FINANCIAL IMPLOSION: Global Derivatives Market at $1,200 Trillion Dollars … 20 Times the World Economy

By Washington's Blog

Theme: Global Economy

Global Research, May 20, 2012
Washington's Blog 20 May 2012

Top Derivatives Expert Estimates Size of the Global Derivatives Market at $1,200 Trillion Dollars … 20 Times Larger than the Global Economy

How Large Is the Derivatives Market?

Everyone paying attention knows that the size of the derivatives market dwarfs the global economy. But how big is it really?

For years, there have been rumors that there is over a quadrillion – one thousand trillion – dollars in notional value of outstanding derivatives. But no one really knew.

Even though the Bank of International Settlements regularly publishes tables showing the amounts of different types of derivatives, some of the categories are ambiguous, and so it has been hard to get a good handle on what's really out there.

For example, one blogger wrote last year:

> Estimates of the notional value of the worldwide derivatives market go from $600 trillion all the way up to $1.5 quadrillion.
>
> Smart guys like bond trader Jeffrey Gundlach said last year that we've got a quadrillion dollar derivative overhang, the government hasn't done anything to fix the basic problems in our economy, and so we'll have another crash.

But I've now found an estimate from a top derivatives expert who confirms the claim.

Specifically, Paul Wilmott – who has written numerous books on the subject – estimated the number last year at $1.2 quadrillion:

The… derivatives market … is 20 times the size of the world economy.

According to one of the world's leading derivatives experts, Paul Wilmott, who holds a doctorate in applied mathematics from Oxford University (and whose speaking voice sounds eerily like John Lennon's), $1.2 quadrillion is the so-called notional value of the worldwide derivatives market. To put that in perspective, the world's annual gross domestic product is between $50 trillion and $60 trillion.

A Clear and Present Danger to the World Economy

The size of the derivatives market is a huge threat to the world economy:

One of the biggest risks to the world's financial health is the $1.2 quadrillion derivatives market. It's complex, it's unregulated, and it ought to be of concern to world leaders ….

***

How big is the risk to the world economy from these derivatives? According to Wilmott, it's impossible to know unless you understand the details of the derivatives contracts. But since they're unregulated and likely to remain so, it is hard to gauge the risk.

But Wilmott gives an example of an over-the-counter "customized" derivative that could be very risky indeed, and could also put its practitioners in a position of what he called "moral hazard."

***

Another kind of market conduct that makes markets volatile is what Wilmott calls positive and negative feedback loops. These relatively bland-sounding terms mask some really scary behavior for investors who are not clued into it. Wilmott argues that a positive feedback loop contributed to the 22.6% crash in the Dow back in October 1987.

As we noted last year:

Bloomberg reported in May:

> Mark Mobius, executive chairman of Templeton Asset Management's emerging markets group, said another financial crisis is inevitable because the causes of the previous one haven't been resolved.
>
> "There is definitely going to be another financial crisis around the corner because we haven't solved any of the things that caused the previous crisis," Mobius said …"Are the derivatives regulated? No. Are you still getting growth in derivatives? Yes."

***

The global financial crisis three years ago was caused in part by the proliferation of derivative products tied to U.S. home loans that ceased performing, triggering hundreds of billions of dollars in writedowns and leading to the collapse of Lehman Brothers Holdings Inc. in September 2008.

Credit default swaps were largely responsible for bringing down Bear Stearns, AIG (and see this), WaMu and other mammoth corporations.

And unexpected changes in interest rates could cause a major bloodbath in interest rate derivatives.

And, no, there have not been any reforms or attempts to rein in derivatives, and the Dodd-Frank financial legislation was really just a p.r. stunt which didn't really change anything.

But the big banks and their minions claim that the huge amounts of derivatives themselves is unimportant because these are only "notional" values, and – after netting – the notional values are deflated to much more modest numbers.

But as [Tyler] Durden – who has a solid background in derivatives – notes:

> At this point the economist PhD readers will scream: "this is total BS – after all you have bilateral netting which eliminates net bank exposure almost entirely." True: that is precisely what the OCC will say too. As the chart below shows, according to the chief regulator of the derivative space in Q2 netting benefits amounted to an almost record 90.8% of gross exposure, so while seemingly massive, those XXX trillion numbers are really quite, quite small… Right?
>
> …Wrong. The problem with bilateral netting is that it is based on one massively flawed assumption, namely that in an orderly collapse all derivative contracts will be honored by the issuing bank (in this case the company that has sold the protection, and which the buyer of protection hopes will offset the protection it in turn has sold). The best example of how the flaw behind bilateral netting almost destroyed the system is AIG: the insurance company was hours away from making trillions of derivative contracts worthless if it were to implode, leaving all those who had bought protection from the firm worthless, a contingency only Goldman hedged by buying protection on AIG. And while the argument can further be extended that in bankruptcy a perfectly netted bankrupt entity would make someone else whole on claims they have written, this is not true, as the bankrupt estate will pursue 100 cent recovery on its claims even under Chapter 11, while claims the estate had written end up as General Unsecured Claims which as Lehman has demonstrated will collect 20 cents on the dollar if they are lucky.
>
> The point of this detour being that if any of these four banks fails, the repercussions would be disastrous. And no, Frank Dodd's bank "resolution" provision would do absolutely nothing to prevent an epic systemic collapse.

The original source of this article is Washington's Blog
Copyright © Washington's Blog, Washington's Blog, 2012

Comment on Global Research Articles on our Facebook page

Become a Member of Global Research

Articles by: Washington's Blog

Disclaimer: The contents of this article are of sole responsibility of the author(s). The Centre for Research on Globalization will not be responsible for any inaccurate or incorrect statement in this article. The Centre of Research on Globalization grants permission to cross-post Global Research articles on community internet sites as long the source and copyright are acknowledged together with a hyperlink to the original Global Research article. For publication of Global Research articles in print or other forms including commercial internet sites, contact: publications@globalresearch.ca

www.globalresearch.ca contains copyrighted material the use of which has not always been specifically authorized by the copyright owner. We are making such material available to our readers under the provisions of "fair use" in an effort to advance a better understanding of political, economic and social issues. The material on this site is distributed without profit to those who have expressed a prior interest in receiving it for research and educational purposes. If you wish to use copyrighted material for purposes other than "fair use" you must request permission from the copyright owner.

For media inquiries: publications@globalresearch.ca