# Derivative Dangers in Financial Markets

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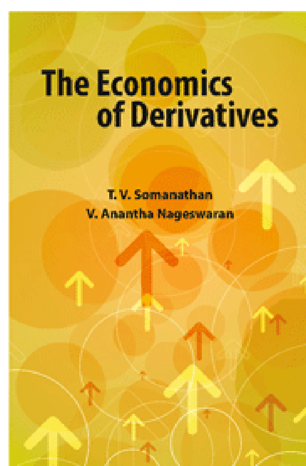


**The Economics of Derivatives**
T V Somanathan and V Anantha Nageswaran
Cambridge University Press;
255 pages; $95

International Monetary Fund chief Christine Lagarde fleetingly remarked during her recent visit to India that perhaps the IMF should have heeded the early warnings of the then IMF Chief Economist and current Reserve Bank of India governor in 2003 on the potentially catastrophic consequences of complex financial products on the global economy. Little has changed since then.

In the Indian context, the National Spot Exchange (NSEL) that traded in commodities without underlying physical stocks collapsed in 2013 inflicting a Rs 5,500-crore damage on allegedly 15,000 investors. NSEL operated in a regulatory vacuum between the Forward Markets Commission (FMC) and the Securities & Exchange Board of India (Sebi) and had evoked a sneer from the then Finance Minister P Chidambaram who derided market regulators for being unable to cope with financial innovators. Current Finance Minister Arun Jaitley endorsed this by announcing the marriage of the FMC with Sebi in his Budget speech this year. Indian equity investors are still smitten by speculation. Trading in equity derivatives by Indian retail investors has surged 27 per cent in the past six months when trading volumes in shares have remained flat.

Are financial markets deceptively healthy? Is financial innovation inherently anti-Volckerian? (Former US Federal Reserve Chair Paul Volcker famously said the only useful financial innovation to mankind is the ATM machine.) Is a unified regulator the answer to financial instability? A brilliantly researched, engagingly pertinent, albeit understandably dour, book *The Economics of Derivatives* by T.V. Somanathan and V. Anantha Nageswaran provides some nuanced answers to these questions. (Disclosure: I have collaborated with the authors individually on various opinion pieces.) Through a blended lens of an academic, practitioner and policymaker, the authors have made an earnest attempt to provide insights into the economic utility of financial derivatives. This is particularly relevant in the Indian context where speculative derivatives trading is nearly 20 times larger than spot equity trading, one of the highest in the world.

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Osama bin Laden could have well caused the global financial crisis of 2008; policymakers should adopt the Hindu cosmic calendar of Brahma where a day equals a year in the life of a man; a credit default swap, that financial weapon of mass destruction as Warren Buffett characterised it, was actually never a swap and was disingenuously named to escape regulatory oversight; the global experience of a unified regulator is mixed and there is no overwhelming evidence of a net positive impact. These are some of the intriguing and provocative observations that the authors make, backed by rigorous thought and research.

The book expectedly traces the history of derivatives and, refreshingly, also its economic impact. Laced with examples from the real world including one of the famous Tirupur incident, the book adopts a textbook mix of charts, numbers and narratives. The text elegantly breaks down complex financial jargon into comprehensible prose and doesn't contain a single Greek alphabet, a remarkable achievement for an economics textbook! The authors don't pull their punches on the dangerous trend of excessive financialisation of economies by devoting an entire chapter exclusively to critique and references throughout the book to the catalytic role played by the celebrated former US Federal Reserve chairman Alan Greenspan.

The book dwells extensively on both the stabilisation and destabilisation impact of financial derivatives and articulates the need for continuous monitoring of the derivatives market so as to not let the tail wag the dog. Smart charts such as the one on crude consumption versus crude futures trading volumes are plentiful, making it on the whole a very intelligent book. The book also contains an overall framework for regulating derivatives and attempts to answer the more fundamental question of whether regulators should stifle financial innovation in the absence of an ability to regulate them.

Given the authors' backgrounds as practitioners, commentators and policy maker in India, it disappointingly doesn't provide forthright answers to the peculiar Indian financial markets' issue of unbridled derivatives trading and if/how/when to address it through policy measures. It is also not resoundingly clear from the book if the economic costs of derivatives outweigh its benefits. In true derivatives' style, the authors seem to have hedged their answer to this question!

Nevertheless, the book swerves eloquently from fundamentals of derivatives to its history to the rapid embrace of liberal economic thought globally to the role of derivates in the global financial crisis of 2008 to the current perilous state of excessive financialisation to a first principles' recommendation of regulating financial innovation.

Overall, amidst the current backdrop of the SEBI-FMC merger, Financial Sector Legislative Reforms Commission recommendations and the mirage of a booming financial market, this book is timed perfectly with well-researched arguments that our policy makers, industry practitioners and academics could do with.