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Derivatives whirlwind could sweep away markets

by Anthony K. Wikrent

Just like the swirling winds of a developing tornado or hurricane, the $1 trillion-plus a day derivatives markets continue to surge to new levels of velocity. But recent statements by prominent elites suggest a growing awareness that the world's financial markets are about to be swept away in a whirlwind of derivatives destruction, just as U.S. physical economist Lyndon LaRouche forecast in June of this year.

Derivatives are financial contracts the value or market price of which are based on (hence, "derived") from other, underlying contracts, or indices of other contracts. The *Wall Street Journal* has estimated that the notional amount of derivatives outstanding at the end of 1993 in the world was $35.098 trillion, almost exactly three-quarters of the total $47.8 trillion of bonds, cash, and stock outstanding in the world. By contrast, the estimated Gross Domestic Product of all countries in the world is about $23 trillion.

In a news release dated Sept. 12, the International Swaps and Derivatives Association (ISDA) announced that the notional amount of swaps outstanding jumped 58.5% at year-end 1993 to $8.475 trillion, compared to the end of 1992. Swaps are one of the five major types of financial derivatives, and are "over the counter" (OTC); that is, they are not traded on a financial exchange, as are futures and options (the two major types of derivatives that are traded on exchanges, and hence, are called "listed").

Swaps are contracts in which two counterparties agree to exchange payments based on respective principal amounts that have different characteristics. According to the ISDA news release, $1.398 trillion of the swaps outstanding was accounted for by more exotic contracts, such as caps, floors, collars, and swaptions (a form of a swap tied to an option). An excellent indicator of where the derivatives market is heading is the fact that the amount outstanding of these more exotic contracts more than doubled, from $634.5 billion outstanding at the end of 1992.

On Sept. 13, the Chicago Mercantile Exchange (CME)—the largest financial marketplace in the world—began trading in currency forwards denominated in deutschemarks. These are the first forwards to be listed on an exchange. Previously, forwards were OTC customized agreements between two companies that exchanged like amounts of principal, each in a different currency, on an agreed-upon future date. There were an estimated $9 trillion of forwards outstanding as of the end of 1993—the largest of the major types of derivatives.

The real attractiveness of the new exchange traded forwards, the Merc boasts, is that when traded in conjunction with deutschemark rolling spot futures contracts, the interest rate differentials between the United States and Germany can be "captured." This marks the new exchange-traded forwards as a highly speculative instrument, with no real relationship to raising capital for economic activity. Moreover, the *Financial Times* noted that a bank trading the CME forwards does not have to meet the capital requirements for forwards laid down by the Bank for International Settlements.

Confirming the explosive growth of derivatives, the Merc boasted that trading in August set another record, totaling 16,473,911 futures and options contracts worth $13.2 trillion in underlying value. With year-to-date volume up 55.4%, trading at the Merc so far this year has already surpassed the volume of trading for the entirety of 1993.

Did derivatives work for Wall Street?

But the foundation beneath this rococo facade is developing cracks that are becoming chasms that will swallow

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the whole structure. During the second quarter, Wall Street posted a pre-tax loss of $623 million, its worst quarterly loss since the 1987 stock market crash, when U.S. investment banks recorded a loss of $2.33 billion before taxes in the fourth quarter of 1987. In the second quarter of 1993, U.S. investment banks posted a profit of $2.38 billion.

The losses of this year's second quarter are largely a result of the collapse in bond prices since the U.S. Federal Reserve began raising interest rates in February, and of losses in bond trading. But the point is, losses of this magnitude are supposed to be negated if not entirely eliminated by financial derivatives. As George Monahan, director of research for the Securities Industries Association, told an EIRNS interviewer on Sept. 14, the securities industry is very cyclical, and securities firms have been repeatedly caught holding large inventories of bonds when interest rates began to rise, causing bond prices to tumble.

Perhaps it is these losses that explain the sudden resignation of Stephen Friedman from the chairmanship of Goldman Sachs. The day after that resignation was announced, it was revealed that Goldman Sachs is casting about for a private investor to inject $250 million in fresh capital into the firm.

But the monotonous mantra from the investment and commercial banks that have developed and sold derivatives is that the risks of rising interest rates can be "managed" by those derivatives. What does it say about derivatives if the investment banks themselves—supposedly the most skilled adepts at derivatives—were unable to successfully manage their interest rate risk in this latest cycle of rising interest rates?

First lawsuit filed

And what about the hapless buyers of derivatives? Hoping to avoid lawsuits, derivatives dealers have paid out over $500 million since May to make good customers' losses on derivatives. The latest such instance is that of Prudential Securities, which announced on Sept. 14 that it was buying back $70 million in mortgage derivatives its brokers had sold improperly, by telling retail customers who bought the collateralized mortgage obligations that they were less risky than they really are.

The issue has finally landed in the courts: On Sept. 12, greeting card maker Gibson Greeting Inc. filed a suit in a federal court in Cincinnati seeking the restoration of $23 million in losses it suffered from interest rate swaps that Gibson had bought from commercial bank Bankers Trust, plus $50 million in punitive damages. It is believed to be the first time ever that a U.S. company has filed suit against a derivatives dealer because of OTC (as opposed to listed) derivatives losses, the *Wall Street Journal* reported.

The Gibson suit alleges that Bankers Trust, "recognizing its opportunity for gain at the expense of an unknowing customer and ignoring its obligations as Gibson's adviser and banker," sold Gibson increasingly complex derivatives over a period of 16 months, and that Bankers Trust "knowingly and deliberately did not reveal the material risks and misrepresented the nature of the transactions and thereby deceived and defrauded" Gibson.

"Bankers Trust and BT Securities repeatedly and intentionally falsely advised Gibson that by entering into proposed transactions, its risks and exposure would be substantially reduced. . . . In reality, Gibson's aggregate risks stemming from these [contracts] dramatically increased. . . . Bankers Trust failed to ensure that Gibson understood the nature of the risks inherent in these transactions."

LaRouche proposal

The portent of all this derivatives news is apparently beginning to be understood among some of the world's elites. At the yearly meeting at Bürgenstock, Switzerland, organized by the Swiss Commodities Futures and Options Association (SCFOA) held over Sept. 3-4, Lord Denis Healey, former British Chancellor of the Exchequer, reportedly noted that about 98% of all foreign exchange transactions are purely speculative and only 2% are related to the financing of world trade, and called for levying a tax on all financial derivatives transactions as a means of dampening speculation, according to the German economic daily *Handelsblatt* (see interview with LaRouche, p. 57). This is exactly the proposal first made by LaRouche in March 1993.

In the Sept. 13 issue of the Paris monthly *Le Monde Diplomatique,* senior French commentator Claude Julien, wrote in a front-page article that governments must reassert control over the liberal free markets, which have run amok and have caused massive damage to the economies of the western countries. Julien also proposed a "tax on speculative capital transactions."

But these proposals are actually too late. LaRouche now warns that the world's financial institutions must be put into bankruptcy organization by the key national governments of the world. Even this is not enough. "These measures cannot launch the urgently needed physical-economic recovery," LaRouche warned his associates on Sept. 15. "Without a dramatically accelerating physical-economic recovery, the financial reorganization will not hold for long, but will simply pass over through crises into a new process of disintegration.

"The only possibility for a physical-economic recovery is the use of state credit, by methods of 'Hamiltonian national banking,' to fund very, very, large-scale, national, regional, and global public works projects in science 'crash programs' and building of basic economic infrastructure in water-management (including ports and inland waterways), modern power systems, modern (e.g., magnetic levitation) railway nets (lessening the emphasis upon highway transport), and systems of *classical* modes of primary and secondary education and culture, health-care systems, and science and technology institutions."