-made disaster: How much did it all cost?[1]", so it is important to say that it is almost impossible to know the exact amount of the financial crisis costs. However, as a matter of reference and according to same newspaper the cost of the financial crisis at 2012 were lying between 5 and 15 trillion dollars[2].

It stands out that there was no control over CDO´s and other financial stuff sold, so subprime crisis took place. **Outside law´s regulation, stopping financial tricks become such a tough task**.

As it can be seen at graphics[3], CDO´s global issuance fell down after 2007.



Even though the CDO´s were reduced so much after 2007, there is a world behind them to analyze. **There is a world related to derivatives, which became star products. A world were derivatives are at the top of the economic business, being the global amount of outstanding contracts at**

[1] Eduardo Porter. ´´Recession´s True Cost is still being tallied´´. *The New York Times* (2015). http://www.nytimes.com/2014/01/22/business/economy/the-cost-of-the-financial-crisis-is-still-being-tallied.html?_r=0

[2] Al Yoon. “Total Global Losses From Financial Crisis: $15 Trillion”. *The Wall Street Journal*. (2012). http://blogs.wsj.com/economics/2012/10/01/total-global-losses-from-financial-crisis-15-trillion/

[3] “A dangerous combination: Financial Innovation and the Supression of Market Forces”. *Economics21*. (2012). http://economics21.org/commentary/dangerous-combination-financial-innovation-suppression-market-forces

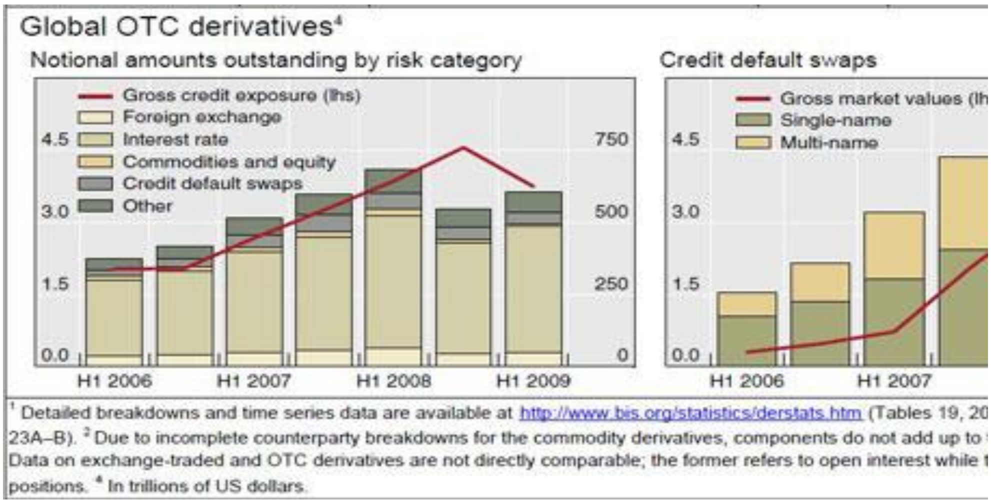
the end of June 2015 as big as 553 Trillion of Dollars according to the Financial Times.

Almost ten years after 2007, it seems the world have lost the track of the financial economy again. Seven years after the beginning of the economic crisis, there are still some questions: How could that situation happen? What is the problem with the derivatives nowadays? Are the countries and the citizens as vulnerable as they were in 2007?

In the derivatives world, there is a wide range of **products** to play with and each one has a different function. Alongside them, there is a **wide range of actors** playing who are in hold of huge quantities of capital. For example, there are investment banks, pension funds, commercial banks, sovereign wealth funds, credit rating agencies and so forth.
And then, there are **markets connecting products and actors**, where the main problems come from. There are so many ways to classify them: stock markets, future exchange markets, financial markets, commodities markets, foreign exchange markets and so forth. However, there are two especially important: regulated markets and non-regulated markets. In a regulated market, the actors are always aware of what goes on, so they know information, prices, and where everything comes from. Regulated markets have a “**counterpart**, who ensures that the deal takes place.

Opposite to this, there are markets without regulation or counterpart, so no information about trades can be known by either actors or Governments. They are called **Over The Counter market (O.T.C**), because there is no physical place where one could exchange stuff and there is no information about any product, so risk of default is always high. However, **OTC may offer invertors what they are looking for**, as there is nothing standard.

However, **O.T.C markets may offer to their clients what they are looking for** as there is not any kind of standard agreement as it can be found in the regulated markets, where all parts must obey the counterpart rules. Actually, the difference amongst these kind of markets seem to be that one can get something specially designed for him.



According to graphics[4], **OTC markets helped to expand subprime crisis**. Actually, as B.I.S (Bank of International Settlements) claims, four years after the subprime crisis began, in 2011, OTC market moved 90% of all operations with derivatives and also with bonds. Its value is calculated in more or less 600 billion Dollars.

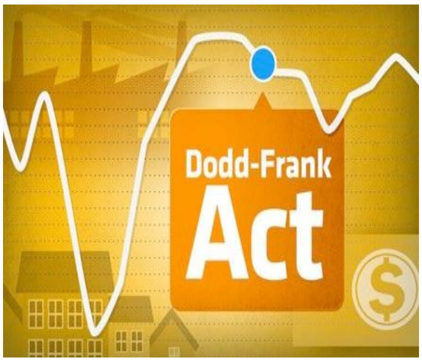
After crisis, **the governments realized that something had to be done** to sort the financial problem and it was necessary to regulate such market; that propose took place at the G20 Summits. As a result, the G20 Summits at Pittsburg (2009) and Toronto (2010) began to say that a change was needed: “To make sure our regulatory system for banks and other financial firms reins in the excesses that led to the crisis, where reckless behaviour and a lack of responsibility led to crisis, we will not allow a return to banking as usual”.

Even so, the **G20 Summits leaded to Country laws**, looking for a kind of counterpart in the OTC markets. Because of it, US created Dodd-Frank Law at 2010. Also as a response to the G20 Summits, the European Union created the European Market Infrastructure Regulation (EMIR), both in order to control the OTC and its derivatives. Also following the G20 agreements, Russia and Japan are also trying to regulate the OTC markets, as well as Australia. In Russia´s case, the NCC (National Clearing Centre) is dealing with deregulation. At Japan´s case, it is the Financial Services Agency. In China, although the CSRC (China Securities Regulatory Commission) is in charge of regulation, China´s deregulation has turned into the most important nowadays, as it is focused on the economy liberalization. So, a**t the same time the majority of the Governments are trying to diminish the OTC markets, China is not so interested** in that

[4] Ron Hera. “Forget About Housing, The The Real Cause Of The Crisis Was OTC Derivatives”. *Business Insider*. (2010). http://www.businessinsider.com.au/bubble-derivatives-otc-2010-5

as they are focused on liberalizing markets which makes its economy stronger. According to Reuters[5] Information Agency: “China's securities regulator said on Friday it would release measures to further promote the development of the New Third Board, the country's most active over-the-counter equity exchange, part of efforts to aid China's small companies”

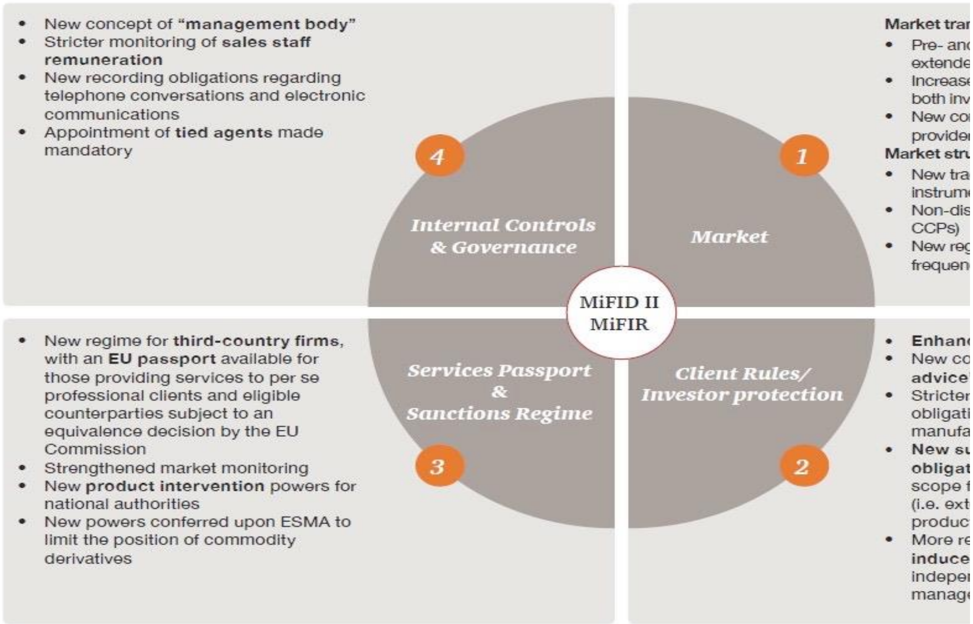
Moreover, **the regulators have not finished yet the enforcement to create a regulation and the OTC markets are still working without any control as there is delay on approving new rule**s. In US, a regulation would not come until 1st of September 2016, as OTC market and actors have not been able to adapt to the new rules. In Europe, MIFID II (Markets in Financial Directive II) are just in an European plan to regulate and to give transparency to the markets that comes from EMIR; they are also trying to give more protection to the client injecting more competition to the off exchange markets, dominated by banks. In the European case, the regulation must wait until the beginning of 2018, as last February Brussels proposed to delay



the regulation.

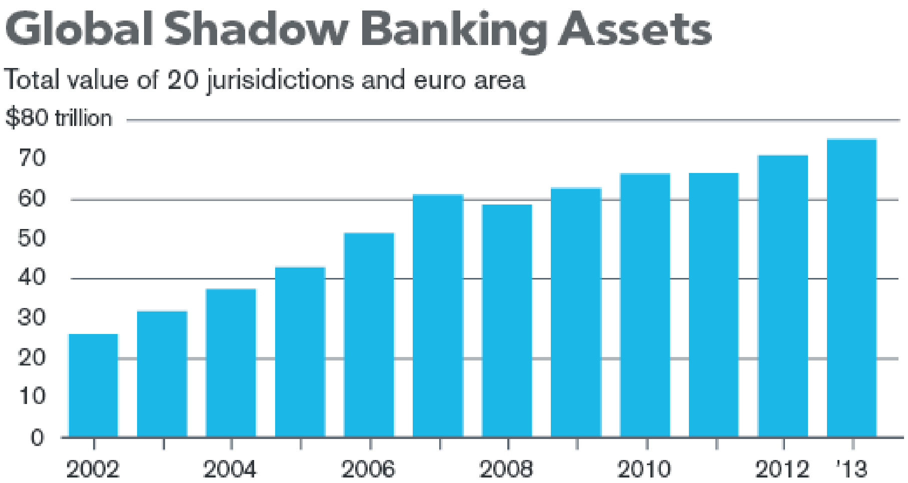
All regulations are trying to give **more transparency, internal control and more protection for clients**. It means that it is necessary to establish a counterpart in order to monitor all the sales by recording every single telephone conversation or internet transaction as well as a new market structure is created with a more restrictive regime by new powers of the Governmental authorities. As an example of what it must be done we could take MIFID II[6].

[5] Samuel Shen. “China securities regulator to promote development of New Third OTC Board”. *Reuters*. (2015). http://www.reuters.com/article/china-regulator-otc-idUSB9N10A02020151120.
[6] Mani. “MiFID II / MiFIR – A Game Changer”. *ValueWalk*. http://www.valuewalk.com/2014/10/mifid-ii/



Moreover, the OTC markets are not the only deregulated way to make business. **There is also the Shadow Banking**, which is a way to find money, basically by loans. So, this way is not working as a natural one -commercial banks pay percentage to their clients for keeping their money, but they also give loans and that interest is big, so they can make money-. In the Shadow Banking, some companies -which are not proper banks as well as some commercial banks- are giving loans without regulation and under a higher risk. <u>Shadow banking were normally used after subprime crisis as a way to find money due to "credit crunch" and it is growing every single year</u>. At 2007, the shadow banking was moving around 60 trillion of dollars globally and at 2013, percentage was higher, reaching 71 trillion dollars. Nowadays it is 75 trillion dollars[7].

[7] Michael Snyder. "The 75 Trillion Dollar Shadow Banking System Is In Danger Of Collapsing". *Washington´s Blog*. (2015). http://www.washingtonsblog.com/2015/07/the-75-trillion-dollar-shadow-banking-system-is-in-danger-of-collapsing.html



As it can be seen in the graphics[8], after the financial crisis, the shadow banking kept growing raising each year with higher levels. Opposite to OTC global derivatives issuance, the shadow banking did not diminish its business levels very much. According to the Financial Stability Board[9]: “Global assets of financial entities classified as shadow banking under the economic functions approach in 26 jurisdictions continued their upward trend, increasing $1.1 trillion in 2014”.

The shadow banking system is even less prepared than normal banking system and it is taking a Dark Turn[10]. Actually, the shadow banking actors have avoided the commercial regulation that the governments implemented after the crisis. For example, as Reuters shows: “Such non-bank investors, which include actors as diverse as asset managers and hedge funds, have largely been spared the regulatory ramp-up banks have seen since the 2008-2009 financial crisis that required them to hold more capital.”

In 2015, the United States began to regulate its shadow banking system. The Wall Street Journal remarks it by saying last year that the Federal Reserve was trying to step up efforts to investigate them and then regulate it. In tge Europe´s case, the regulation started being approved last year too, as the European Parliament approved the regulation introducing a mandatory reporting of securities financing transactions to help regulators to spot the build-up of the risky positions, according to Reuters agency.

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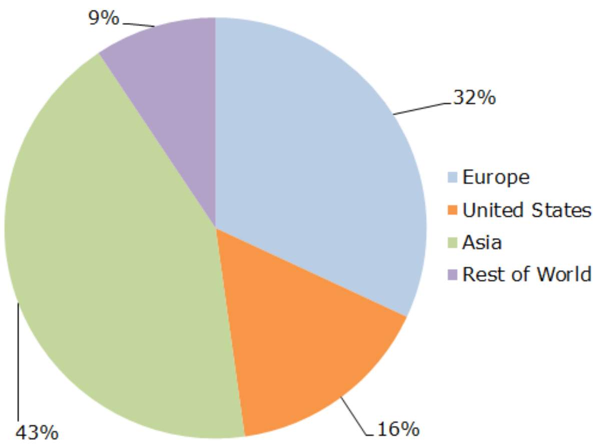
[8] Sheridan Prasso. “Shadow Banking”. Bloomberg. (2015). http://www.bloombergview.com/quicktake/shadow-banking
[9] “Global Shadow Banking Monitoring Report 2015”. Financial Stability Board. (2015). http://www.fsb.org/wp-content/uploads/global-shadow-banking-monitoring-report-2015.pdf
[10] Peter. J. Wallison.” Regulation of Shadow Banking Takes a Dark Turn”. Thw Wall Street Journal” (2015). http://www.wsj.com/articles/peter-wallison-regulation-of-shadow-banking-takes-a-dark-turn-1423527609

Keeping the same way China has with the OTC markets, the Chinese shadow banking is growing and there is not effort to regulate it. Using Federal Reserve Bank of San Francisco[11] words: "Asia contributed to the growth rate of shadow banking at a level disproportionate to its share of total assets. In fact, Asia added more to the increase in global shadow banking than either Europe or the United States (at 2014)". Graphics shows so:

SHARE OF BANKING (2014)



SHADOW GROWTH

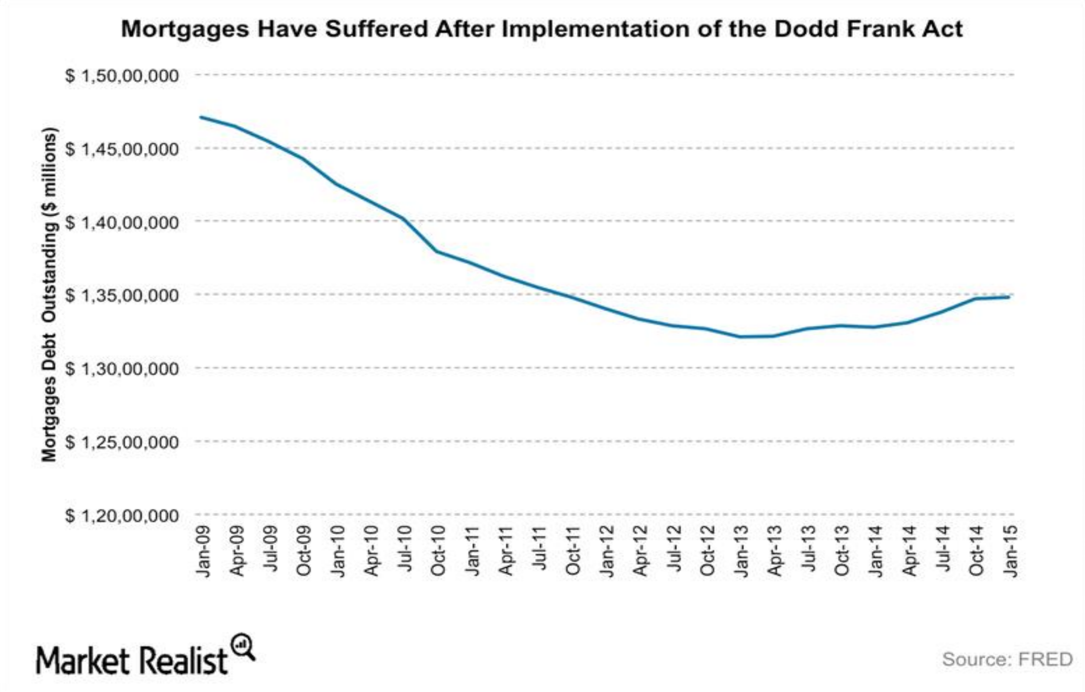
CONCLUSIONS

There are four big problems in this new regulatory effort towards a better regulated economic global system.

1. **Too much regulation could be bad for economy**. An excess to regulation could make investors to avoid using an improved OTC

[11] Nicholas Borst. "Asia is the New Engine of Growth in the Shadow Banking System". *Federal Reserve Bank of San Francisco*. (2015). http://www.frbsf.org/banking/programs/asia-program/pacific-exchange-blog/asia-is-the-new-engine-of-growth-in-the-shadow-banking-system/

market as well as an improved shadow banking system, so they could create another structures to keep on same business. Then, regulation could act lowering business levels as it can be seen at this graphics[12], which shows how mortgages have been reduced as there is not as much demand as it should be.

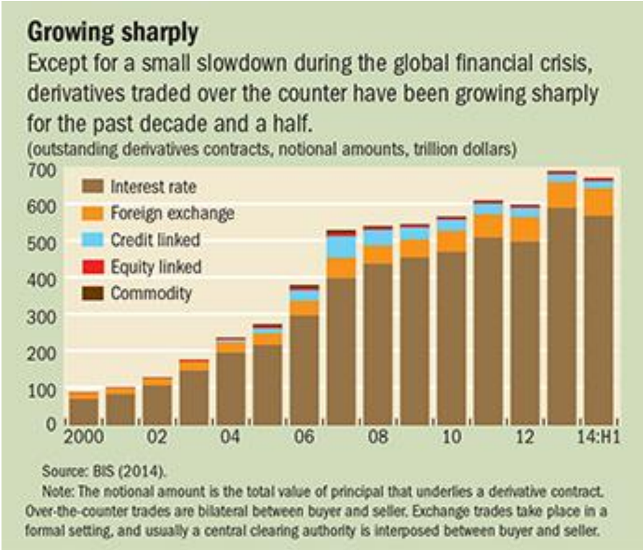


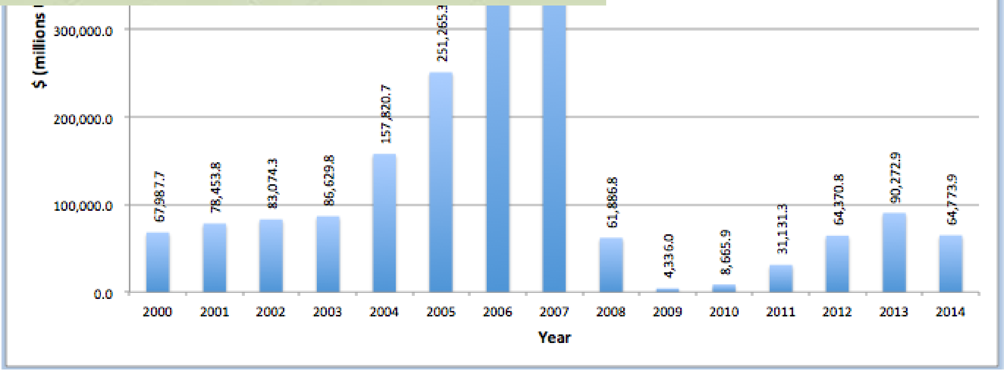
2. **There is not an international regulation**. Every country, such as Russia, Australia, Japan or US, may try to control their non-regulated markets turning them into a regulated ones, as well as their shadow banking system. However, too much part of business is expanded by different parts of the world and, as usual, there will always be competence amongst countries and authorities. An international world needs same regulation. If not so, differences amongst countries could lead to a failed system.

3. Regulation will take control of OTC markets at different times, depending on the country, and between 2016 and 2018, all delay would be over. That delay proves that **great many actors are not satisfied with the regulation coming over, as well as some are not ready**. Moreover, it can not be said that the majority of the actors demand that regulation, as there is delay in approving them.

[12] Rebecca Keats. "The Dodd-Frank Act Has Suffocated Mortgages". *Market Realist*. (2015). http://marketrealist.com/2015/11/dodd-frank-act-suffocated-mortgages/

However, there are citizens who are demanding more control over the economy.





4. **China does not seem interested in regulating** either OTC markets or shadow banking. According to its economic liberalization and market deregulation, China is going against what could be considered the majority or world governments desire to tackle the deregulated economy.

A subprime crisis could happen due to a massive lack of financial regulation, so derivatives could spread the way they did. Nowadays, derivatives business are still strong and are used in a way that can not be controlled. There is no real control and it is also prove that the economy is overcoming politics by far. Actually, CDO´s, the bad boys of subprime crisis, are growing in number again as graphics[13] shows:

So the market is taking a step forward to the regulation because a liberalized and vigorous financial sector plays a key role in the

[13] A Political Junkie. "Collateralizated Debt Obligations. An unlearned lesson". *Viable Opposition* (2014). http://viableopposition.blogspot.com.es/2014/05/collateralized-debt-obligations.html

economic growth and the countries can not get rid of that part of the economy. At the same time, some actors are vital to the countries and they are, sometimes, too big to fail. Due to it, the governments find themselves into a dilemma as financial economy represents huge part of it, but there is where main problems come from. There is no other way to deal with this dilemma than regulation behind the economy, giving actors freedom but also controlling their actions.

Economy will always work this way, looking for freedom and, once they get too much and problems appear, the regulation would try to catch it. Definitely, although the economy works in cycles, reaching an international regulation over OTC markets and shadow banking. The international law would not impede actors to be away from law and keeping businesses hidden or to create derivatives based on toxic assets, but when regulation is needed due to an excess of freedom, like nowadays, cooperation and information sharing will be effective. The economy is not a step ahead of the law, but two.

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