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10 Book reviews on global economy and geopolitical readings

ESADEgeo, under the supervision of Professor Javier Solana and Professor Javier Santiso.

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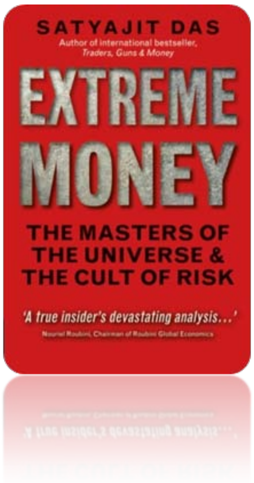
Obra Social "la Caixa"

Extreme Money: The Masters of the Universe and the Cult of Risk

Das, Satyajit (2011), UK: FT Prentice Hall



"Debt, once a source of shame, became an essential part of the modern lifestyle."

"To make a billion dollars, it is no longer necessary to actually make anything."

"After the 9/11 attacks, President George W. Bush urged Americans to go shopping as the best way to help them and the country recover."

"In a world of global money flows, what happened in America no longer stayed in America.

Basic Idea and Opinion

In the world of Extreme Money, everybody is supposed to get wealthier, but only a minority actually does: the minority that runs the game, made up of a powerful coalition of financiers, business interests, regulators and politicians. Satyajit Das claims to be telling the story of the modern world, in which money has become the main way to make money. He argues that our society relies on a global economy built on debt and constant speculation. This has created a "cult of risk" mentality, which has undermined the security of the financial system and has ultimately led to a deep recession. Das is very critical in his analysis of the current economic situation and argues there is no simple or painless solution to the financial crisis, but one thing is certain: countries cannot rely on debt and speculation for prosperity. From now on, the world must simply live within its means. In the end, it all comes down to common sense.

While the book is accessible, well documented and covers a broad range of topics, it is not very well structured. A number of chapters are divided into 15 sections, some of which are only one or two pages long, and they are not always organized chronologically. This gives the impression of overall fragmentation and lack of a main narrative thread. However, the voluminous material comprised in this book contrasts with the author's black humour and unique insights. It is full of facts, statistics and quotations from such diverse people as Shakespeare, Tyra Banks, George Orwell or F. Scott Fitzgerald. Although parts of it might be difficult to follow for those who do not have a foreknowledge in finance, such as the ones dealing with complex financial products, both the author's sophisticated style and his intellectual, literary and artistic interests, as well as his deep knowledge of the financial sector, turn this book into a valuable guide to understanding the evolution of the complex modern financial system and the intricacy of the current situation of the global economy.

The author

Satyajit Das has worked in the area of financial derivatives and risk management for over 30 years for banks such as Citicorp Investment and Merrill Lynch, and as a consultant advising investors, banks, corporations and central banks throughout the world. He presents seminars on derivatives worldwide and is the author of many key reference works on both derivatives and risk management: *Swaps and Financial Derivatives* (2005); *Credit Derivatives, CDOs and Structured Credit Products* (2005); and *Traders, Guns & Money: Knowns and Unknowns in the Dazzling World of Derivatives* (2006), which was an international bestseller. Finally, he is also co-author of *In the search of the Pangolin: The Accidental Eco-Tourist* (2006). Das was recently featured in Charles Ferguson's 2010 Oscar-winning documentary *Inside Job*.

The value of money and the concept of trust

Money is universally accepted as a payment, a medium of exchange, a measure of the market value of goods and services, a standard unit of value and a store of wealth, but it only exists in our minds. It is a matter of trust and faith. Das emphasizes that nowadays money exists as pure information and has no intrinsic value.

The author essentially illustrates three types of money: First of all, there is ***commodity money***, which is simultaneously money and a tradable commodity. Commodities do have intrinsic value, and restrictions on their availability can artificially limit the amount of money, simultaneously limiting the volume of activity and trade. In economic chaos, war or collapse, this type of money reappears. The attachment to gold, one of the most valued commodities of all times, still remains in the twenty-first century. Between 2007 and 2008, individuals purchased 150 tons of gold in the form of coins, which made gold prices increase dramatically.

Flat or ***paper money*** is the second type of money. It is a mere promise; therefore it relies on a system of trust and faith. It is the dominant currency of our time and a medium of exchange. While there are no limits to the amount of money that can be created, it can easily be damaged or destroyed.

Finally, there is **credit money**, a future claim against someone that can be exchanged today for real goods and services, but which introduces new risks. The person behind the claim may be unable to pay. The system works as long as everyone believes the debt can be paid back and the market value of assets bought with that debt keeps rising. According to Das, the economy gravitates towards debt-fuelled consumerism, inflation and rising debt, all of which leads to a cycle of credit booms and which may end in a situation of unsustainable levels of debt, such as what happened in 2008. At each step of the transition from commodity to paper to credit, money becomes more unreal and detached from the real goods and services that it can be exchanged for.

To Satyajit Das, money is nothing and everything. He states that the ultimate metaphor of modern money is portrayed in a construction called *Mirrored Room* by the artist Lucas Samaras in 1966. To Das, one perceives a feeling of infinity and abstraction by looking at it. Money – according to his interpretation of this particular work of art – is endless, capable of infinite multiplication and completely unreal. The world is involved in creating, manipulating and chasing reflections of real things, and finance is the interplay of the real and its endless reflections. In the end, money would change the real world through ***financialisation***, a concept that defines the conversion of everything into monetary form. For most people, money was the link between work and self-sufficiency (ultimately food supplies); it provided financial independence and protection against uncertainty. For some people, it symbolised social acceptance, power and influence.

With time, finance has gradually replaced industry, with trading and speculation becoming major activities. Particularly in the twenty-first century, business people sought to make money in ways not necessarily directly linked to the *making of things*. Speculators, for instance, made money from trading oil even if they did not actually produce it, refine it or consume it. It was the beginning of the so-called speculation economy. Almost a quarter of the rich in 2006 owed their fortunes to the finance sector, compared to less than a tenth in 1982.

Business improvements are slow and risky, whereas financial changes are easy, more predictable and quicker. This is how financial engineering replaced real engineering. Rather than making things, trained engineers joined banks to provide powerful financial structures for companies. Das also exemplifies a few companies that did not always succeed when speculating, such as the Japanese carmaker Honda, which announced losses of $180 million from trading in shrimp and shellfish; or Procter & Gamble, which lost $157 million in interest rate trading. *Financialisation* has deeply affected businesses and corporations, which restructure constantly. Automobile companies, for example, offered financing to buyers, insurance and other financial services, which were even more profitable than the cars themselves. Some companies became conglomerates, such as GE, whose size and complex structure made it difficult to understand and analyze, and increased the lack of transparency.

However, *financialisation* has not only changed businesses and the way they operate. Banking institutions have also expanded and diversified their activities over time. In the past, regulators set the rates that the bank could pay its depositors as well as the rates it could charge borrowers and the specific amount it could lend. After the 1929 stock market crash, the Glass-Steagall Act of 1933 sought to separate commercial banking and investment banking in order to prevent conflicts of interest where the same institution was simultaneously lending (granting credit) and investing (using credit). However, in the 1980s, the controls over banks were progressively loosened. On one hand, supporters of deregulation argued that distinctions between loans, deposits and securities were increasingly difficult in practice. On the other hand, banks claimed that the ability to expand into broader financial services would diversify their activities, therefore reducing risk. Today, banking has become a commercial activity driven by shareholder returns.

Das explains two banking models: in the ***traditional banking model***, banks simply took short-term deposits and made longer-term loans. Their ability to grow depended on their shareholders' capital and their ability to collect deposits. The shareholders received modest and predictable returns, and the major risk the banks ran was borrowers not paying back. In the new ***originate-to-distribute*** model, banks made loans – which they kept for a short period of time –, bundled them into securities and then sold them to eager investors in a process known as ***securitisation***, thus creating a money machine. Since investment banks, mortgage brokers and independent credit card providers could also make loans and sell them off, the competition rose, which led to lower profit margins. All the actors desperately searched for more borrowers, which triggered an exceptional growth in lending. Additionally, banks argued that since they did not plan on holding on to the loans they made, they were not risky, even if they were given to low-quality borrowers. Unfortunately, banks enhanced short-term performance while risking longer-term damage.

The author concludes that money has evolved from its modest origins to extreme money, which shapes the world. The relationship between the real world and its endless monetary reflections now drive economies and cities, but it is a fragile construction.

The new global financial machine

Das details five types of extreme money: private equity, hedge funds, securitization, structured finance and derivatives. He states that hedge funds and private equity managers are *financial oligarchs*, who have risen to power in the past thirty years and have concentrated economic power, wealth and risk, playing outside the regulatory sphere and the democratic process. They have shaped the so-called *Masters of the Universe* who, according to Das, should not be trusted because they have mistakenly led us to believe that the future could be brought forward and lived on today. He specifically criticises the actions of Milton Friedman, central banker Alan Greenspan and Ben Bernanke, among many others, who have preached what he calls ***financial fundamentalism***, a concept that describes the liturgy of economics and finance, first developed by scholars at the University of Chicago. According to the author, it has been proven over time that creating complex financial products cannot create money, because markets cannot keep returning it at high returns indefinitely.

Another important concept to understand Das' idea is ***financial alchemy***. In medieval times, alchemists developed techniques to create gold (money). Today, in the age of capital, financiers have developed techniques based on fundamentalist money theories, which exploited the society's faith in money. Private equity, securitisation, derivatives and hedge funds promised enormous wealth. However, in reality they were "opaque risk packages" which would eventually fool both customers and financiers.

Financial alchemy took the form of more and more borrowing, initially in the form of ***private equity and junk bonds***. Private equity, originally called leveraged buyouts (LBOs), was about high levels of leverage – debt. The game was buying low and selling high, with other people's money, but LBOs did not improve the companies. Managers used short-term measures to boost performance – cutting costs deeply and reducing investment. After that, the business was sold or its shares were offered to public investors, allowing the private equity firm to sell out and cash in. The emphasis was on the numbers, meeting financial targets to pay down debt. The success of LBOs relied on management incentives and privileged access to information about a company's activities to lower the price. Looser lending conditions were encouraged by banks that no longer held on to the loans, repackaging them using securitisation and derivatives for sale to investors.

Financial alchemy, in the form of securitisation, allowed low-quality buyout loans to be repackaged into investment grade, even AAA rated bonds, increasing the number of potential buyers. In a virtuous spiral, increasing availability of cheap debt drove larger transactions, which in turn increased the flow of money into buyouts driving new transactions. In 2007, to purchase businesses, private equity firms paid on average nine to ten times the company's annual cash flow, an increase of 62 percent from 2001, when they paid around six times cash flow. The amount of debt increased by around 50 percent, as companies borrowed six times annual cash flow compared to four times in 2001.

Securitisation would also become a powerful and destructive form of alchemy. The author states that it is a recipe for "cutting and dicing debt into more debt" – mortgage loans, credit card loans, car loans, loans to people, to companies, etc. Poor quality loans are no barrier to an acceptable final securitised product. The key to securitisation is the allocation of risks between different investors. Regulators loved the theoretical idea of breaking risk into tiny particles, distributing it widely. In practice, risk was spreading like a virus through the financial system, ending up in unknown places in the hands of investors, who did not understand the complex risks they assumed. Securitisation was alchemy, creating and multiplying borrowing for a debt-addicted world. Designed to allow transfer and reduction of risk, it ended up burning everything and everybody it touched.

Das particularly compares bankers to Henry Ford, arguing that they are good at mass production and in quickly adopting and developing a successful product. The ability to repackage all kinds of debt into highly rated securities allowed the debt levels to reach enormous proportions. The early focus in the United States was on MBSs (mortgage backed securities) – repackaging and selling off mortgages guaranteed by government-sponsored entities. As securitisation became accepted, bankers adapted the technique to pools of private mortgages, automobiles (CARS – certificate for automobile receivables) and credit card debt. In the late 1980s, Milken created CBOs (collateralised bond obligations) and CLOs (collateralised loan obligations), repackaging corporate debt. Soon, corporate loans, private equity loans, loans secured by commercial real estate and emerging market junk bonds were all being securitised. In the 1990s securitisation underwent a makeover and was rebranded as CDOs (collateralised debt obligations), a term assuming various types of underlying loans and securitisation formats.

Rebranded as ***structured finance*** or ***structured credit***, securitisation increasingly involved layers of complex leverage repeatedly using the same debt as collateral. Debt now bought more debt, as the same underlying loan was leveraged and re-leveraged in a seemingly endless spiral of borrowing. At each stage, the banks charged fees and earned margins from the money they lent. Investor demand for securitised debt decreased the cost of loans to the borrower, in turn bringing down investor returns. Bankers were forced constantly to create highly rated bonds with attractive returns, repackaging unsellable junk in complex chains of debt.

Das claims that banks did not understand the products they were creating and selling. Risk was broken up into fragments that were difficult to understand and value. He states that there is a strong correlation between the complexity of an instrument, its remoteness from the real economy and its likelihood to spread contagion. The problem was not lending money to poor people, but lending it poorly.

Banks then started packaging risk into discrete, tradable bundles, known as ***derivatives***. They have no intrinsic worth, since their value essentially comes from an underlying financial asset – share, bond, commodity or currency. They allow hedging the risk of changes in the price of assets. Over time, dealers began trading derivatives, risking their own money. If the *Mirrored Room* by Lucas Samaras is the ultimate symbol for *extreme money*, then derivatives are the ultimate, universal financial instrument for manipulating that world, creating, and chasing endless reflections of real things. In a thoroughly post-modern contradiction, far from reducing risk, derivatives increase risk, often with catastrophic consequences.

Hedge funds, the last form of *financial alchemy*, essentially borrowing to purchase assets, is a strategy that only works in moderation. Increased borrowing to buy assets artificially boosts asset values, generating profits that allow further leverage until the supply of money ceases. When the asset price bubble bursts, the pressure to liquidate assets triggers losses.

If private equity, securitisation and derivatives were alchemy, then hedge fund managers had to be the alchemists of the age of capital. Gradually problems emerged, because hedge funds did not consistently deliver the expected returns. In fact, average returns dropped from 18.3 percent year in the 1990s to 7.5 percent in the 2000s, but investors still chased yesterday's returns.

The 30-year history of *financial alchemy* is the rise of private equity, securitisation, and derivates and ultimately the *Masters of the Universe*. The growth of these instruments owed everything to *financial fundamentalism*.

The greedy financial elite

The new financial oligarchy exercised significant political power and shaped economic and social agendas. According to Das, the financial elite was limited, too smart and essentially insatiable. However, since the late nineteenth century, speculators and financiers have been idolised. JP Morgan, for instance, has been known as "Financial Titan", "Finance's Napoleon" or "Zeus". The bank's actions have been considered heroic in a world where financiers are allowed to operate at the edge of morality and legality.

All of the problems of the "Extreme Money economy" ended up causing the global financial crisis that began in 2006/7. Massive debt and speculation from both individuals and corporations were the basis of growth and prosperity; savings were insufficient to provide for the future; financial tricks had exaggerated company profits; and entire countries had artificially *financialised* their way to higher living standards. The author argues that the economic and financial models indeed failed, and that the available tools and knowledge were not enough to manage the crisis and rebuild the economy.

One of the biggest problems - according to Das - was focusing on growth and inflation as painless means to adjust the deeply indebted global economy. Indeed, coordinated government action across the globe stopped the crisis turning into a depression, but temporary capital injection covered up unresolved problems of the economy that had to be dealt with. The European debt crisis shifted the problem from financial markets to governments, which were forced to embrace the new austerity programmes to stabilize their economies, raising taxes and cutting expenditures. However, the difficulties Europe was facing covered up a bigger problem – US government debt, which was growing at $1 trillion a year. Government debt problems were almost universal, and concerns about banks re-emerged, since they had lent over $2.2 trillion to the PIGS, with French and German banks alone lending over $1 trillion. Das comments on Spain, where the government was forced to rescue the regional saving banks known as *cajas*.

When the income and cash flow generated are insufficient, the only choice governments' have is to print money, thus inevitably destroying the value of their currencies. In such situations, commodities tend to rise. In Germany, gold was recently made available from vending machines in airports and railway stations (*gold-to-go*).

Das argues that governments kept borrowing money and speculating as a quick way to achieve economic growth and wealth, and criticises the fact that they allowed an unsustainable degradation of the environment and an uneconomic use of non-renewable natural resources, like oil. Additionally, the author claims that governments and central banks may not be able to address deep-rooted problems in the current economic order, since in the last 30 years they have repeatedly intervened in the economy to increase the prices of financial assets. Printing money (or other forms of *financial alchemy*) might not be able to create wealth at all. In any case, Das doubts that the governments' bet on growth and inflation will succeed, because public borrowing cannot substitute for private demand for an indefinite period. Eventually, governments will be forced to reduce debt. As a consequence of their actions, living standards in some countries or parts of society will need to fall. Inequality will rise; there will be job insecurity and stagnant incomes. The world will be economically fragile and companies will struggle to survive and maintain profitability.

In 2010, people went on strike and protested against cuts in jobs, salaries, benefits, pensions and working conditions, as governments embraced austerity to restore public finances. Ordinary people complained about paying for the costs of the crisis, but Das adds that their responsibility is difficult to ignore. Homeowners did not complain when their properties rose in value, investors ignored generous pay packets for bankers, and others simply turned a blind eye to excess.

The author does not suggest a simple solution to the crisis: global debt must be reduced, the financial part of the economy must shrink, and the incentive structures in finance must change. Individuals simply have to spend less and save more, and companies must learn to balance their books better. Banks have to go back to financing real things and serve as a mechanism for matching savers and borrowers. Most importantly, countries cannot rely on debt and speculation as a way to achieve prosperity. Das expresses it clearly: the world must live within its means. In this "Extreme Money economy", we will have to face the short-term painful costs of reforming the global and local economies and longer-term slower growth, as well as lower living standards. Das claims that until everybody is aware of the fundamental problems, no real progress is possible.

In the end, the author is not as optimistic as one may have hoped. Apparently, there is still little acknowledgement of the need to cut debt or the problems of debt-fuelled economic growth. At the 2011 World Economic Forum at Davos, it was forecasted that global borrowings would double between 2009 and 2020 to $213 trillion, a growth rate of 6.3 per year. Additionally, the lobbying power of financial institutions is a barrier to real change. Finally, Das criticises that remuneration in the financial sector has returned to pre-crisis level, even though higher payments do not always reflect extraordinary returns. For instance, in 2010, hedge fund manager John Paulson earned $5 billion, higher than the $4 billion payday from his successful bets against sub-prime mortgages.

This book is essentially about the dangerous money games that created artificial growth, prosperity and wealth in a *financialised* world, where "financial fundamentalism" and "financial oligarchs" changed the global economy, engineered by "financial alchemy". A great guide to understanding how the financial sector has developed over the last thirty or forty years.