Study Questions

The Global Economy: Connecting the Roots of a Holistic System
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Chapter 7: The Financial Sector: Ten Fatal Flaws

Section 7.1 Charles Ponzi

1. Ponzi
a. What lessons can we learn from the Ponzi scheme?

Section 7.2 The Financial Sector: An Overview

Terms to Consider
financial sector
Wall Street
New York Stock Exchange
primary sector
secondary (industry) sector
tertiary sector
services
quaternary sector
quinary (nonprofit) sector

Questions to Consider:

1. Introduction
a. Did you think it was odd for the author to start out the chapter describing a scam? Why did she do it?
b. What does the financial sector of the economy encompass?
c. What is Wall Street?
d. What are the 5 sectors of the global economy?
e. Briefly describe each sector.

Section 7.3 The Rise of the Financial Sector

Terms to Consider:
bubble
financialization
Wall Street
Main Street

Questions to Consider:

1. Problems with the Financial Sector
a. What has been a major problem with the financial sector since the 1980s?
b. Describe how has the economy flip-flopped. Why has it flip-flopped?
c. What is a bubble?
d. How is the financial sector squeezing value out of already created value?
e. How does the financial sector create profit?

2. Financial Managers
a. How have financial managers benefitted economically in recent years?
b. Why has finance attracted intelligent, highly educated workers?
c. Why is it important in a stable economy to maintain a balance between the different economic sectors?
d. How has the financial sector mushroomed into such a powerhouse?

3. The 1970s
a. How has the crisis of the 1970s been resolved?
b. What are financial products?
c. Why did financialization take off after the crisis of the 1970s?

4. Overproduction
a. What role did overproduction play in the shift to financialization of the economy?
b. What is the split between Main Street and Wall Street?

Section 7.4 Recklessness: The Master Narrative

Terms to Consider:
recklessness
greed

Questions to Consider:

1. Recklessness:
a. Do you think risk-taking is part of the American story?
b. What evidence do you have that supports your statement?
c. What part did greed play in the financial crisis?

Section 7.5 10 Fatal Flaws in the Financial Sector

Terms to Consider:
Non

Questions to Consider:

1. The Flaws
a. Why was it unusual for the financial crisis of 2008 to happen in the U.S.? Were you surprised by the crisis?
b. Would you add or remove any of the fatal flaws from the list?

Section 7.6 Fatal Flaw #1: Too Big to Fail Banks (TBTF)

Terms of Consider:
spreads
investment banks
commercial banks
Federal Deposit Insurance Corporation (FDIC)
Glass-Steagall Act
liberalizing
shadow banks

Federal Reserve
lender of last resort

Questions to Consider:

1. Banks
a. What was banking's 3-6-3 rule in the past?
b. What is the essential function of banks?
c. What are spreads? Why are they important?

2. Investment Banks and Commercial Banks
a. What is the difference between investment banks and commercial banks?
b. Why were the two types of banks separated in the 1930s?

3. Federal Deposit Insurance Corporation (FDIC)
a. When was the Federal Deposit Insurance Corporation (FDIC) set up? Why was it set up at this time?
b. Why have banks been heavily regulated since the early 1930s?
c. In the past, what procedures did homeowners have to go through to get a home loan? Why?
d. Do you feel better having banks regulated?

4. Bank's Responsibilities
a. How did banks provide a check on U.S. corporate activity?
b. What changes occurred in the banking industry in the 1980s?
c. What impact did "liberalizing" the international financial sector have?
d. Why was the financial sector liberalized?
e. What was the result of this liberalization?

5. Shadow Banks
a. What are shadow banks?
b. How are shadow banks different than regular banks?
c. What services do they perform?

6. Federal Reserve
a. Why is the Federal Reserve called the "lender of last resort?"
b. Who gets to borrow money from the Fed?

7. Financial Sector Contributions
a. Why does the financial sector contribute so much money to political candidates?
b. Why did Senator Dick Durbin from Illinois say that the "banks own the place (Congress)?"
c. Do you think that Senator Durbin is right? Explain.

Section 7.7 Fatal Flaw #2: Unchecked Deregulation

Terms to Consider:
deregulation
Riegle-Neal Act
Robert Rubin
Glass-Stegall Act
Financial Services Modernization Act
Gramm, Leach, Biley Act

Commodity Future's Modernization Act of 2000
Phil Gramm
Brooksley Borne
Securities and Exchange Commission (SEC)
Hank Paulson

Questions to Consider

1. Deregulation
a. What is the neoliberal rationale for deregulation?
b. What rationale do supporters of managed capitalism give for regulation?
c. What impact did the passage in 1994 of the Riegle-Neal Act have on the banking industry?
d. What role did President Clinton's Treasury Secretary, Robert Rubin have on passing deregulation laws?
e. What was the importance of the merger in 1998 of Citibank with other financial institutions?

2. Financial Services Modernization Act in 1999
a. What was the significance of the Gramm, Leach, Biley Act or the Financial Services Modernization Act in 1999?
b. Why was Glass-Steagall Act so despised by deregulators?

3. Commodity Future's Modernization Act of 2000
a. What was the Commodity Future's Modernization Act of 2000?
b. Who pushed the Commodity Future's Modernization Act through Congress?
c. What were the consequences of this act?
d. What role did Brooksley Borne play in the Commodity Future's Modernization Act of 2000?
e. Who silenced Brooksley Borne? Why was she silenced?

4. Investment Banking Culture
a. What is the significance of the investment banking culture coming out on top after the mergers?
b. What is the debt to-net capital ratio? Why is it important in banking?
c. What happened to the debt to-net capital ratio leading up to the crisis of 2008? Why did the banks want a high debt to-net capital ratio?
d. Why didn't the government step up to regulate the financial sector during the 1990s to 2000s?
e. Do you think regulation has a place in the banking industry? Explain.

Section 7.8 Fatal Flaw #3: A "Markets Know Best" Federal Reserve

Terms to Consider:
Federal Reserve
inflation
fiscal policy
monetary policy
"fine-tuning"
Alan Greenspan
central banks
"irrational exuberance"
Home Ownership and Equity Protection Act
George W. Bush
liquidity

Questions to Consider:

1. Federal Reserve
a. How do governments manage their money today?
b. What three things give value to money?
c. What is inflation?
d. What is the reason for inflation?

2. Fiscal and Monetary Policy
a. What is the difference between fiscal and monetary policy?
b. How does the Fed make money available or expand the money supply?
c. Can the Fed really create money out of "thin air"? Why does it create money?
d. When does the Fed want to contract the money supply? How do they do it?

3. Alan Greenspan's Policies
a. Do you think the policies of Chairman of the Fed Alan Greenspan caused problems in the economy?
b. Explain the following: The job of the central bank was "to take away the punch bowl just as the party gets going?"
c. Why didn't Alan Greenspan take away the punch bowl?
d. What was the significance of the Home Ownership and Equity Protection Act passed by Congress in 1994?
e. What was Greenspan's response to this act?
f. What did Greenspan do in 2001 when the economy was on the verge of a serious recession? What were the results of his actions?

4. George W. Bush Administration
a. What did the administration of George W. Bush push for during the short recession in 2001? Why?
b. What is liquidity?
c. Was liquidity a problem in the 2000s? Explain.

Section 7.9 Fatal Flaw #4: A Real Estate Bubble and Out of Control Lending

Terms to Consider:
"originate and hold"
Fannie Mae
Federal National Mortgage Association
Freddie Mac
Federal Home Loan Mortgage Corporation
Ginnie Mae
Government National Mortgage Association
securitization
illiquid assets
liquid assets
mortgage-backed securities
"originate and distribute"
Community Reinvestment Act
"underserved"
NINJA
"liar loans"
home equity loans
equity

adjustable rate mortgages ARMs
“teaser rates”

Questions to Consider:

1. Home Buyers
a. Do you think home buyers were in any responsible for contributing to the financial crisis of 2008? Explain.

2. History of Home Lending
a. What was the “originate and hold” model of banking in the past?
b. Why did President Franklin Roosevelt and Congress create Fannie Mae (Federal National Mortgage Association)?
c. Why was Freddie Mac (Federal Home Loan Mortgage Corporation) launched in 1970?
d. What was the significance of Government National Mortgage Association (Ginnie Mae)?

3. Securitization
a. Why was the securitization process so important?
b. What was the significance of mortgage-backed securities?
c. Why did the “originate and hold” method of mortgage lending change to “originate and distribute?”
d. What was the fundamental flaw in the originate and distribute process?
e. Why was this flaw so significant?

4. Community Reinvestment Act
a. What was the significance of the Community Reinvestment Act in 1977?
b. How did “subprime” mortgages come about?
c. Who were the “underserved?”

5. Effects of Securitization
a. In what ways were borrowers no longer subject to careful scrutiny by lenders in the 2000s?
b. What does it mean when the author says that “lending practices had gone wild?”
c. What kinds of home loans were issued to borrowers?
d. How could these loans be made?
e. What effect did low interest rates have on the housing bubble?
f. Why did lenders want borrowers to take on these more risky loans?

6. Home Equity Loans
a. What were home equity loans?
b. Why did borrowers want these kinds of loans? What did they use this extra money for?
c. What is equity?

7. The Bubble Inflates
a. Why was it said that homeowners used their homes as their own ATM machine?
b. Where were most of the key real estate bubble areas?
c. How did real estate prices spiral out of control?
d. Who do you blame for this occurrence?

Section 7.10 Fatal Flaw #5: A Mountain of Debt

Terms to Consider:
debt

Hyman Minsky
Minsky moment
leverage

Questions to Consider:

1. Cycle of Debt
a. What is debt?
b. What is the basic message of economists Carmen Reinhart and Kenneth Rogoff? Why are they wary about debt?
c. What did Hyman Minsky say about debt?
d. When does the Minsky moment arrive?

2. Leverage
a. What is leverage?
b. What does Naomi Prins mean when she states, "It wasn't the subprime market collapse that wrecked the banks and the greater economy; it was all of the borrowing on top of the subprime loans that did the deed."
c. Why couldn't investment banks compete with the money and leverage of the commercial banks?
d. What was investment bankers' response to this problem?
e. Why does excessive debt create instability in a financial system? Explain.

Section 7.11 Fatal Flaw #6: Dicey Financial Products

Terms to Consider:
securitization
bond
predatory lending
"moving business"
"storage business"
hedge funds
derivatives
futures trading
Chicago Board of Trade
Fischer Black and Myron Scholes
notional amount
collateralized debt obligations (CDO)
junk bonds
credit default swap (CDS)
synthetic credit default obligation
house of cards

Questions to Consider

1. Growth of Securitization
a. Why has there been a tremendous burst of speculative activity since the 1970s?
b. Why are financial products so complex?
c. Why did Wall Street revive the securitization industry?
d. What is securitization? What is its advantage?
e. Why were mortgages securitized?
f. What was the fatal flaw in the securitization process?

g. Why were mortgages prime material for securitization?
h. Why were securitized mortgages considered such a good investment?
i. What other products were securitized?

2. Bonds
a. What is a bond?
b. What benefits did bonds provide for the financial sector?

3. Mortgage Bankers
a. What problems did securitization pose to investors? What benefits?
b. Why did mortgage lenders succumb to predatory lending in the mid-2000s?
c. What does it mean that bankers had gone into the "moving" business?
d. What other factors besides the sub-prime mortgage crisis caused the 2008 crisis?

4. Hedge Funds
a. What is a hedge fund?
b. What are hedge fund investment strategies?
c. Why do hedge fund investors invest their own money in the funds?
d. What are hedge fund investors' fees?

5. Derivatives
a. What are derivatives?
b. What are the underlying assets in derivatives?
c. What are derivatives used for?
d. What is futures trading?
e. Why were futures contracts first developed in commodities markets?
f. How do farmers use futures contracts?
g. What role did mathematicians Fischer Black and Myron Scholes play in the derivatives market?
h. What is the notional amount? Why it is so high?
i. Explain why derivatives are a double-edged sword?
j. Why were derivatives a tool well suited to deception in the financial industry?
k. What does Warren Buffet think of derivatives?

6. Collateralized Debt Obligations (CDO)
a. What are collateralized debt obligations (CDO)?
b. What are junk bonds?
c. What is the relationship between CDOs and junk bonds?
d. What are CDOs squared?
e. What are the problems with these financial products?

7. Credit Default Swaps (CDS)
a. What is a credit default swap (CDS)?
b. What were the problems with the CDS?

8. Synthetic Credit Default Obligations?
a. What is a synthetic credit default obligation?
b. What is a synthetic CDS?
c. How did General Electric use a CDS in the example in the book? Does this seem legitimate?

9. Insights: Financial Products

a. How were the financial products leading up to the financial crisis like a house of cards?
b. How did other countries around the world suffer from these risky financial products?

Section 7.12 Fatal Flaw #7: Financial Speculative Mania

Terms to Consider:
speculation

Questions to Consider:
1. Speculation
a. What is the relationship between the deregulation of financial markets and the burst of financial speculation?
b. What does Nomi Prins mean when she says that finance is one of the few disciplines based on the creation of absolutely nothing?
c. Did the financial products created by Wall Street contribute to the real economy?
d. In what areas has the financial sector done a good job?
e. Why is the profitability of the financial sector dependent on speculative coups?
f. What was investor Warren Buffet's opinion about derivatives?

Section 7.13 Fatal Flaw #8: Moral Hazard and Lack of Transparency

Terms to Consider:
moral hazard
AAA rating
American International Group (AIG)
transparency

Questions to Consider:

1. Moral Hazard
a. What is moral hazard? Give some examples.
b. Explain how the market badly misjudged the risk of subprime mortgages.
c. Why would the Federal Reserve and the U.S. Treasury Department bail out some companies that undertook too much risk?
d. Do you think this is the right thing to do?

2. Transparency
a. What does transparency mean in the financial industry?
b. Why don't the big banks like transparency?

Section 7.14 Fatal Flaw # 9: Deceptive Rating Agencies

Terms to Consider:
credit rating agencies
Standards & Poors
Moody's Investors Service
issuer pays model

Questions to Consider:
1. Credit Rating Agencies
a. What is a credit rating agency (CRA)?

b. What role did they play in the financial crisis?
c. What are the top three credit rating agencies?
d. How did the credit rating agencies' compensation method used by their clients change since the 1970s?
e. Why did rating agencies give high ratings to mortgage-backed security bonds?
f. How did they profit from this procedure?
g. Why is it important that ratings of financial products are accurate?
h. How did the issuer-pays model of compensation contribute to the deceptive ratings issued by the credit rating agencies? How can this be fixed?

Section 7.15 Fatal Flaw # 10: Bloated Compensation Plans

Terms to Consider:
ephemeral
bonus
compensation

Questions to Consider:

1. Compensation Plans
a. What does it mean that the value of money is ephemeral?
b. What does it mean that Wall Street financial products do not provide any immediate benefit to most of the country? Do you agree with this statement?
c. How were many traders and bankers paid? Do you think this is fair?
d. What advantage do hedge fund managers have over average Americans in the way they are compensated?

Section 7.16 Concluding Insights: The 10 Fatal Flaws in the Financial Sector

1. Insights
a. How is Wall Street able to create their immense wealth?
b. In what ways does Main Street suffer from Wall Street's actions?
c. What can be done to stop this pattern of wealth flowing to Wall Street at the expense of Main Street?