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EIR Economics

Derivatives tax is attacked at hedge fund hearing

by Richard Freeman

On April 13, at a hearing on a new financial speculators' instrument called hedge funds, Rep. James Leach (R-Iowa) launched into an impassioned attack against any attempt to tax hedge funds and other financial derivatives out of existence. Without naming names, Leach was attacking the author of that tax proposal, Lyndon LaRouche, who on March 9, 1993, proposed a 0.1% federal tax on each separate derivatives transaction.

The hedge fund hearing was called by Rep. Henry Gonzalez (D-Tex.), chairman of the House Banking Committee. Hedge funds employ mountains of leverage, borrowed primarily from banks, to massively speculate on the derivatives markets.

During his testimony, Congressman Leach, who is also notorious as a co-conspirator on the Whitewatergate assault on the presidency, got each of four government regulators present to second his opposition to any attempt to control what LaRouche has identified as the biggest financial bubble in world history. "Do you think we should be toying with taxation?" Leach asked. Comptroller of the Currency Eugene Ludwig fumbled about for an answer, which amounted to "no." Federal Reserve Board Governor John LeWare was more adamant: "Taxation is the power to destroy. It could drive derivatives offshore," he warned, adding, "the financial markets are one of America's crown jewels." Securities and Exchange Commission Chairman Arthur Levitt, Jr. said he had "grave reservations," about a tax and that instead all that was needed was "more disclosure." Commodity Futures Trading Commission acting chairman Barbara Holum echoed Levitt.

These four financial watchdogs' collective "no" to a derivatives tax was in keeping with their other absurd testimony that the financial markets, which liquidated nearly $2 trillion in face values in the first quarter of 1994, are functioning "perfectly" and "just fine."

Two factors triggered Leach's wild tirade. First, on the day before the hearing, Representative Gonzalez introduced as legislation HR 4170, the "Derivatives Safety and Soundness Act of 1994," which includes a provision for the U.S. comptroller general to complete a study that "evaluate[s] the feasibility of imposing a tax or transactions fee on speculative derivative contracts and estimate the expected revenue." No specific amount for the tax is entered into the bill. But on March 28, Gonzalez made clear his thinking, stating, "I think ultimately, the only way you could stop, in fact, overnight, [derivatives trading activity, is] if you imposed a 0.1% tax on those transactions. You'd see an immediate deflation."

Second, Leach, and just about everyone else, knows that Lyndon LaRouche, an announced 1996 U.S. presidential candidate, is the author of this derivatives tax proposal. He can recall that LaRouche's 1993 proposal was printed up and distributed in the tens of thousands of copies, and was the subject of previous House Banking Committee written testimony on Oct. 28, 1993, as well as written testimony submitted to the April 13 hedge fund hearing. Implementation of LaRouche's proposal would restore America and its credit system to the rule of law. It would create the circumstances in which the structure of the derivatives markets might be properly investigated. Moreover, this tax constitutes a precise means to surgically lance and dry out the derivatives bubble, by erecting a tax barrier on the high turn-over use of derivatives.

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Danger of $2 trillion meltdown

But things have gotten worse since LaRouche made his proposal last year. The turbulent financial events of the first three months of this year prove that while the tax is still essential, by itself it will not be sufficient to control the coming collapse. It has now reached the point where *the derivative transactions which are subject to taxation are themselves in the process of collapsing. What is needed now, is an answer to the question: Is there life after the derivatives bubble is dead and gone?*

A global financial collapse is already in progress, and has been so since before the beginning of the year. From 1993 onward, the collapse has been global in scope: from Chile, and the case of the Codelco raw materials company; to Argentina, and its bond and stock market; to Venezuela and the case of Banco Latino; to Spain and the multi-hundreds of millions lost by that country's fourth-largest bank, Banesto; to the United Kingdom and the Hongkong and Shanghai Bank-owned Midland Bank; to France and the case of the multibillion-dollar loss at Crédit Lyonnais; to Germany and the $1 billion-plus loss by the non-ferrous metals firm Metallgesellschaft; to the reputed several billion-dollar losses at Malaysia's cental bank, and the banks of Indonesia. All these losses were related to derivatives trading.

If one takes the decline in U.S. bond prices, in the range of 14-15% over the last 90 days, as a general measure, which is also matched or exceeded by the range of fall in certain stock markets around the world, as well as in certain specialized markets, such as the intensely illiquid market in mortgage-backed securities, then the nominal first-quarter bill for the losses in notional, and where applicable actual cash value, of all derivative and spot-cash markets will total $2 trillion. This is not the market "blowing off" excesses; it is not a market correction. Rather, *this is reverse leverage with a vengeance: the collapse of the biggest financial bubble in history.*

At this point, only fundamental economic policy changes to rebuild a new financial and monetary system, will do any good. Federalizing the Federal Reserve System, under the provisions of Article I, Section 8 of the U.S. Constitution, is a first order of business. The country needs a reorganized credit system to create qualified employment for people through rebuilding basic economic infrastructure in transportation, power generation, and water supply and capital goods production. Similar emergency programs are now on the table for every country on the globe.

Casino economics

Unfortunately, little of this sense of reality penetrated the hearing on hedge funds. The mere catalogue of wreckage in recent weeks shows hedge fund losses of the size that even a few years ago would have been unthinkable; from the $600 million lost by speculator George Soros's Quantum Fund on one day, Feb. 14; to the $1 billion loss of Steinhardt Management's hedge fund; to the early April bankruptcy liquidation of the entire market holdings of the $600 million in assets, exotic mortgage securities derivatives, of David J. Askin's hedge funds.

Hedge funds are effectively gambling pools, in which a group of investors who have to ante up starting values of between $250,000 to $1 million apiece, put their money at the disposal of a gun-slinger investor, who will manage the money as if it were his own. Meanwhile, this general manager of the fund, called the senior partner, promises to make as much money in any way possible, using whatever market—options, commodities, currencies, stocks—is most promising. The idea is to use piles of borrowed money, or leverage, increasing one's rate of return several-fold.

Hedge funds work on anywhere from 5:1, up to 50:1 leverage. I.e., for every $1 billion of the hedge fund's own money under management, it borrows from $5 to $50 billion. The over 300 hedge funds have $75 billion in assets under management, meaning they could control an astounding $375 billion to $3.75 trillion of publicly traded bonds and stocks. By comparison, the average trading volume on the New York stock exchange is but $11 billion daily.

The hedge funds are set up under contrived legal arrangements to stay outside the reach of most regulation. They usually have 99 or fewer U.S. investor partners, in order to circumvent the Investment Company Act of 1940, which would otherwise regulate them. They are also structured to evade the Securities Act of 1933. Hedge funds are often set up off-shore so that foreign investors avoid U.S. tax laws, and U.S. investors lessen their taxation.

From mid-March through mid-April, hedge fund operators, combined with other derivative market players, dumped hundreds of billions of dollars of U.S. Treasury and foreign Treasury bonds, sending the market crashing. Yet, when questioned on this subject at the Gonzalez hearing, each of the four regulators said two contradictory things: a) that there was and is no market crash, just a tiny correction; and b) that while some serious damage resulted, neither the hedge funds, nor derivatives traders, nor banks, etc. were responsible for the damage. That is, they insisted that nothing happened; but if something did happen, no one was responsible.

Asked by a congressman if the situation of the past months was not parallel to the 1980s collapse of the real estate market caused by incompetent investors, Fed Governor LeWare defiantly responded, "The real estate market was overbuilt. Today, the stock and bond markets were overbought. That's all—just a healthy correction." When asked about the risk posed by hedge funds—and, by implication, derivatives—LeWare trumpeted, "They are no significant risk." Do hedge funds pose a threat to the banking system, which is the largest lender to the hedge funds? Currency comptroller Eugene Ludwig reeled off this formula: "Hedge funds do not pose a systemic risk to the banking

system. . . . Our examiners report that those banks are adequately controlling their risks."

A worm-like George Soros

The hearing reached its nadir with the testimony of megaspeculator George Soros, whose highly anticipated appearance drew a mob of 250 press and others. The popular press never fails to portray Soros as very intelligent and smooth, a worldly figure. But upon hearing him testify for nearly two hours, that impression is quickly changed. Under his smooth persona, one can perceive an obsessively object-fixated person, whose answers become very predictable, uttered in short, hack-like phrases. Moreover, Soros frequently contradicted himself, withdrawing what he had said only five minutes earlier. One had the strong impression of witnessing the testimony of a worm.

Unfortunately, Soros's testimony was never challenged. Soros was unctuously introduced for 10 minutes by Rep. Tom Lantos (D-Calif.), a leading hit-man for the Anti-Defamation League of B'nai B'rith, who called Soros "a close friend of many years," both having been born in Hungary. Lantos hailed Soros's private philanthropy work in the former East bloc, which, as *EIR* has reported, is nothing more than a controlling mechanism for the International Monetary Fund's disastrous shock therapy policies.

Soros said that there are those who have "spread lies about how I make my money." Engaging in classic misdirection, which no one in Congress tripped him up on, he said that mutual funds were responsible for the market downturn, and so were the banks and people using derivatives—but not his own Quantum Fund's use of derivatives. "As far as my hedge funds are concerned, I believe you are looking in the wrong place." He insulted Congress, stating that "Frankly, I don't think hedge funds are a mater of concern to you [Congress] or the regulators." Then, contradicting himself, Soros told Congress that hedge funds needed more regulation. Under questioning later, he reversed himself again, saying, "Banks monitor hedge funds better than they do other customers. There's really nothing to regulate on hedge funds."

Soros was asked why his Quantum Fund, which is heavily dominated by the Rothschild bank, could not possibly go afoul or create problems. his arrogant reply: "I own a large share of my own company. That's the best guarantee it will not be over-leveraged." No congressman even questioned that cheap salesman's "trust me" ploy. Soros also asserted, "I see no imminent danger of a market meltdown or crash."

Yet Soros repeatedly made statements that provided enough rope to hang himself and the four regulators who testified before him, if any congressman had been alert. For example, he stated, that "instruments of hedging [such as derivatives] pass risk onto the system," creating and building up systemic risk as a function of derivatives trading. This is exactly what every bank and derivatives trader denies has happened over the last five years.

China model is heading for a crash

by Michael Billington

The much-heralded "China model," which has been based on the promise that a large accumulation of capital can be squeezed from an impoverished peasantry deployed as cheap labor in low-technology export industries, is fast approaching its unavoidable breakdown crisis. During March, Beijing's economic leaders scrambled to reimpose state controls on several sectors of the economy, in an effort to stop both the 20%-plus inflation and the uncontrolled speculative investment in real estate, smuggling, drugs, and sweatshop light industries.

There are serious questions, however, as to whether or not the central government can enforce the new controls in the face of regional resistance, which is being sponsored and supported by British-based operations to split China, or at least to so weaken the central government that the foreign "globalization" looting spree is not disrupted. Britain's foremost geopolitical policy think-tank, the International Institute of Strategic Studies (IISS), released a report entitled "China Changes Shape: Regionalism and Foreign Policy," written by senior fellow Gerald Segal, which explicitly calls for western nations to deal directly with the governments and businesses in regional centers, especially in Guangdong province in the south, rather than with Beijing. "It may be," the report states, "that the only way to ensure that China does not become more dangerous as it grows richer and stronger is to ensure that in practice, if not in law, there is more than one China to deal with." This is, of course, a policy oft repeated over the 150-year history of British operations in China.

The IISS report points out that the People's Liberation Army still represents centralized authority; but the increasing involvement by both the Army itself and by the individual officers in money-making ventures has created strong interests linked to the regional economies. Meanwhile, Segal writes, "Beijing [can] no longer impose austerity measures on the national economy, and rich provinces [can] raise funds from local investment and abroad." This refers primarily to the fact that Hongkong (i.e., British) banks and investors can issue credit directly in Hongkong dollars, which are now accepted as legal tender in Guangdong province.

The IISS program is being realized in the current crisis.