A macroeconomic view on investments and innovations = a fair tale about 3 myths

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Development and innovations of financial products
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Agenda

1.	Introduction
2.	Myth 1 – sustainable economic growth
3.	Myth 2 – ‘good’ financialization
4.	Myth 3 – innovations
5.	Conclusion

Introductory notes

- Macro view on investments and innovations through discussion of 3 myths

1) Sustainable economic growth is possible (vs. excessive financialization)
2) Financialization helps both real and financial economy (vs. distributive activities)
3) Financial innovations mitigate risks (vs. importance of risk-adjusted return)

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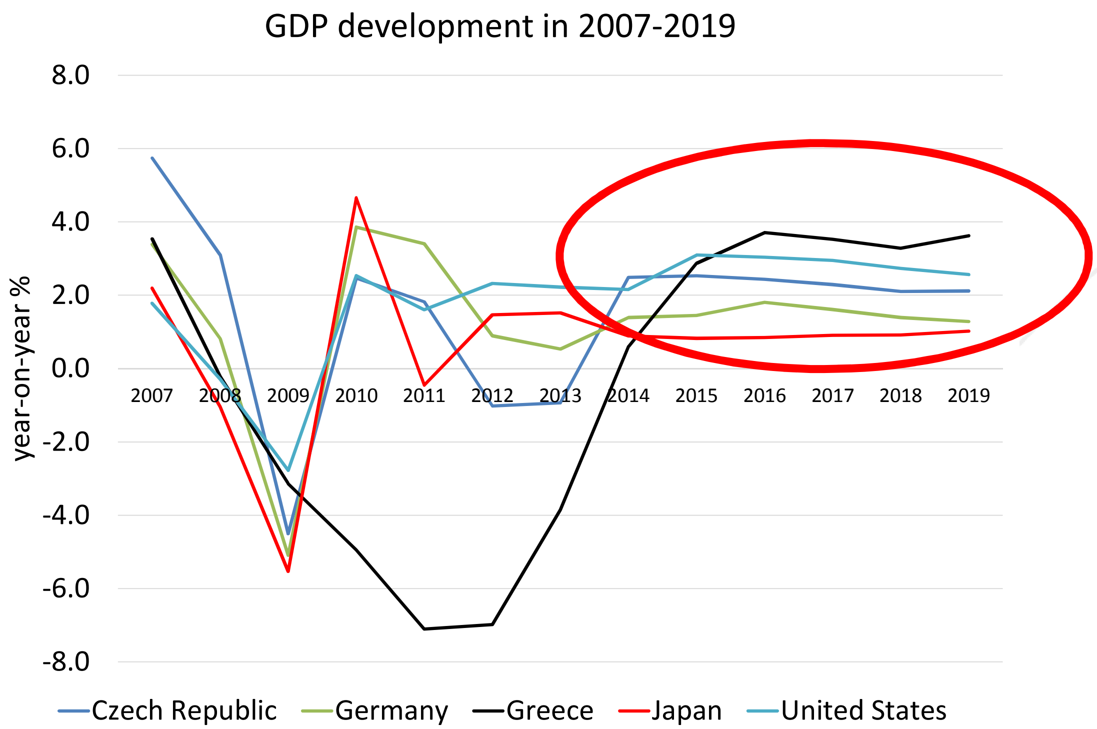
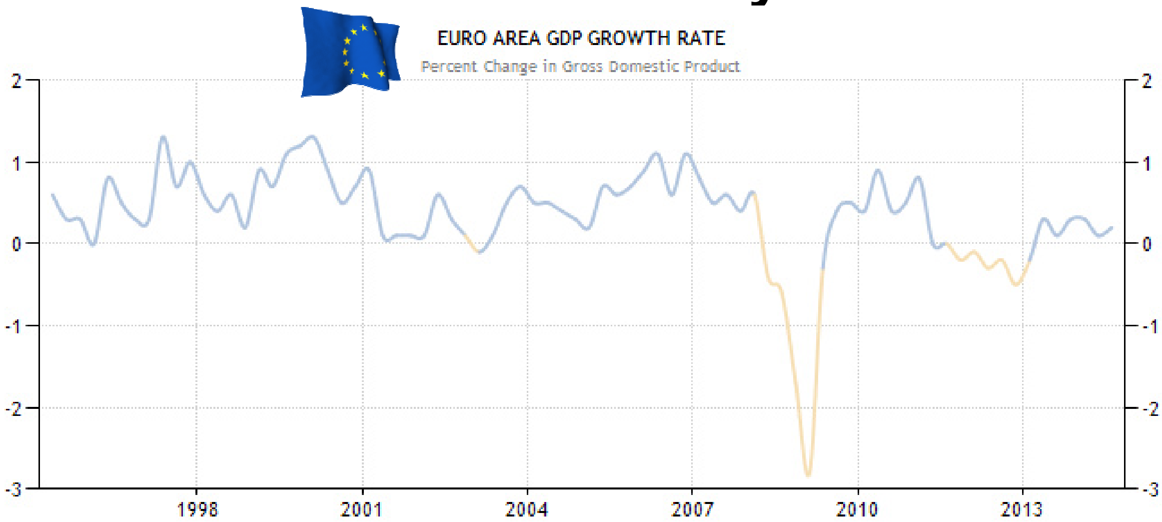
The recent IMF forecast for 2015-2019 -> stable economic growth = an illusion as usual!

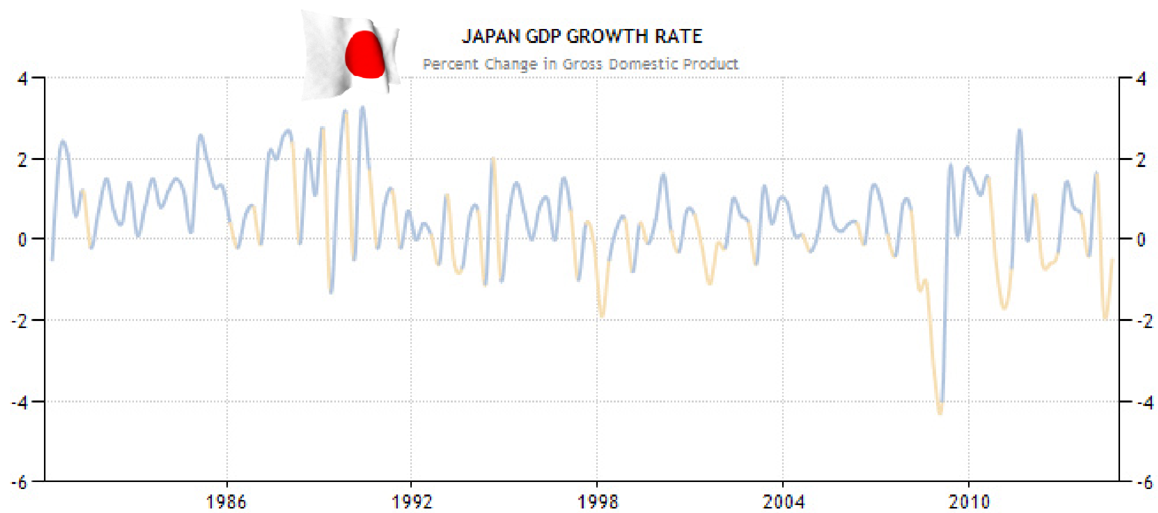


Source: IMF (2014). World Economic Outlook, October 2014

- Notoriously optimistic forecasts of 'respected' institutions follow neither history nor reality...
- Typical feature of the Ponzi Planet

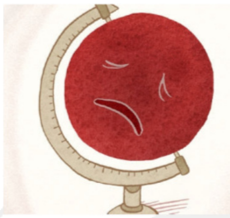
Sustainable economic growth not enjoyed in the recent history – no lessons learnt ☹





SOURCE: WWW.TRADINGECONOMICS.COM | CABINET OFFICE, JAPAN

- The Japanese economic ice age = the future of the EMU ☞ lost decades

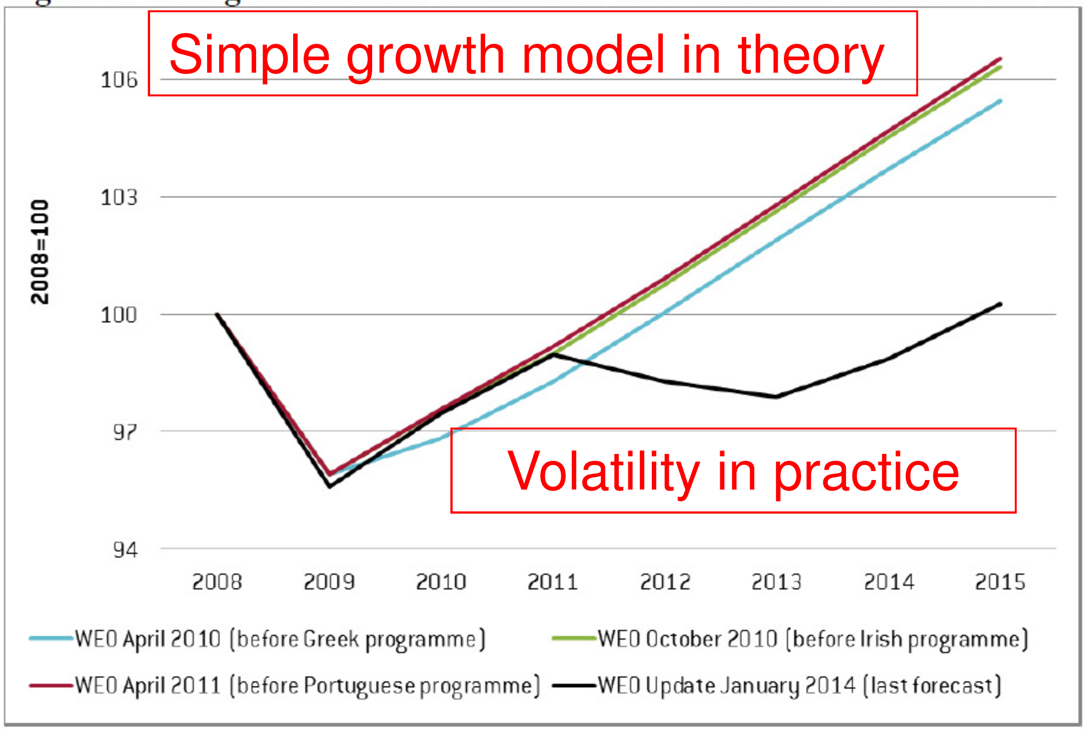


- Secular stagnation of developed countries

MYTH BUSTED

Illusionary economic growth expected by the IMF for the EMU in 2010-2014

Figure 1: Changes of the IMF forecast for euro-area GDP between 2010 and 2014



Note: For each line, numbers for years after the release date correspond to GDP forecasts.
Source: IMF, World Economic Outlook Database.

- Who believes these optimistic forecasts by the EC, ECB, IMF and WB et al?
- Why these institutions do not respect volatility as a fact?
- Because they lack any responsibility for their predictions!

Source: European Commission (2014). The Troika and financial assistance in the euro area: successes and failures

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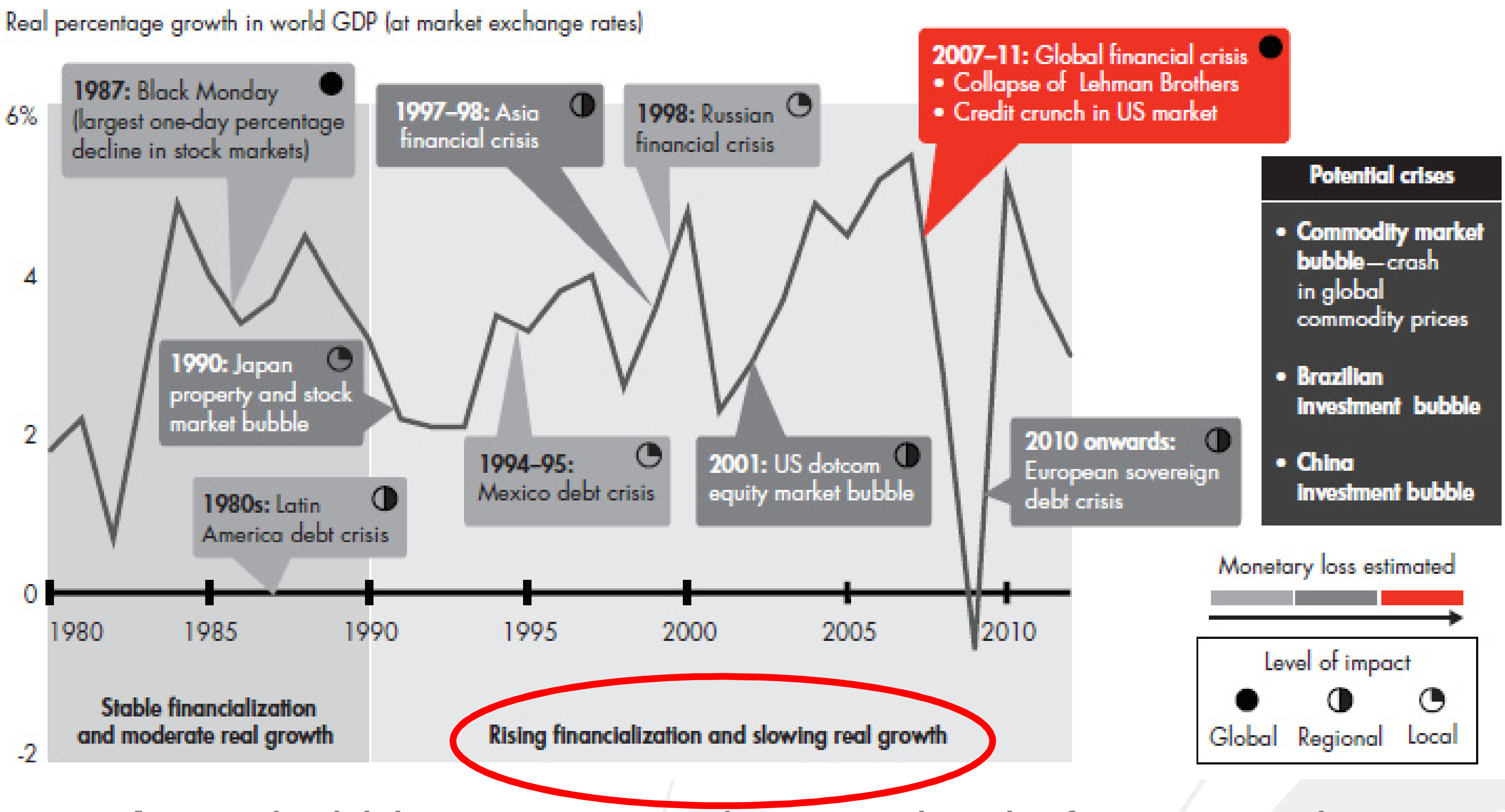
Financialization – definition

- Financialization (FIN) is a process whereby financial markets, financial institutions, and financial elites gain greater influence over economic policy and economic outcomes.*
- FIN = <u>making money out of money</u>
- Creative activities (increase a society’s wealth) vs distributive activities (FIN)
- FIN isn’t bad in itself but excessive FIN is**

*Source: Palley, I.T. (2007). Financialization: What It Is and Why It Matters, Working Paper No. 525, The Levy Economics Institute

**Sources: Arcand, J.L. (2012). Too Much Finance?, IMF Working Paper WP/12/161; Cecchetti, S.G. Kharroubi, E. (2012). Reassessing the impact of finance on growth, BIS Working Papers No 381

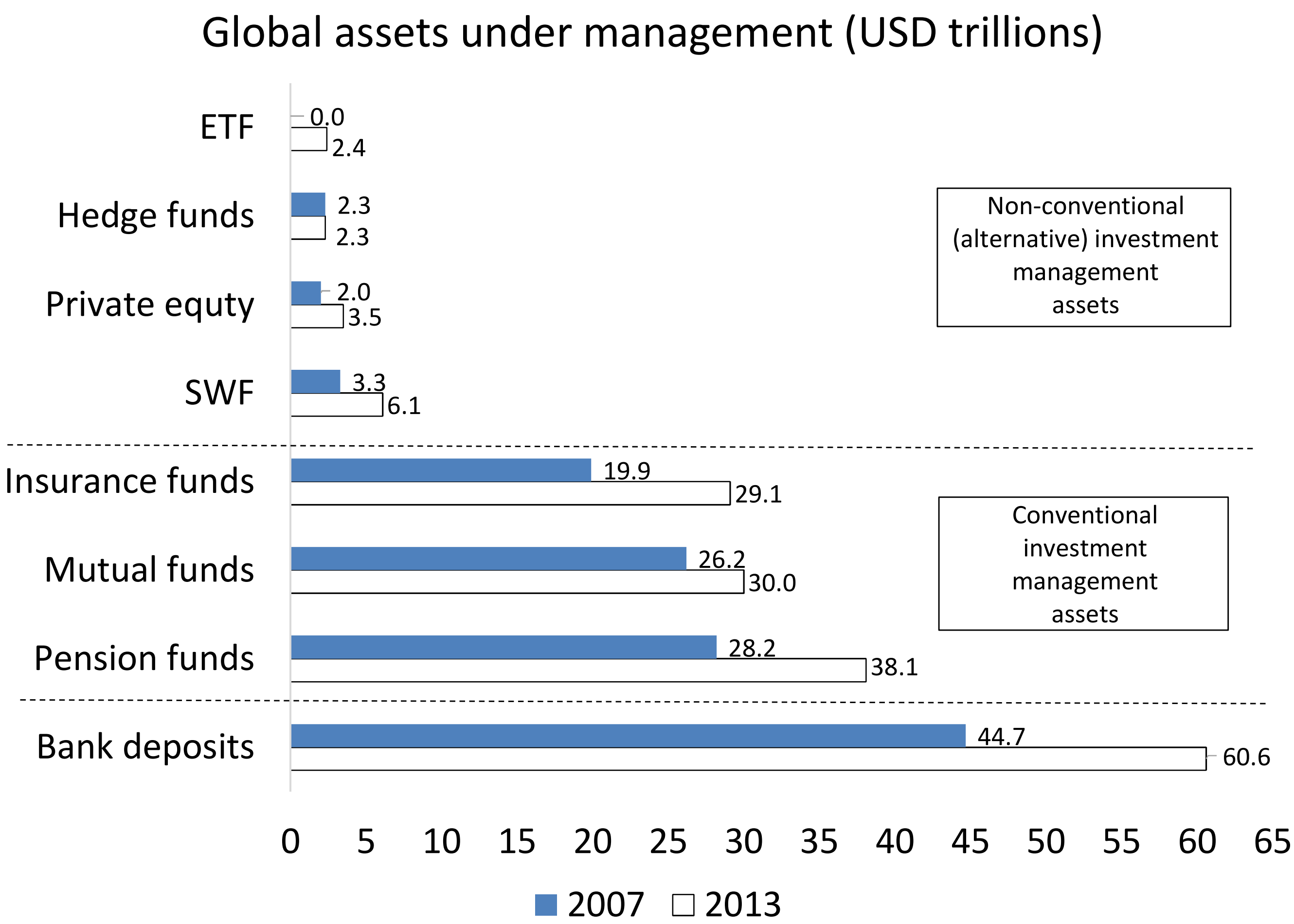
Financialization and assets bubbles



- Asset bubbles appear to be growing in frequency in the recent era of rising FIN and slowing growth

Source: Bain (2012). A WORLD AWASH IN MONEY Capital trends through 2020

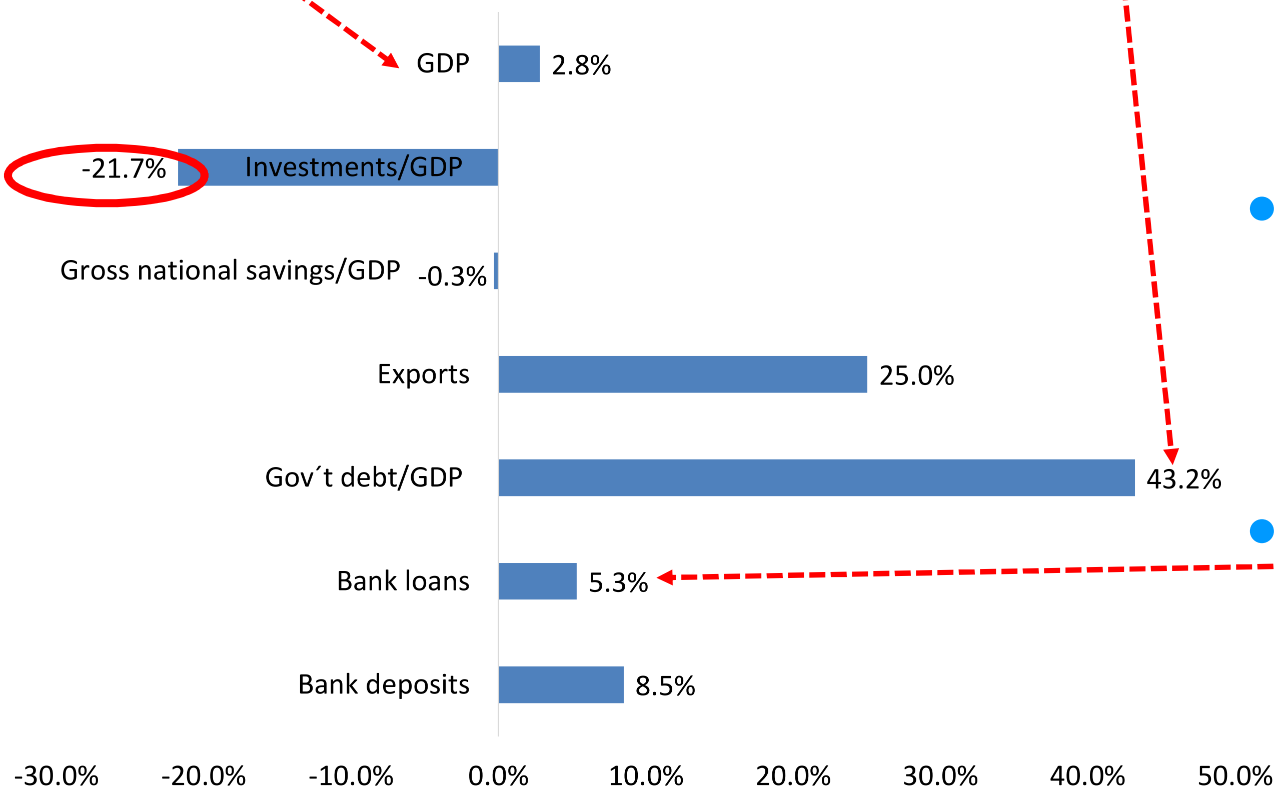
Global AUM increased by 36% between 2007 and 2013 to $172tr (vs. World GDP $75tr)



Source: Author based on various sources
Note: ETF = Exchange Traded Funds, SWF = Sovereign Wealth Funds

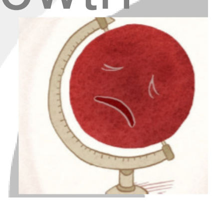
The EMU between 2007 and 2013: sluggish economic growth but increasing gov´t debt!

Macro and bank variables of the EMU between 2007 and 2013 (change in %)



Source: Author based on various soruces

- Modest increase in bank deposits and loans
- Excessive FIN: high reliance of EMU firms on banks
- Zombie banks in the EMU/credit crunch hinder economic growth as in Japan



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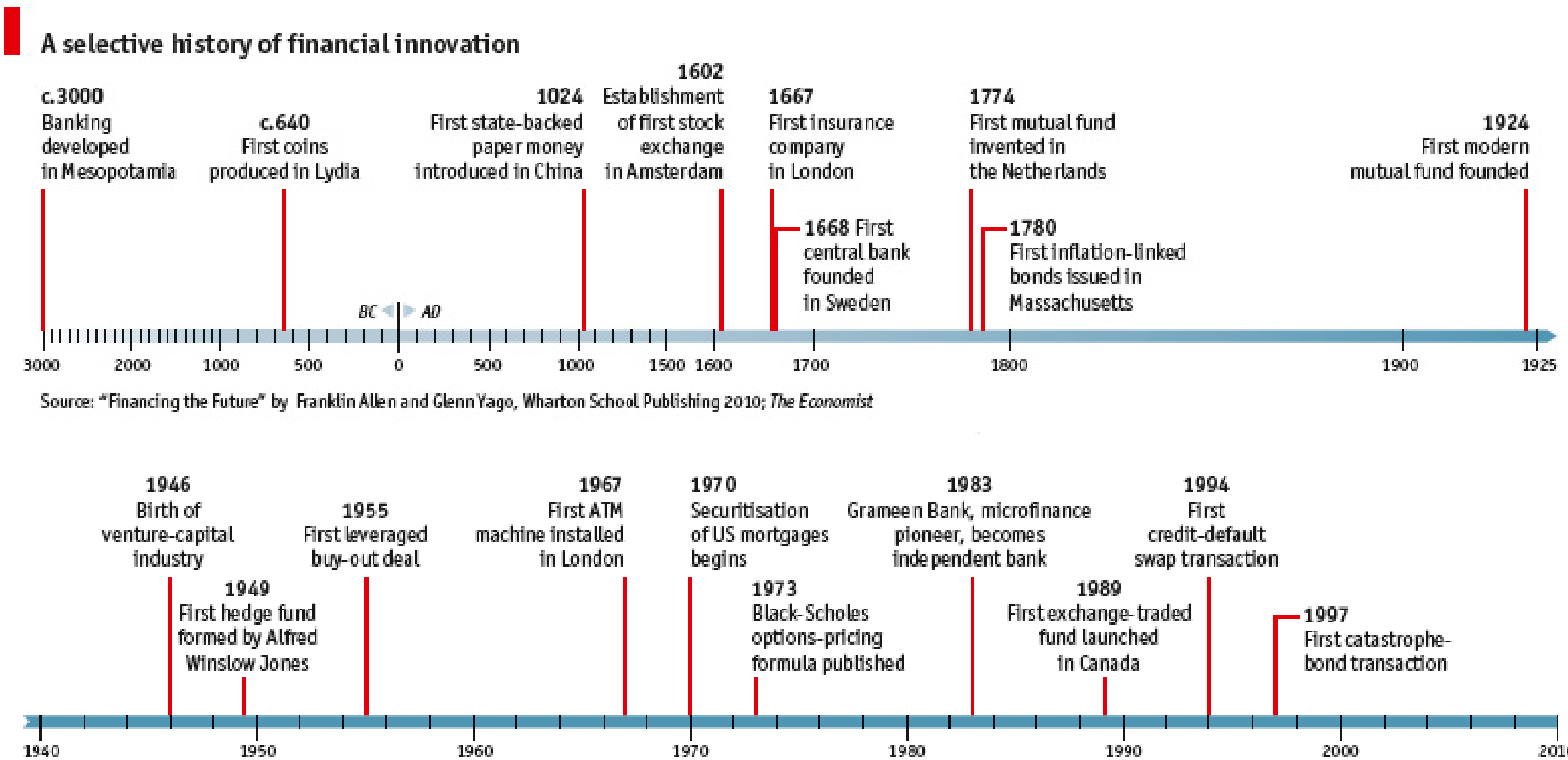
History of financial innovations

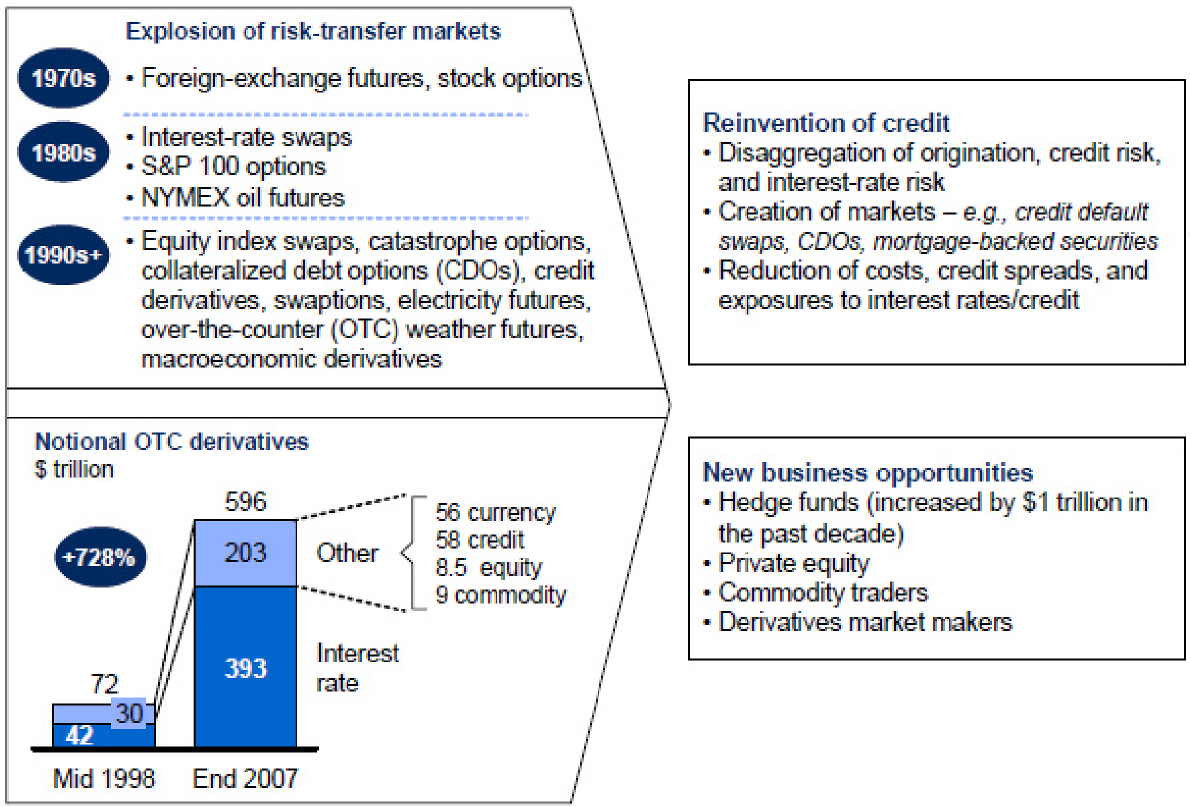


- Innovation = the key to increasing productivity
- Technology driven innovations (ATM) vs. modality driven innovations (derivatives for risk transfer)

Source: The Economist 24/2/2012

MYTH BUSTED

Risk innovations set off a revolution in the financial services industry



- Risk never disappears! However, derivatives as modality driven innovations help create the illusion that risk can disappear!

Source: McKinsey (2008). The Risk Revolution

Regulation obviously spurs financial innovation!

Regulation	Original purpose	Unintended consequence
Regulation Q (US, 1930´)	Cap on int. rate on bank deposits	Boom of money market funds (MMF)
Big Bang (USA, UK, 1970´)	Free capital flows	Steroids for investment banks (advising on IPOs, M&As…)
Basel I+II (globally, 1990´)	Higher financial stability through higher capital	AAA-securitisation, real estate boom
Regulation of mutual funds (USA, 1990´)	Stability of MFs (ban on short sell)	Boom of hedge funds
Volcker´s rule on proprietary trading (USA, 2010´)	Higher banks´stability	Boom of hedge funds, Higher systemic risk
Basel III (globally, 2010´)	Higher financial stability	New insurance products (liquidity management)

Source: Teplý, P. (2012). Financial innovation under ineffective bank regulation: does economic capital matter in banking?. AITEC Banking & Mobile Money COMESA 2012, Nairobi, Kenya

Recent reinvention of innovations

- Global low-interst rate environment ☞ search for yield and financial engineering
- The role of advisors maximizing their own renumeration rather than client´s wellbeing
- Potential dynamites = risky (re)inventions

1) Structured credit derivatives (ABS purchased by the ECB won´t help)
2) High-yield bonds (hybrid+junk)
3) Synthetic ETFs

4) Carry trades

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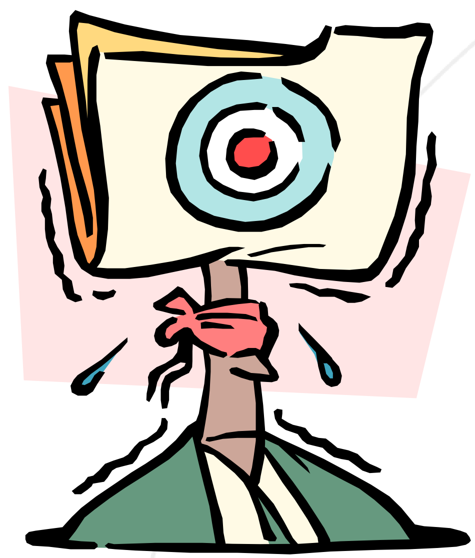
3 myths busted + 2 general conclusions

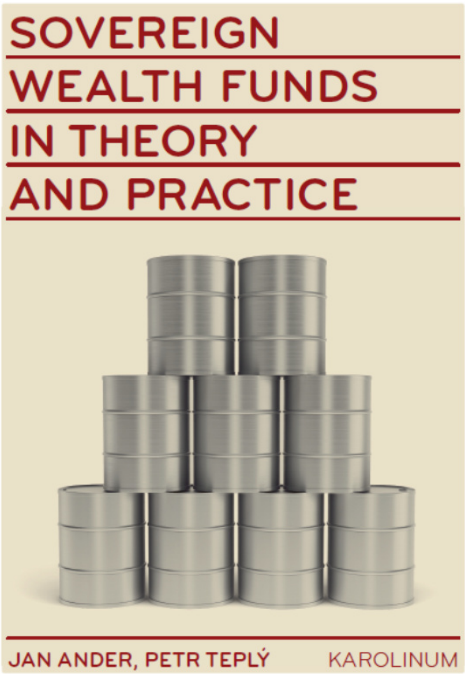
1) Sustainable economic growth is not possible
2) Financialization has caused divergency between real and financial economy
3) Financial innovations cannot mitigate all risks
4) The future of the EMU = the Japanese economic ice age of lost decades
5) Volatility = the only certainty in the recent uncertain world

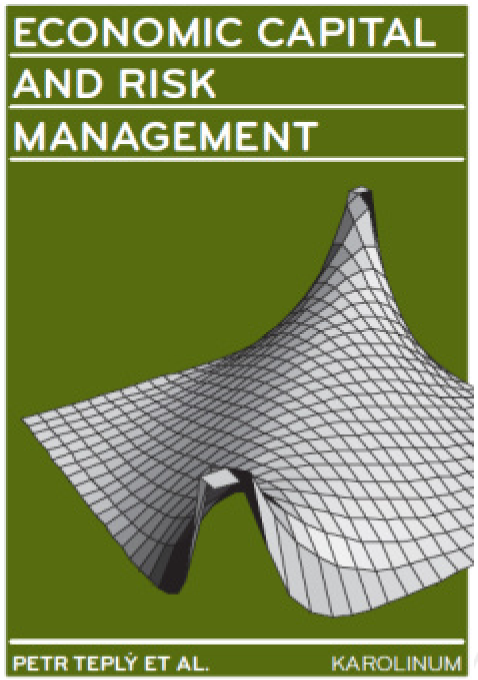
Discussion

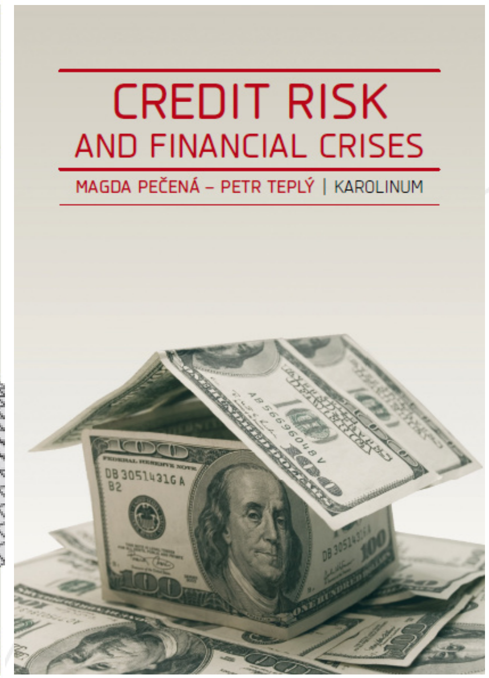
Thanks for your attention.
Let´s discuss it now!

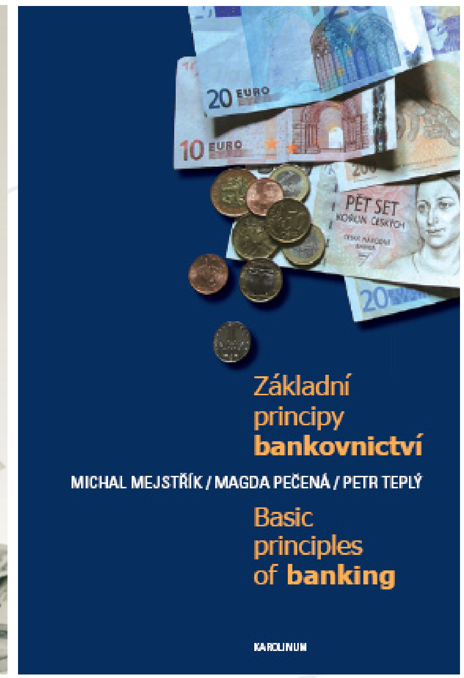


Useful sources









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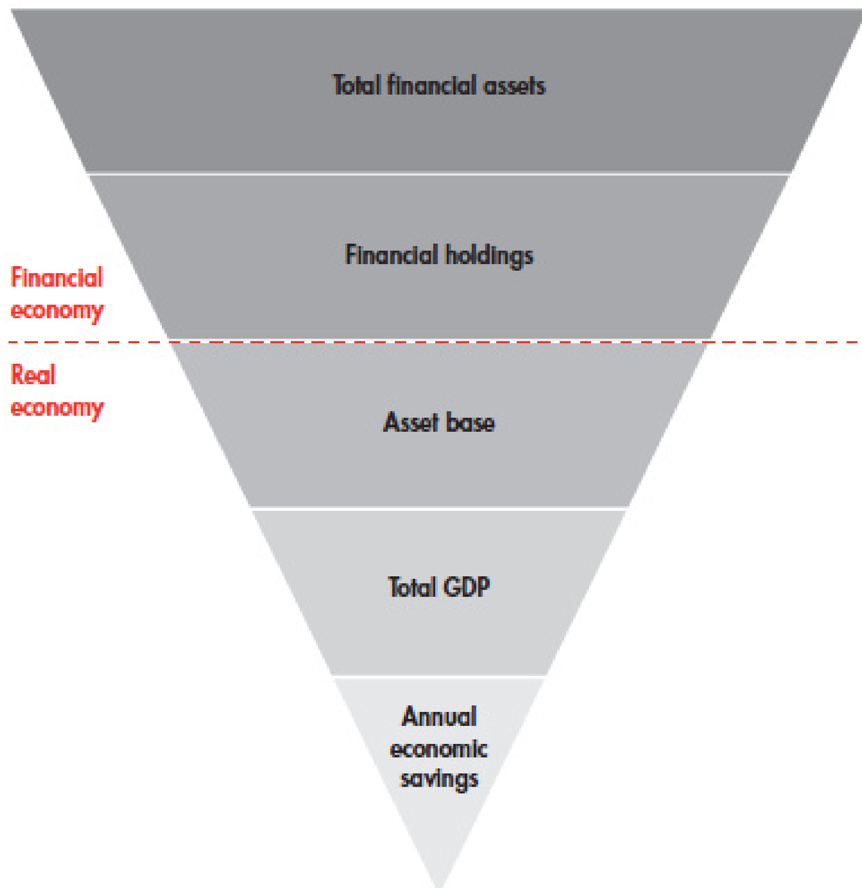
What is the difference between financial and real economy?



All financial assets of all sectors
Includes financial holdings of direct owners, as well as financial assets controlled by and held on the balance sheet of banks and other financial intermediaries

Financial assets of all sectors excluding the financial sector
Securities, mutual funds and other financial instruments in the hands of households, corporations, governments and other direct owners

Accumulated tangible and nontangible assets of all sectors
The sum total of all factories, farms, infrastructure, intellectual property and the like—everything that might appear as a nonfinancial asset on a balance sheet

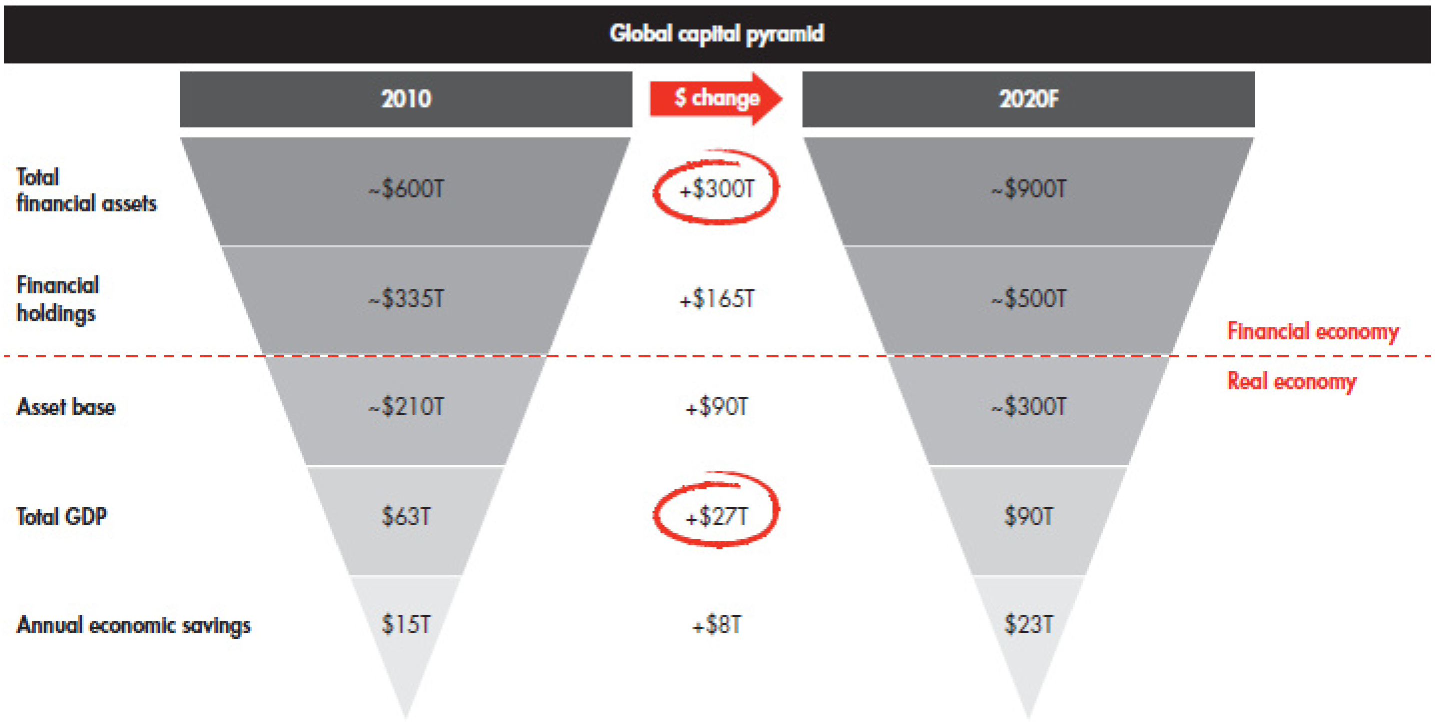
Total annual economic output
Total global GDP, or the real output of goods and services

Annual economic output not immediately consumed
Derived from gross world savings (the sum of gross national savings at the country level), this represents the underlying free GDP available for investments. It does not include depreciation, so some of this amount needs to be reinvested to maintain a constant asset base.

Source: Bain (2012). A WORLD AWASH IN MONEY Capital trends through 2020

Why a rapid increase of financial assets vs. sluggish GDP growth?

Figure 1.1: A $27 trillion growth in global GDP will support a $300 trillion increase in total financial assets by 2020



Source: Bain (2012). A WORLD AWASH IN MONEY Capital trends through 2020

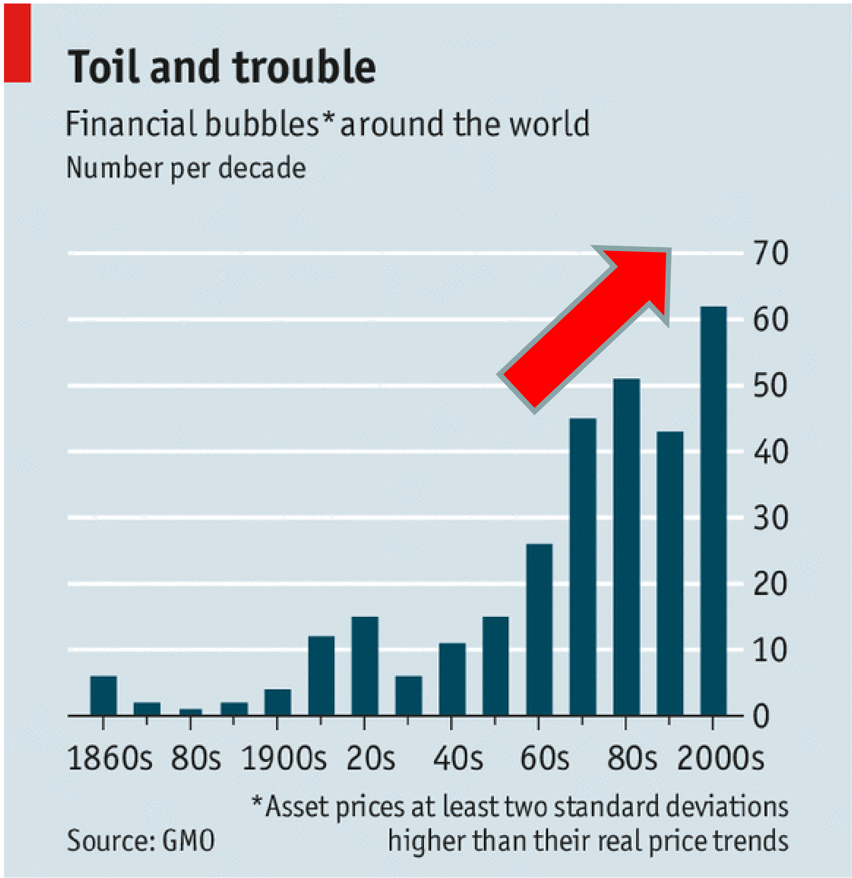
...because investment bankers love to play in global (perverse) casino and need volatility for this game!

The Ponzi Planet implies...

1) Unsustainable governments´ debt
2) Unsustainable social security systems
3) “Printing“ money (by central banks)
4) “Paper“ optimistic economic growth models

Source: Author based on Feierstein, M. (2012). Planet Ponzi, Glacier USA LLC

Result of the Ponzi Planet ☞ since 1973 a rising number of financial bubbles



Volatility of financial markets = certainty in an uncertain world

Source: The Economist 7/12/2013