Showdown coming on derivatives as Gonzalez, Fed square off

by Anthony K. Wikrent

The stage appears set for a dramatic showdown later this year, over the regulation of the $35 trillion derivatives market, between the Committee on Banking, Finance, and Urban Affairs of the U.S. House of Representatives, and the U.S. Federal Reserve System. In a news release dated Aug. 31, Banking Committee Chairman Henry B. Gonzalez (D-Tex.) announced that the committee was initiating an investigation into the situation of Charles County, Maryland, which effectively lost all of its operating budget because of soured investments in derivatives. Gonzalez also vowed to press ahead with legislation to tighten regulation of derivatives. Just one day later, the U.S. Federal Reserve released an "unofficial" study warning that any attempt to crack down on the market in U.S. government bonds—the world's second largest basis for derivatives, after foreign exchange—could force trading to shift overseas.

The stark contrast in the approaches being taken by Gonzalez and the Federal Reserve demonstrates once again that the Fed is entirely a creature of the money center banks it supposedly is regulating, and that not until central banking is replaced by national banking will problems such as derivatives be eliminated.

Local taxpayers burnt

The immediate impetus for Representative Gonzalez's statement is the announcement by Charles County (about 40 miles southeast of Washington, D.C.) in late July, that its entire operating budget of $27 million had been frozen because of $1.3 million in losses on investments in financial derivatives (see *EIR,* Aug. 19, 1994, p. 4). Derivatives are financial contracts whose value or market price is based on another, or index of other, financial contracts.

In his statement, Chairman Gonzalez said, "Now that local taxpayers have been added to the long list of Wall Street mutual funds and private companies that have been burnt by derivatives, it is even more imperative that Congress pass legislation regulating the volatile and at times risky, derivatives business. . . . How many more firms, pension funds, and counties are we going to read about losing money due to derivatives before the Congress takes action?"

For the past two years, regulators, derivatives dealers (the large investment and commercial banks that create, sell, and trade derivatives), and the financial press have not only debated what to do about derivatives, but also mused about how large the market might be. On Aug. 25, the *Wall Street Journal* published an estimate accompanying a front-page article on derivatives, giving a figure of $35.098 trillion invested in derivatives worldwide. That is double the amount calculated for the end of 1992 by the congressional General Accounting Office in its May 1994 report on derivatives. The *Wall Street Journal* calculated that the derivatives markets are now about three-quarters the size of the total cash, bonds, and stocks in the entire world (which the *Journal* calculated to be $47.800 trillion).

The LaRouche proposal

In March last year, U.S. physical economist Lyndon LaRouche proposed that all derivatives transactions be taxed at the rate of one-tenth of 1% of their notional values as a means of assaying the market, and beginning to rein in the most speculative, highly leveraged abuses. In October, Gonzalez's Banking Committee began a series of hearings on derivatives, during which it became apparent that the dealers and the Federal Reserve were not above outright lying in their attempt to prevent regulation of their $35 trillion shell game.

These Banking Committee hearings were lent urgency by the spectacular corporate failures of Ferruzzi in Italy and Metallgesellschaft in Germany, stemming from enormous losses in derivatives investments by those companies. In January, sudden action by the governments of Germany and Japan precipitated billions of dollars in losses by U.S. hedge funds. In February, the first of several interest rate hikes by the U.S. Federal Reserve touched off a still-continuing series of derivatives losses in the portfolios of companies, pension funds, mutual funds, and state and local governments.

New losses are being reported almost every day. In another article on Aug. 25, the *Wall Street Journal* reported that U.S. financial firms, hoping to avoid long and far more costly court fights, have shelled out $425 million since May to make

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good clients' losses on derivatives.

But almost twice that amount may have been lost by one mutual fund firm alone, Piper Jaffray, which had up to 60% of the money in its care in derivatives. Reportedly, there were hundreds of local governments, especially in Minnesota, that had invested in Minneapolis-based Piper Jaffray's funds. In his statement on Aug. 31, Gonzalez noted that "clearly, there is a huge number of supposedly sophisticated managers of public funds, mutual funds, corporate and pension funds, who don't really understand the risks of arcane derivatives."

Worse than the S&L crisis

Representative Gonzalez and other members of Congress are especially worried that these derivatives losses may be developing into a disaster on a bigger scale than the savings and loan crisis.

"Although the banking regulators who came before the committee last October assured me that they were on top of the derivatives situation, I don't share their confidence," Gonzalez declared on Aug. 31. "Having lived through the S&L crisis, I know all too well that the regulators are not always on top of a situation."

In the United States, regulation of derivatives is segmented among several different agencies. The Federal Reserve oversees most commercial banks, and is the agency which conducts government interventions in the foreign exchange markets, while the Comptroller of the Currency (part of the Treasury Department) oversees nationally chartered banks. The Office of Thrift Supervision oversees what remains of the Savings and Loan institutions. The Securities and Exchange Commission oversees investment banks and the stock and bond markets. The Commodities and Futures Trading Commission oversees the futures markets.

What to do with an instrument sold by a commercial bank, which is based on the point spread between U.S. future long-term bond yields and Japanese bonds? It is exactly by operating in such "gray areas" between regulatory authority that derivatives have been able to grow so explosively. And in some cases, such as with the three large U.S. insurance companies that have emerged as large derivatives dealers, there is no regulatory oversight at all.

Traders fear regulation

The focus of the Aug. 25 *Wall Street Journal* article is the increasing hysteria of derivatives dealers as they try to contain growing congressional and regulatory pressure for bringing derivatives under control. The *Journal* reported that Ernest Patrikis, general counsel of the New York Federal Reserve Bank, recently warned dealers, "Should a major corporation fail, and throw thousands of people out of work, there will be legislation. The attitude in Washington is, 'This won't happen on my watch.' "

Patrikis' statement is especially significant, because amidst all the confusion, the Federal Reserve has attempted, with some success, to elevate itself to a position of an overall primary regulator of derivatives, by claiming concern for financial stability in *all* markets. The problem is that the Fed, as is typical for a central bank, makes no distinction between money and wealth.

Central versus national banking

Money represents wealth created by society in the past. Money itself is not wealth. Money is merely the paper representation of wealth. The crucial problem with derivatives is that they generate new money without also creating new wealth. Thousands of years of history show that allowing new money to be created without also creating new wealth is a sure recipe for economic and financial catastrophe.

This is why central banking must be replaced by national banking. Under national banking, government of the people ensures that credit obtained from the people, is used to build infrastructure projects for the benefit of the people: clean water and sanitation systems, flood control, ports and harbor improvements, highways, railroads, especially projects using advanced technology such as magnetic levitation systems. The building of such projects ensures that the water, transport, power, and other necessities of life are available to ensure that people do not perish from the earth.

But, the Federal Reserve's operating branches are owned by the commercial banks the Fed is supposed to be overseeing; hence, the Fed has no interest in making any distinction between wealth and money. It should thus be no real surprise that a Federal Reserve study released on Sept. 1 warned that any attempt to regulate the market for U.S. government debt—which the study estimated to have a turnover of about $400-550 billion a day—would lead to market participants and activity fleeing overseas to foreign financial centers.

On the face of it, the warning is laughable. The Fed study itself admits that trading in New York dwarfs that in London and Tokyo, which together account for only about 4% of all U.S. bond trading volume. It would be a matter of months, perhaps years, before the structure needed to support such a volume of trading could be put in place overseas. And with the proper type of capital controls, such as those imposed in Venezuela in August, the U.S. government could easily prohibit trading in its debt overseas.

No, the Federal Reserve study is actually a warning by the derivatives dealers to the Congress and others to lower the heat. But the nation cannot afford *not* to call their bluff. As Representative Gonzalez said at the end of his statement, "Despite the concerted and well-funded lobbying effort to derail any derivatives legislation, I am determined that we pass some type of legislation lest we risk another crisis like the savings and loan situation. To do otherwise, Congress would be abrogating its oversight role, and shortchanging the American taxpayer."