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The standard deviation that will kill us all

by Anthony K. Wikrent

Readers of *EIR* may have recognized that the cover story of the March 29 issue of *Forbes* magazine was the Anglo-American financial establishment's response to Lyndon LaRouche's proposal, issued on March 9, to impose a universal tax on all sales of financial derivatives. *Forbes,* of course, made no explicit mention of LaRouche or his proposal, referring derisively only to "critics who long for a simpler variety of capitalism—or for no capitalism at all," at the end of its seven-page paean to the goddess Fortuna.

Unfortunately, the irony of *Forbes*'s implicitly arguing that derivatives merely represent the latest, albeit bewilderingly complex, development of "capitalism," is lost on most people, since they mistakenly believe that monetary and financial processes alone comprise an economy. The fact is that the monetary and financial processes superimposed on the world economy by the financiers of the cities of London and New York do *not* represent capitalism. This is highlighted by two recently released reports, one from the Bank for International Settlements (BIS) and the other from the U.S. Federal Reserve. Both are part of an ongoing discussion about how to regulate trading in derivatives. The LaRouche "sales tax" proposal, one-tenth of 1% on the notional value traded, levied on every sale, would settle the matter quite readily, and permit the necessary re-regulation of financial markets.

$1.7 trillion a day

What *Forbes* venerates is a financial and monetary system in which *$1 trillion every business day* changes hands in the world's foreign exchange markets; $600 billion in underlying values (notional principal amount) is traded in the U.S. futures markets; $107.8 billion in U.S. government debt instruments is traded; and $15.7 billion in U.S. corporate debt changes hands. And, oh yes, for those who still follow the Dow Jones Industrial Average, $5.2 billion in corporate equities changes hands on the New York Stock Exchange every day.

This is not capitalism. It does not even deserve to be called a "system." It is monetarism and usury, unleashed, untrammeled, run amock. It is a parasite that has become tens of times larger than its host.

Back at the beginning of the U.S. republic, some had a good idea of what capitalism is. Alexander Hamilton, in No. 15 of *The Federalist Papers,* devised a test, succinctly expressed in only one sentence: "Is private credit the friend and patron of industry?" Of course, in those days, they also had a good idea of what industry is. There are today, for example, fools who talk, with completely straight faces, about the "leisure industry," referring to chains of hotels with too many rooms and too few vacationers; or the "gaming industry," referring to the vice of gambling; or the "entertainment industry," referring to a process of national menticide.

The point is, that the financial and monetary system must be subordinated to the primary task of the economy—which is the organization of the means and powers of production for the purpose of applying the scientific and technological fruits of creative human mentation to the useful transformation of nature and natural resources; "useful" meaning that it aids and abets the human race in the birth, raising, and sustenance of successive new generations. It is the same point made by Sony founder and chairman Akio Morita, when he says that finance should serve to smooth the way for production.

Pax Britannica

Part of the problem today is that the financial and monetary system is dominated by the enemies of Hamilton. Last

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month, the BIS issued a new report, entitled "Central Bank Survey of Foreign Exchange Market Activity in April 1992," which shows that foreign exchange trading worldwide increased 42% from April 1989 to April 1992, to an estimated $880 billion per business day. This $880 billion is an adjusted figure, with double-counting netted out. The key feature to focus on is that London has increased its share of world currency trading, from 25% in 1989 to nearly 30% in 1992. London now trades more dollars and deutschemarks than the United States and Germany.

Trading in London is also increasingly concentrated, with the 10 most active banks in the city accounting for 43% of trading in 1991, compared to 36% in 1986, according to a report issued last year by the Bank of England. That means that 10 British banks alone account for nearly one-fifth of the $1 trillion of world currency traded every day. (One trillion dollars is a new estimate by the BIS, issued for the Group of Seven meeting in December.) It gives an entirely new meaning to the adage, "The sun never sets on the British Empire."

Increasing risk, fewer firms

The financial derivatives market in the United States is similarly becoming more concentrated. According to a new study by the U.S. Federal Reserve, the Federal Deposit Insurance Corp., and the Office of the Comptroller of the Currency, entitled "Derivative Product Activities of Commercial Banks," increasing concern about the credit worthiness of counterparties to a derivative transaction is directing more and more of the business into fewer and fewer hands. As a result, the study found, the derivatives position of Citibank, Bankers Trust, and J.P. Morgan rose over 33% in 1992. The three banks had over $2 trillion in principal notional value of interest rate-related derivatives at the end of 1992, up from under $1.5 trillion a year before, and $1.8 trillion of notional values in foreign exchange related derivatives, up from $1.4 trillion at the end of 1991. This means that these three U.S. banks alone account for about one-third of all the interest rate and currency swaps outstanding.

A previous study by the BIS, "Recent Developments in International Interbank Relations," issued in October 1992, noted the reasons for increasing concentration in the derivatives markets. "Over the past few years, a number of wholesale markets have shown clear signs of greater concentration of activity among the financial firms with top credit status. This seems to be particularly true of those highly rated firms that have the capital to take large positions, and possess the technical expertise and the information processing and communications systems needed to manage books globally. There also appears to be a greater tiering among market-makers between firms that can handle the origination of very large transactions and smaller players which focus more on the distribution of instruments to their customers."

The BIS report mentioned, but did not detail, that the collapse of Drexel Burnham Lambert in 1989, which reportedly forced the U.S. Federal Reserve and the U.S. Treasury to step in and help dismantle and offset tens of billions of dollars worth of derivatives contracts, and the U.S. bond-bidding scandal around Salomon Brothers in 1991, had created greater caution in the selection of counterparties and bank intermediaries. An additional consideration in the selection of a bank intermediary has been the implementation of the Basel Capital Accord, mandating minimal capital requirements for all banks whose countries are members of the BIS.

The BIS report warned that "the perceived credit standing of a financial institution can deteriorate rapidly. Since the failure of one such key player would entail larger losses to other participants in the markets than if exposures were more dispersed, increased concentration implies that financial market stability could be affected more heavily than in the past by the sudden decline of any such firm."

Among the recommendations of the October 1992 BIS report was that participants in the derivatives markets be compelled to mark their instruments to market value at the end of each business day. But in the United States, there has been strong resistance against the promulgation of such rules by the Federal Accounting Standards Board.

The third standard deviation

Business Week also carried an article about derivatives in its March 29 issue. Like the *Forbes* piece, it began with a discussion of Salomon Brothers.

Forbes began by enthusiastically describing how Salomon had sold Boeing warrants in Frankfurt on March 9, even though Boeing had never issued or authorized any warrants for sale in Germany. As *Forbes* happily described it, Salomon "created the security out of thin air, hedging itself by buying shares of Boeing and also buying unlisted puts from a source it won't reveal."

Business Week, however, noted that on March 4, Salomon announced it had lost $250 million from trading for its own account. "What in God's name could you do in two months to lose a quarter-billion?" *Business Week* quoted one Salomon rival asking rhetorically.

The question was answered at the end of the article: The assumptions used to program the computers on Wall Street are proving to be all wrong. "The models are fine, given the right volatility assumptions," said First Boston Corp. director Andrew S. Carron. But, "there's no way of knowing for certain that you've put in the right assumptions."

Stephen Robert, chairman of Oppenheimer and Co., told *Business Week,* "Risk managers at brokerage firms talk about [being hedged enough to protect themselves if prices move] two standard deviations from the norm. However, it's the third standard deviation that happens once in a blue moon—that's what kills you."

The real problem, of course, is that until it's understood that those processes are actually "cancerism," there are going to be a lot more blue moons.