Speculation in Financial Markets
The Main Cause of 2008 Economic Collapse

> Men think in herds, it will be seen that they go mad in herds while they only recover their senses slowly and one by one.[1]

Never before the subject of financial speculation has attached so much public attention as it does today amidst the debris of enormous fortunes lost in the financial debacle of 2008.

Behind much of the contemporary dismal economic news, about real estate foreclosures, bank bankruptcies, astronomical in size government bailouts, stock market crashes, commodity collapses, derivatives fiascoes, and outright fraud, lurks the word "speculation" and its magnificent creation the "bubble". "The Fed cannot reliably identify bubbles in assets" said indifferently the current Federal Reserve chairman Ben Bernanke, even as early as October 2002.[2]

But the creation of a financial bubble presupposes the existence of a speculative boom in financial assets which was led by an irrational behavior described as "mania". Where the word mania emphasizes the irrationality and the word bubble foreshadows the bursting.[3] Hence the Federal Reserve chairman chose to deal with the effect and not with the cause: the bubble creation and its implosion which is the last phase of speculative orgy where speculation detaches from logic and turns to delusion and madness building castles in the air.

Even the almighty Alan Greenspan, the venerable ideologue of the doctrine of unfettered capitalism, commonly known as the "oracle" stated in 2004, that a

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[1] Charles Mackay, *Extraordinary Popular Delusions and the Madness of Crowds*, Second Edition 1852, London Harmony Books, p.xx

[2] A few months after joining the Federal Reserve as a member of the board of governors, following his resignation as chairman of economics department at Princeton University.

[3] Charles Kindleberger, *Manias, Panics and Crashes. A History of Financial Crises*, Basic books, revised edition, 1989, p.20

national housing bubble was unlikely. In defense, Bernanke, a year later, in August 2005, taking a similar position on the housing situation affirmed[4] "the house prices are been supported in very large part by very strong fundamentals". Reminding us of Irving Fisher's immortal phrase that "prices have reached a permanent plateau" in 1929, just few days before the stock market collapse began that led to the Great Depression.

And all this ostensible economic growth was taking place in front of our eyes as the majestic bubble of prosperity built on debt was flown proudly into the air waiting for the tempest to implode it. Ironically, the bursting initially was caused by the infamous now collapse of the sub-prime housing market in mid 2007, following the bankruptcy of two Bear Stearns (now defunct) hedge funds specializing in mortgage-backed securities (MBS).

The alchemical creation of abundant liquidity via securitization or structured finance coupled with exotic financial derivatives[5] resulted in phenomenal prosperity of world financial markets unparalleled in the history of capitalism. But the stability of such prosperity based on "phantom" money was precarious and naturally a cause of anxious concern, except to monetary authorities finance ministers and bankers. All of them were hypnotized? Or are as Charles Kindleberger states with a nervous laugh: "monkey see, monkey do."[6] To us it is incredible, it is shocking, it is a culmination of financial insanity. But this belongs to psychoanalysis, to Carl Jung and Freud and not to financial analysis.

It was the greatest Ponzi scheme[7] ever created since the inception of capitalism some 300 years ago, taking as origin the date of the creation of the

[4] Bernanke's statement was made to reporters, following his briefing to president Bush about the possibility of a housing bubble in his ranch late August, 2005.
[5] The value of financial derivative products according to the New York Times as of 31st of December 2008, amounted to the astonishing sum of about $540 trillion in nominal value. The most notorious and literally lethal derivatives are the credit default swaps (CDS's) with a nominal value of approximately $50 trillion, collateralized mortgage and debt obligations (CMOs CDOs) and naked short sales. An explanation of all these instruments will require a whole treatise.
[6] Charles Kindleberger, ibid, p.19.
[7] The name is derived from Charles Ponzi an Italian born as Bianci who immigrated to Montreal Canada around 1907. Initially he worked in a firm that helped his fellow Italians arrange their remittances back to loved ones in Napoli and Palermo. Subsequently, he was arrested and jailed in

Bank of England in 1694. It is a Ponzi scheme because it is a form of financial pyramid built on debt which is funded on new debt financed by new borrowers who must be continually sacked in the bottom in order to pay off the creditors at the top. And when the old borrowers fail to make payments or a lack of new creditworthy borrowers develops, the impossibility of paying the creditors at the top becomes reality. As a result, the precarious speculative pyramid collapses because parts of the debt structure of the pyramid must be liquidated at current market prices. But due to the fact that these are not genuine assets but debt, at times of crises where all confidence is almost lost and the economy freezes, they become illiquid and remain unsold. For those "assets" which later renamed "toxic assets" was intended the initial Paulson[8] rescue plan of a $700 billion bailout that was rejected by Congress in late October 2008, causing a meltdown in stock prices.

The abnormally severe breakdown of the financial system that followed resulted in more than $33 trillion in equity losses globally. This revealed reckless finance practice by all financial institutions, particularly those called money center banks. The fact that credit was created ad hoc and lending was encouraged to entities of doubtful creditworthiness should be emphasized. Since they generated untenable credit situations and speculative bubbles all over the field of finance and commerce. The method of lending was handled

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Montreal for forging signatures in a series of checks. Upon release from prison he moved to Boston Massachusetts and rechristened to Charles Ponzi. In early 1920 formed a firm under the name Securities and Exchange Company. Under this solid name he made the following offer to the public: if you hand over your cash with the Securities Exchange Company (SEC) for 90 days you get back you original capital plus 40% profit on your investment. The initial customers were immigrants and some policemen in the Boston area. True to his word, Ponzi, he delivered the profit promised. Soon the word got out and the inflow of cash increased dramatically. The decoy was that he paid off earlier investors with funds received from later customers. When the scheme was uncovered Ponzi lost in excess of three million dollars and put to jail. He finally died in Rio de Janeiro Brazil, in a charity ward. His name is placed in the Pantheon of financial fraud and often is eulogized by the media when a shocking financial scandal emerges having as a base a similar fraudulent scheme such as the recent Madoff Ponzi scheme involving a $50 billion swindle.

[8] Henry "Hank" Paulson, the Secretary of Treasury of the U.S. government under Bush administration since June 2006 to January, 2009. A former C.E.O of Goldman Sachs and a fundraiser of the Bush family and the Republican campaign was the protagonist of the financial meltdown drama. A very energetic man and a former football player as Dartmouth lineman in the 1960s. He was slow to grasp the seriousness of the credit crunch since as early as August, 2007, informed President Bush that this is the strongest global economy he has ever seen in his business lifetime. He accepted the position at the Treasury after receiving a huge fringe benefit of capital gains tax exemption given to Federal appointmentees who have to sell stock holdings before they take office. Hence, when Paulson sold his $500 million of Goldman Sachs stock, he saved tens of millions of dollars in taxes. In other words, he achieved the impossibility of success: killing two birds with one stone.

with such carelessness as to make an additional cause of a greater disaster later.

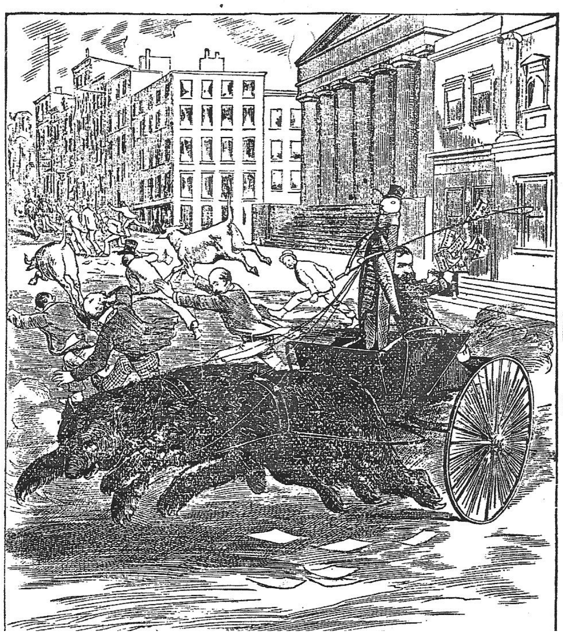
The financial innovation of structured finance or financial engineering involving, as mentioned earlier, the monsters of asset backed securities (ABS), collateralized mortgage and debt obligations (CMOs CDOs) and the deadly credit default swaps (CDS) complicated immensely the financial system. As they are not only interlinking tighter all the parts of the system making it more vulnerable to systemic risk, but also weaken even more the financial structure due to the irrationally high leverage ratios (30:1). This enormous leverage factor was utilized by banks and financial intermediaries, erroneously assuming that they could hedge this huge risk via the CDS market which is supposed to be a vehicle for transferring risk away from their heavily leveraged capital structures. But when the counterparty assuming to insure their risk is an offshore hedge fund with a tiny capital base located in a geographical region barely inhabited by indigenous people, it does not take, but the smallest disturbance in the system to lead to cascading defaults. And this is exactly what happened.

Furthermore, as long as no regulatory agency had the intention or the authority to oversight these highly speculative operations, and as long as, Mr. Greenspan, who for 18 years commanded the powerful Federal Reserve, believed that unregulated markets move smoothly from one state of equilibrium to another following the workings of Adam Smith's invisible hand[9], the catastrophe was imminent. Because a Ponzi finance structure is built on debt which is funded by new debt since the cash flows from operations are not sufficient to pay either the principle or interest on

[9] Alan Greenspan, *The Age of Turbulence*, Penguin Books, 2007, p.367. Indeed, on the same page of his 530 page autobiography he poses the question: how can anyone be sure that an unregulated global system will work? And he answers emphatically "yes it does, day in and day out". While in another page (370) he states: "the market place itself regulates hedge funds today through what is known as counterparty surveillance". "Why do we wish to inhibit the pollinating bees of Wall Street?" (p.372). Just a bit over a year later from the publication of his opus, in October 24, 2008, a contrite Greenspan confessed before the Senate Banking and Finance Committee (which the writer happened to see televised real time) that he has "found a flaw" in his thinking. He acknowledged that he was "in a state of shocked disbelief" of the present financial turmoil. His iron faith in markets and deregulation was completely shattered. And he added: "the whole intellectual edifice of modern risk management broke down".

outstanding debt. Hence such finance units in order to remain solvent have two options, either to borrow, or to sell assets. But selling in a bear market is most likely to lead to a collapse of asset values. And this scenario has also been verified by the harsh reality.

Additionally, Ponzi finance or overindebtness which is primarily induced by easy monetary policy has no specific definition according to erudite Joseph Schumpeter.[10] But results in many unproductive or non performing loans rendering the debt structure vulnerable. Thus the slightest impairment in the values of collateral enforces liquidation and a readjustment of the debt structure. The liquidation initially will create a panic as part of the debt structure crumbles, which in turn will lead to a further liquidation due to fallen prices. Thus a vicious downward spiral is created that forces the whole financial system into a crisis. And here we are in the midst of the crisis with our necks barely sticking out of the stormy waters.



Spiros Lavdiotis, 25/1/2009

[10] Joseph Schumpeter, *Business Cycles*, McGraw Hill, 1939, p.123.