THE ORIGINS OF THE CRISIS

A. LISTENING AND WRITING

BURNING DOWN THE HOUSE

1. Watch the video from CNBC, 29 June 2007, and complete the missing information on page 2. http://www.youtube.com/watch?v=0YNyn1XGyWg
2. What process is Steven Liesman explaining?
3. What is the purpose of the sentences marked in bold in the text?
4. Rewrite the explanation, summarising the information in one paragraph, using objective language.

B. VOCABULARY

1. In pairs invent definitions for the terms given.

a.	b.	c.
to set the bar high	to urge	to reel
market jitters	to take down a notch	tender offer
to fall from grace	junk status	dismal

d.	e.
to track developments	to be caught out
shake-out	(to come to) a sticky end
to unwind	the final throes

2. Match each term with its real definition.

C. SENTENCE SWAPS

From each of the articles that follow on pages 4 and 5, 2 sentences have been swapped with sentences from 2 other articles. The group's first task will be to recreate the original articles by replacing the alien sentences with those that belong.

1. Read your article to identify the 2 sentences that do not belong.
2. Reread your article and take notes on the content of the article. Ignore the alien sentences.
3. Explain your article to the other students in your group so that they can try to identify if yours is the text from which their alien sentences were taken.
4. As you listen to your group members' explanations, try to identify the texts from which your alien sentences were taken.
5. As a group, reassign the alien sentences to their original texts.
6. As a group, synthesise the information from the 4 articles into a graphic form, e.g. a diagram, flowchart or table. To do this you will need to decide on a conceptual analysis that classifies the information from the 4 texts.
7. Present your results to the class.

A. BURNING DOWN THE HOUSE

TV presenter:

How do you create a subprime derivative and how do you blow it up? Senior economist Steven Liesman knows and he's going to explain with the help of the ... here. Steven

Steven Liesman:

We call this Burning down the house because that's sort of what's been happening. This looks like the books of some hedge funds or investment banks we know right now, now that we have these subprimes blow up.

But what we have to do first, we have to create it first. And then we'll show you how it went bad.

Now work with me on this Bill, if you don't understand anything here, you let me know.

Now you start off very simply here. You take a bunch of mortgages here, ok, Joe, Fred, Jane, ok. They're a hundred thousand, two, or three hundred thousand dollar mortgage. You put it into one big thing. ……………………………………………………………………………..

That's step 1. We have more to go. Bear with me on this. That's the easy part.

Now, you take a bunch of these mortgage backed securities, and you put it into one very big thing. You see, that's a 50 million dollar piece, that's a 50 million dollar piece. ……………………………………………………………………………………………………
……………………………………………………………………………………………………

Now watch what we're going to do here. ……………………………………………………
………………………………………………………………………………….. Bill, you just watch. We're gonna make some good paper.

So now we have this thing here, a one billion dollar vehicle, right? Now is the tricky part because what we're going to do is we're going to slice it up into 5 different pieces, ok, 5 different pieces, call them tranches, call them levels, call them what you will.

……………………………………………………………………………………………………
……………………………… Why?

Because what we're doing here, your triple B minus tranche here, they're gonna take the first losses from whoever is in the pool. …………………………., ok, all the way up to about 8 % of the losses, these guys are assuming it. So what you're saying is: You got it, you got losses in your thing, I will absorb those losses and pay you for them. …………………………………
……………………………………………………… . All the way up to triple A where 24% of the losses are below that, ok? So the whole 24% of it has to go bad before they see any losses, and they get, you will see, a relatively low interest rate. **So what is triple A paper?** Here's what we've done. Here's the magic of this as far as Wall Street is concerned. …………………….
…………………………………………………., ok, we have a triple A tranche here, ok?

Now, we're going to show how it's blown up here. Here's a little nuclear bomb action there, ok? Here's the issue when it was issued. ………………………………………… now it's 7.7,
……………………………………………………………………………………………………
……………… Tremendous losses in there and gains for the guys that come in now and hold this paper.

What's interesting about this is that this thing suggests that there will be 80 or 90% losses and all they've been is in the 12% range. Well some guys are seeing a lot of value here.

Let's look at some of the keys to the blowup here now, ok?

……………………………………………………………………………………………………
…………………………………………….. and really caught up into the minus triple B.

If housing worsens, if things get worse from here, the big question here are ratings downgrades. If that triple A paper suddenly becomes seen as B paper or even just single A paper, …….
…………………………………………………………………………………………………….

So that's what you do, you take a whole bunch of mortgages, you put them in a pot, you slice them up and you sell them out there and the blowup has come because of a lack of belief, not in actuality, but in belief in the credit worthiness of these subprime loans.

TV presenter: There has to be a lot of faith in some of these investments that they make.

S.L.: As they said in the song, "We're in for nasty weather."

TV presenter: Thank you, that was very clear. Well done.

B. Vocabulary

2. Match each term with its definition.

1.	to set the bar high	a.	to encourage
2.	to be caught out	b.	to follow or pay attention to progress or changes
3.	to fall from grace	c.	to create a standard that will be hard for others to follow
4.	to urge	d.	to lose your high status
5.	to track developments	e.	to find yourself unexpectedly in a difficult or unexpected position because you were not prepared
6.	to come to a sticky end	f.	to find yourself in an unpleasant or very difficult position from which it is unlikely that you will recover
7.	to reel	g.	to reduce the status of something/someone
8.	to take down a notch	h.	to sell
9.	to unwind	i.	to return to a normal state
10.	to hock	j.	to react unfavourably to a shock
11.	market jitters	k.	miserable
12.	the final throes	l.	a US practice of offering securities to the public to buy by auction
13.	junk status	m.	a low rating indicating that the bond or … is worth very little
14.	shake-out	n.	uncertainty in the market, fear that the market will fall
15.	tender offer (NG)	o.	reaction to change where assets return to realistic values
16.	dismal	p.	the final stages

D. A Marxist explanation of the crisis.

Watch and listen to David Harvey's explanation of the current financial crisis. As you listen complete the charts below, then answer the questions on page 6.

http://www.youtube.com/watch?v=qOP2V_np2c0

Cause		Features	Solutions
1.	Human frailty		
2.	Institutional failure		
3.	False theory		
4.	Cultural values		
5.	Failure of policy		
6.	Internal contradictions of capital accumulation		

Case for a closer look at hedge funds

The move by Standard & Poor's to downgrade $453bn (£240bn) of General Motors and Ford debt to junk status was always going to become an event in the market no matter how well flagged. It is not every day that two of the credit market's biggest borrowers are taken down a notch. The carmakers' debt has been used in so many different structured products that some investors were bound to feel a difference.

Markets have been reeling this week with rumours that some hedge funds were wrong-footed by the development. Some which had apparently been shorting GM shares and buying the bonds were caught out when the shares rose last week following a tender offer by Kirk Kerkorian, the billionaire, and the bonds fell after the downgrade.

While there is no evidence that any hedge fund faces a big liquidity crisis, market jitters over their potential exposure highlight the sensitivities surrounding these sophisticated investment vehicles. Hedge funds have not had a good year, with dismal returns from some of the most popular strategies such as convertible arbitrage. Iceland’s banks expanded rapidly by increasing overseas lending to more than 10 times the size of the country’s economy. It is difficult to track hedge fund developments closely since they are highly secretive and many of their strategies rely upon exploiting little-known niches. But hedge funds have become such large and integral players in the global financial system in recent years that their exposure and investment strategies need to be better understood by regulators. Hedge funds regularly account for a quarter to a third of equity trading volume in New York and London. They have become some of the biggest and most profitable customers for investment banks.

Regulators typically rely on the banks to ensure that funds are not taking on too much debt or exposure. But in a speech to the Bond Market Association last month, Timothy Geithner, president of the New York Federal Reserve, highlighted the concentration and growth of hedge funds in financial markets as a challenge of risk management: "Although hedge funds help improve the efficiency of our system and may also contribute to greater stability over time by absorbing risks that other institutions will not absorb, they may also introduce some uncertainty into market dynamics in conditions of stress." Add to that the fact that many of the instruments in the credit derivatives market in which many hedge funds are dealing have not been tested in a difficult environment.

The credit cycle must turn at some point, even if not now. When it does, there could be a shake-out as some hedge funds unwind their positions. As the housing market turned toxic, so the loans that Bear Stearns, Lehman Brothers, Fannie Mae et al, had cheerfully advanced, bought up, repackaged and insured, lost value. While there appears little danger to the financial system as a whole from hedge funds, regulators need to know a lot more about their activities.

The Financial Times, 12 May 2005

Lehman reports record profits

By David Wells in New York

Lehman Brothers yesterday reported record profits that surpassed analysts’ expectations, which set the bar high for rival investment banks about to report third-quarter earnings this week and next.

Net income rose 74 per cent from a year earlier to $879m (€716m) and Lehman shares rose $1.66 to $113.94 in midday trading in New York. These accounts are at the centre of the crisis.

Investors placed bets that rivals also performed well in the quarter, which is traditionally a slow period for Wall Street. Shares in Bear Stearns, which reports earnings today, and Goldman Sachs and Morgan Stanley, which report next week, posted gains.

Lehman has invested heavily in talent and businesses in recent years, expanding its ability to serve clients. Once known primarily as a bond house, it has stolen market share from rivals, including in mergers and acquisitions, and has built an investment management business and an equities franchise. It has also expanded its international operations.

Some investors may also discover they have underestimated the risks to which they are exposed.

Investment banking revenues increased 55 per cent from a year earlier to $815m, driven by debt and equity underwriting as well as success in arranging mergers and acquisitions. Lehman advised on three of the largest completed acquisitions for the quarter.

One area where Lehman Brothers has excelled is in its mortgage business. Lehman has created a business that both underwrites, securitises and trades mortgages. It originated mortgages in the US, the UK and the Netherlands and is thinking of expanding to South Korea and Japan, Mr Goldfarb [the chief administrative officer] said.

The Financial Times, 15 September 2005

Wall Street's bloody Sunday

The crisis gripping the US financial markets shows no signs of ending after an unprecedented weekend of drama

Richard Adams

Has Wall Street ever seen a weekend like the one it has just been through? Perhaps, in the depths of the great depression - but nothing in recent memory, not even the collapse of the hedge fund LTCM 10 years ago, comes close to the drama and crisis that the US financial system is going through.

In case you haven't been paying attention, here's what's happening. Richard Fuld, chairman and chief executive, yesterday said the record results this quarter proved that the company's investment over the years had increased its ability to generate earnings. Merrill Lynch, for years one of the titans of Wall Street, hocked itself in a firesale to a rival, Bank of America. And AIG, one of the world's largest insurance firms, is begging for a $40bn emergency loan from the US government to stave off its own destruction. In the words of the Wall Street Journal: "The American financial system was shaken to its core".

And that was just on Sunday. It doesn't pay to take the weekend off on Wall Street these days – it was just last Sunday that the US Treasury confirmed it was taking control of Fannie Mae and Freddie Mac – the vast American mortgage agencies – at a cost to the taxpayer estimated to eventually range between zero dollars and a few hundred billion.

And as the minutes ticked over from Sunday to Monday on the US east coast, Lehman Brothers finally threw in its towel and filed for bankruptcy. In one way or another it will be the end for a bank that started in Alabama back in 1844 – a sticky end considering that last year it had sales of $57bn and only a few months ago was named by Business Week magazine in its 50 top performing companies for 2008. (Business Week's citation, in hindsight, looks wise: "Still, the firm is highly leveraged. The final throes of the global credit contraction will test just how good it really is." Now we know.)

What links all these once-buoyant institutions? All of them – from Fannie Mae to AIG – have been caught up in the bonfire of the vanities that was the US housing market, the same underlying cause that six months ago saw the combined forces of Wall Street and Washington rush to prop up and then dismember another former investment banking stalwart, Bear Stearns.

With conventional strategies producing low returns, some hedge funds are seeking out new and more exotic products. The Federal Reserve, abetted by the US Treasury, pumped cash into the financial markets to prevent them seizing up. But their efforts were hampered by the very financial instruments that the masters of Wall Street had invented. The blizzard of options and derivatives the banks have used in recent years are Byzantine in their complexity, making it very difficult to value the potential losses on the books.

The Guardian, 15 September 2008

Bank governor says he warned of lending risks

By David Ibison in Reykjavik

The governor of Iceland's central bank has defended his controversial role in the collapse of the country's banking system, saying he repeatedly warned the heads of the banks that they were in danger but was ignored.

David Oddsson, prime minister between 1991 and 1999 and father of the liberal politics that revolutionised the economy, has fallen from grace in the aftermath of the crisis. There have been demonstrations calling for his resignation, where protesters chanted "David out!" and sang the socialist anthem "The Internationale" outside his office in Reykjavik.

Mr Oddsson said he urged the banks to deleverage.

Lehman shares have gained 30 per cent so far this year and are trading at an all-time high. When it became difficult to raise funds on wholesale markets, they turned to deposit funding by offering high interest rates to savers across Europe. Lehman Brothers, one of the largest and oldest US investment banks, is going bust, barring an unlikely last-minute government bailout.

Mr Oddsson's comments reveal worrying limits on the ability of the central bank to ensure the financial system's stability. They also contribute to the growing belief that Iceland's banks had become so economically and politically powerful that they could disregard central bank guidance.

Oversight and regulation of the banking system is expected to form a central part of the conditions imposed on Iceland by the International Monetary Fund when an expected announcement is made, possible as early as today, of a $65bn (4.7bn, £3.7bn) bail-out for the country, backed by co-ordinated action from other central banks.

The Financial Times, 24 October 2008

D. A Marxist explanation of the crisis (cont.)

1. What is meant by 'systemic risk'?
2. David Harvey claims that crises can be triggered by excessive power. In what way is today's crisis different from that of the 70s?
3. How was the crisis in the 70s overcome?
4. What factors (a chain of problems and solutions), which were the result of the solution to the 70s crisis, led to the current one?
5. What are the 3 barrier points he refers to in the accumulation of capital? How are these overcome?
6. What was happening to profits in the financial sector and the manufacturing sector during the 90s?
7. What does he imply about the future?

E. The Eurozone Crisis

1. Match each expression (a-g) with an opposite (i-vii).

a. to borrow	i.	cash-poor
b. alarmingly	ii.	to lend
c. flexibility	iii.	revenue
d. cash-rich	iv.	to expand
e. to start a rush	v.	reassuringly
f. to contract	vi.	to delay
g. expenditure	vii.	rigidity

2. Match each expression (a-g) with one similar in meaning (i-vii).

a. to undertake (to do something)	i.	to be spent
b. to set (monetary policy)	ii.	to make up the difference
c. to go (on something)	iii.	to decide what … is to be followed
d. to pour … in	iv.	to make certain
e. to plug a gap	v.	to bring about / to cause
f. to ensure	vi.	to agree
g. to engineer	vii.	go give

3. Complete each expression with the appropriate preposition.

a. to be reliant ……………… Europe
b. to withdraw ……………... the euro
c. to struggle ……………… austerity measures

4. This article was published in *The Guardian* on 11 June 2012. It has been divided into two parts. In the analysis of the financial crisis the writer essentially describes situations, evaluates situations (often as problems), describes reactions to situations and describes the ensuing consequences. In doing so he creates chains of cause and effect.
Read your part and create a flow chart to explain the chains of cause and effect. Using your flow chart only explain the course of events to your partner.

E. The Eurozone crisis (part 1)

How did we get here?

When governments borrow money **they** issue a bond which is purchased by commercial banks or institutions such as pension funds. **This** means that they are borrowing for a fixed term at an agreed rate, undertaking to return the cash at a predetermined point in the future. Among the large borrowers in the contemporary eurozone market are Spain, Portugal and Greece. **These** are regular names in eurozone crisis media reports. When the EU countries entered into the euro currency, it was agreed the new European Central Bank would set monetary policy for **these members**. **This** was good news for the weaker nations because having the support of their stronger partners meant **they** could borrow money at much more favourable rates than before. Helped by **this cheap credit**, countries like Greece, who had an Olympic Games to support, started a rush of borrowing by issuing a great quantity of government bonds.

Money out but no tax in

In Greece, much of the borrowed cash went on public sector wage rises, but without any tax increases to compensate. Debt totals rose alarmingly, and **the facts** speak for themselves:

- Britain's debt is around 63% of gross domestic product;
- Italy and Greece owe 120% and 160% respectively.

Labour costs rose alarmingly for **these nations with high debt/GDP scores**. Whereas German productivity has been steady for more than 10 years compared to the weaker nations – thereby reducing **its** unit labour costs by 3% — Greece has faced a 61% increase in **its** labour costs. **This** has made goods produced by the nation extremely uncompetitive compared with Germany. Before the introduction of the euro, Greece could have just de-valued the Drachma until parity was reached, but now, because **they** are tied into the euro, Greece no longer has that flexibility.

Competitiveness grows the market

Germany's competitiveness is also allowing **them** to grow their economy through trade with the increasingly important and cash-rich emerging market nations. **This** is not open to uncompetitive eurozone countries, as **their** cost of goods is too high. Instead, **they** rely on **their** traditional trading markets, **many of whom** are similarly struggling with recession forecasts and austerity measures.

E. The Eurozone crisis (part 2)

Stopgap liquidity

To help a country like Greece to recover, the European Central Bank has poured almost a trillion euros in to the European Banks. And while **this** is helping to plug the gap at the moment, it is becoming increasingly likely that some eurozone countries will be unable to pay back the money **they** have borrowed. **This** would mean that any contracts placed with members of the eurozone would be at risk – **they** would not be able to pay for goods or services or to borrow from **their** banks to do so. Some business sectors are suffering more than others from public expenditure cuts and austerity measures. For instance, pharmaceutical companies and suppliers of medical equipment are finding long delays in receiving payment for medicines and other products delivered to state-run health services.

Three options

There are **various options** for addressing the eurozone crisis.

- Inject enough cash into the affected countries to stabilise **their** economy;
- Support **those countries** as they go through painful and highly unpopular austerity measures to get **them** back to being competitive;
- Accept some countries withdrawing from the euro.

It is worth making contingency plans for **these scenarios** and being aware of what business with Europe might be like under **these options**. Forewarned is forearmed. Although most forecasts for this year show the UK and US in growth, the European Central Bank is suggesting that the eurozone will contract by about a quarter of 1%. With the UK reliant on Europe for 50% of **its** exports, **this contraction** affects **us** all.

Confidence

A loss of business and consumer confidence has meant businesses are saving rather than investing. Households are also saving rather than spending. In **that environment**, it's hard to engineer a recovery and [**Ø]** explains why there has been a relapse back into recession.

Competitiveness

In order to achieve recovery, it is absolutely vital for economies to take action to ensure **they** are competitive. **This** is not only on the global stage but against countries **they** are locked into monetary union with. The reality is that some eurozone countries have remained uncompetitive with high wage levels and low productivity holding back **their** chances of recovery.

E. The Eurozone crisis (cont)

5. Rewrite each piece of following information taken from the article on the Eurozone crisis in one sentence using the word given. The word must not be changed in any way.

a. ENABLED
Weaker nations such as Greece and Portugal could borrow money at much more favourable rates after they entered into the euro currency.

b. LED
Countries like Greece, who had an Olympic Games to support, started a rush of borrowing by issuing a great quantity of government bonds.

c. SPENT
In Greece, much of the borrowed cash went on public sector wage rises, but without any tax increases to compensate.

d. ALMOST
Britain's debt is around 63% of gross domestic product. Italy owes 120%.

e. DUE
Germany's competitiveness has allowed them to grow their economy through trade with the increasingly important and cash-rich emerging market nations.

f. BECAUSE
Greece has faced a 61% increase in its labour costs. This has made goods produced by the nation extremely uncompetitive compared with Germany.

g. IF
It is becoming increasingly likely that some eurozone countries will be unable to pay back the money they have borrowed. This would mean that they would not be able to pay for goods or services or to borrow from their banks to do so.

h. BECAUSE
With the UK reliant on Europe for 50% of its exports, contraction in the eurozone affects us all.

i. LED
A loss of business and consumer confidence has meant businesses are saving rather than investing.

j. BECAUSE
Some eurozone countries have remained uncompetitive with high wage levels and low productivity holding back their chances of recovery.

F. High-frequency trading: The fast and the furious

The Economist, 25 February 2012

1. Complete each gap with one suitable word.

ON FEBRUARY 3RD 2010, at 1.26.28 pm, an automated trading system operated [1] …… a high-frequency trader (HFT) called Infinium Capital Management malfunctioned. Over [2] …… next three seconds it entered 6,767 individual orders to buy light sweet crude oil futures on the New York Mercantile Exchange (NYMEX), [3] …… is run by the Chicago Mercantile Exchange (CME). Enough of those orders [4] …… filled to send the market jolting upwards.

A NYMEX business-conduct panel [5] …… what happened that day. In November 2011 it published a list of Infinium's alleged risk-management failures and fined the firm $350,000. Infinium itself [6] …… admits nor denies any violation of the exchange's rules. It takes the same line on a $500,000 fine it was [7] …… at the same time for alleged transgressions on the CME itself in 2009.

Those alleged failures pull back the curtain on some of the safeguards that are [8] …… to protect traders, exchanges and markets [9] …… erratic ultra-fast algorithms. The NYMEX panel found that Infinium had finished writing the algorithm [10] …… the day before it introduced it to the market, and had tested [11] …… for only a couple of hours in a simulated trading environment to see how it [12] …… perform. The firm's normal testing processes take six to eight weeks. [13] …… the algorithm started its frenetic buying spree, the measures designed to shut it down automatically did [14] …… work. One was supposed to turn the system [15] …… if a maximum order size was breached, [16] …… because the machine was placing lots of small orders rather than a single big one, the shut-down was not triggered. The [17] …… measure was meant to prevent Infinium from selling or buying more [18] …… a certain number of contracts, but because of an error in the way the rogue algorithm had been written, [19] …… also failed to spot a problem. To complete the catalogue of errors, the firm then allegedly breached another CME rule when an [20] …… used a colleague's trading ID to put on positions that would offset its unwanted exposures.

2. On the basis of the punctuation in paragraph 2, answer the following questions.

1. Is it possible to separate the subject from the verb with , ? If yes, in what circumstances?
2. What is the difference in punctuation when a dependent clause follows the independent clause from when the dependent clause precedes the independent clause? Find two examples in the paragraph to justify your answer.
3. Is it possible to join two independent clauses with , ? If yes, in what circumstances?
4. If you join two independent clauses with *and*, *but* or *or* how do you punctuate the sentence.
5. Does every sentence have a subject?

3. Insert the necessary punctuation in the final paragraph.

this incident was unusual for ending in a fine but in other respects it was not that uncommon the “flash crash” of may 6th 2010 when american equity markets nosedived by almost 10% in the course of a few nerve-shredding minutes grabbed popular attention although it was not directly triggered by high-frequency traders the official reports suggested they helped fuel the uncontrolled selling often flash crashes result from algorithms interacting with each other and forming an infinite loop for a simplified example take two algorithms that are both programmed always to outbid the best offer in the market so they will go on outbidding each other usually such loops are spotted and stopped sometimes manually and sometimes automatically without many people noticing but the fact that they happen at all feeds the perception that today's equity markets have turned into something more akin to science fiction than a device for the efficient allocation of capital how the critics ask can anyone assess the fundamentals of a company in a fraction of a second how can lumbering institutional investors let alone the little guy hope to compete with the HFTs and what is to stop a new set of algorithms from unleashing havoc