

Derivatives: the last gasp of the speculative bubble

by John Hoefle

Two years ago, on March 9, 1993, Lyndon LaRouche proposed a one-tenth of 1% transaction tax on the notional principal amount of each derivatives transaction in the United States. The proposed tax would serve two functions. First, it would work to bring the derivatives market under some semblance of control and begin to let some air out of the speculative bubble, and second, it would raise an estimated \$60-80 billion in federal tax revenue the first year, and lesser amounts in succeeding years as the bubble dried up.

"Derivatives are an investment in something for which there is really no security, which takes wealth—money in the form of wealth—out of the productive and trading process, and never puts anything back in," LaRouche warned at the time. "What we have, is the prospect of a derivatives bubble which grows like a cancer at the expense of the host, and shrinks its host, at the same time that its appetite is growing, while the means of satisfying that appetite are collapsing. Not a very sound investment."

EIR took that warning to Congress, to state and local officials across the country, and to government officials and relevant individuals around the world. Most of them had no idea what we were talking about.

They do now, and many of them are beginning to admit: "LaRouche was right. We should have listened to LaRouche."

At the time of our warning, the notional principal amount—"face value"—of derivatives securities worldwide was about \$13 trillion. The face value of derivatives securities outstanding grew by \$4 trillion (33%) during 1993, to \$17 trillion at year's end. In 1994, that figure rose \$29 trillion (181%) to \$45 trillion, more than 40 times the \$1.1 trillion at the end of 1986.

Had this bubble been choked off in 1993 as LaRouche

recommended, we could have saved the world a lot of pain.

Compare the growth of derivatives worldwide to the growth of U.S. Gross Domestic Product (GDP). U.S. GDP rose, in current dollars, from \$2.7 trillion in 1980 to \$6.6 trillion in 1994, an annual rate of 6.6% a year, for a total growth of 143%. During the eight years of the derivatives bubble, GDP rose by 5.6% a year, and 65% overall, while worldwide derivatives grew at a rate of 56% a year, or 4,055% overall.

Not even the drug trade, which we estimate is growing at a rate of 25% a year, is growing that fast, but it does give you a good idea where a lot of that drug money is being invested.

Saving a bubble with a bubble

The appearance of derivatives in 1986 was no coincidence: The derivatives market was created to bail out the global financial system, to keep the financial bubble going.

The 1980s has been called the decade of greed, which it was. But it was also a decade of debt. The Reagan-Bush economic miracle, so-called, was fueled by a massive growth in government, corporate, and individual debt. Total U.S. credit market debt grew from \$6 trillion at the beginning of the decade, to \$14 trillion at its end. Much of this debt was incurred for speculative purposes: to buy overvalued real estate, to buy companies through leveraged buyouts, to buy junk bonds, to buy anything from which to make a quick buck.

This process worked for a while, but things began to go wrong in 1986-87 when the drop in the price of oil punctured the Texas real estate market. Within a couple of years, the six major Texas banks had gone under, as had much of the savings and loan sector, a major financier of real estate and buyer of junk bonds. This, combined with the uncollectibility

of the banks' loans to the so-called developing sector, set off a chain-reaction collapse of the U.S. banking system. Things were beginning to fall apart, despite all those months of what Reagan and Bush called "uninterrupted economic recovery."

In mid-1989, the Federal Reserve began a series of actions to try to save the U.S. banking system. The Fed began lowering interest rates—a process which would continue for five years—to increase the banks' profits.

It was not enough.

Just before Thanksgiving Day, 1990, the Federal Reserve Bank of New York secretly took control of the bankrupt Citicorp, America's largest bank. Two weeks later, federal regulators held a secret meeting to discuss how to keep the insolvency of Citicorp, Chase Manhattan, Chemical, Manufacturers Hanover, Security Pacific, and the Bank of New England from blowing out the system.

The Bank of New England was closed in January 1991, after a year on life support. The reason the bank was kept open for a year after everyone knew it was gone, can be summed up in one word: derivatives. Even the *Wall Street Journal* admitted, almost two years after the fact, that it had taken regulators and the bank one year to unwind the Bank of New England's \$36 billion in derivatives. The world banking system nearly slid into "gridlock," the *Journal* admitted, citing a senior official at the Office of the Comptroller of the Currency as saying, "If we had a real problem with one of the larger banks, a meltdown scenario would be a real possibility."

Keep that statement in mind when, today, regulators insist that there is no crisis, even though some of the banks have derivatives exposures approaching one hundred times that of the Bank of New England.

Regulators then turned their attention to the big zombies. In a six-week period beginning in June 1991, shotgun marriages were announced between 6 of the 12 largest banks in the United States. Chemical and Manufacturers Hanover announced a merger, as did BankAmerica and Security Pacific. A merger between NCNB and C&S/Sovran was also announced, forming what is today known as NationsBank. The Fed's Citicorp, being too big for anyone to swallow, remained on federal life support, kept alive in part by billions of dollars from Saudi Arabia, part of the price for the U.S. war against Iraq.

In conjunction with its lowering of interest rates, the Fed encouraged the banks to jump whole hog into derivatives speculation. And they did. By the end of 1994, the U.S. banking system as a whole had some \$4 trillion in assets and liabilities on its balance sheet, and another \$16 trillion in what the Federal Deposit Insurance Corp. (FDIC) called "off-balance-sheet derivatives."

It's worth noting here that the FDIC didn't report any derivatives figures until December 1993, when a figure of \$12 trillion—more than three times the U.S. banking system's then \$3.6 trillion in assets—suddenly appeared in the

FDIC's *Quarterly Banking Profile* for the third quarter.

The FDIC probably would not have even published these figures, had it not been for hearings on derivatives held in October 1993 by House Banking Committee Chairman Henry B. Gonzalez (D-Tex.), at which the Comptroller of the Currency was compelled to present statistics on the size of the banks' derivatives holdings. With the cat out of the bag, the FDIC didn't have much choice.

EIR played a significant role in this process. Not only were we invited to submit written testimony for the derivatives hearings, but Gonzalez had in September cited the work of *EIR* in exposing the size of the banks' derivatives activities.

Without these interventions, it is likely that much of this data would not yet have seen the light of day.

The bulk of these derivatives are held by a handful of big banks, in particular the banks of the Fed's bailout list and their money-center associates. As of mid-1994, 80% of all U.S. bank derivatives were held by six banks—Citicorp, Chemical, J.P. Morgan, Bankers Trust, Chase Manhattan, and BankAmerica. Each of these banks held more than \$1 trillion in derivatives, and four of them held \$2 trillion or more. Chemical Bank alone, with just \$170 billion in assets, had derivatives of \$3.1 trillion, a figure equivalent to three-quarters of the assets of the entire U.S. banking system.

The rapid growth of derivatives has much to do with the record profits claimed by U.S. banks over the last three years (\$32.3 billion in 1992, \$43.1 billion in 1993, and \$44.7 billion in 1994). The growth curve of U.S. bank profits, taken as a whole, follows closely the growth of derivatives since 1989, but diverges ominously in 1994, when bank profits increased only slightly and derivatives zoomed, indicating that the game is nearing its end.

Blowout begins

In February 1994, the Federal Reserve reversed its five-year policy of lowering interest rates, and began to raise them again. Prompting the Fed to act, was a series of huge derivatives losses in 1993, including a \$1.6 billion loss by Showa Shell Sekiyu in March, a \$3 billion loss by Ferruzzi in August, and then a rash of losses in December, when Kashima Oil lost \$1.5 billion, Metallgesellschaft lost \$1.3 billion, and the central bank of Malaysia lost \$3 billion. All told, there were \$10.4 billion in derivatives losses reported in 1993.

In moving to bail out the banking system through the use of derivatives, the Fed had only made things worse. But its attempt to reverse course and bring the bubble under control by raising interest rates, merely triggered huge losses by those who had bet that rates would continue to drop.

The losses began almost immediately, starting with the highly leveraged hedge funds. George Soros's Quantum hedge funds lost \$600 million in one day in February on foreign exchange and interest rate derivatives, while Julian Robertson's funds lost \$875 million and Michael Steinhardt's lost \$1 billion.

In March, the Granite Partners hedge funds run by David Askin failed. Askin specialized in buying the “toxic waste” left over when mortgages are turned into collateralized mortgage obligations, or CMOs. The liquidation of the Askin holdings—whose value had been decimated by rising interest rates—threw the entire CMO market into a tailspin, causing hundreds of millions of dollars of losses to holders of mortgage derivatives, and some \$3 billion in losses at Kidder Peabody, which did not survive the year.

The losses continued to mount throughout 1994, culminating in the December bankruptcy of Orange County, California, whose \$2 billion loss signaled a phase change in the derivatives collapse. The crisis shifted to Mexico, where it was temporarily calmed by an emergency \$50 billion rescue package, then moved to Asia, where it brought down the British Empire flagship Barings Bank.

As of this writing, more than \$35 billion in derivatives losses have been reported, including \$13.8 billion in losses to financial institutions, \$12.1 billion in losses to corporations, and \$9.3 billion in losses to governments. These losses are just the tip of the iceberg; the worst is yet to come.

Criminal enterprise

The derivatives market is essentially a criminal enterprise designed to loot people and their governments in order to save the bankers, in much the same way that casinos loot the public for the benefit of the mob. It isn't a game, and the bankers wouldn't be doing it if it weren't profitable. But that profit is illusory. In the world of derivatives, the profits are “paper” profits, mere pieces of the bubble, while the losses are real.

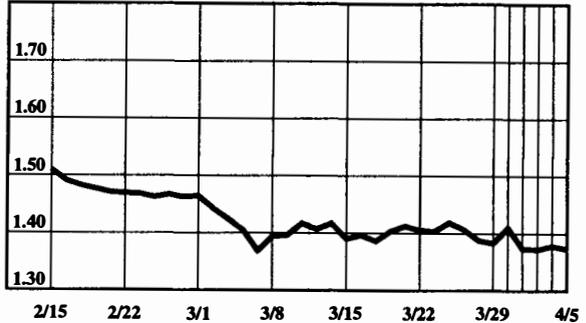
Take Orange County, California, where the county investment fund reported hefty profits over the past few years. These profits have evaporated, leaving 187 government entities and over 2 million residents to deal with the losses. The residents of Orange County face higher taxes and fees, reduced government services, and a lower standard of living, courtesy of their county's foolish gambling in the derivatives casino. Industrial companies have been looted, as have their employees, through derivatives; their employees pay the price through layoffs, salary cuts, longer working hours, and other forms of austerity. Our world has become a meaner place, as more and more people are sacrificed to the bubble.

The whole thing is a racket. First the international bankers induce the governments to abandon fixed exchange rates for currencies, then they manipulate the values of those currencies in order to profit from the fluctuations. Having caused the fluctuations, the bankers then create derivatives to sell to their customers, to help them protect themselves against losses due to the fluctuations. It's quite similar to the type of extortion racket favored by organized crime: Throw a rock through somebody's window, and then sell them “insurance” against vandals. This is a system which needs to be put into bankruptcy reorganization.

Currency Rates

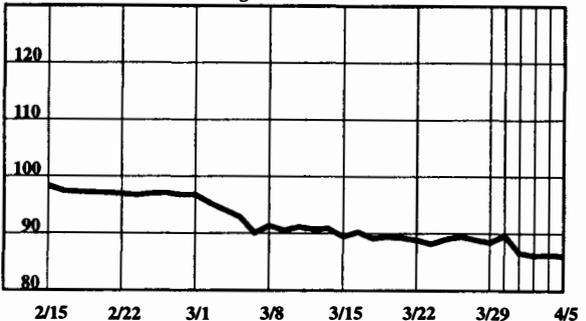
The dollar in deutschemarks

New York late afternoon fixing



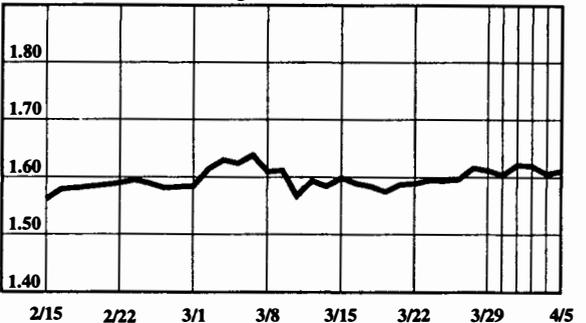
The dollar in yen

New York late afternoon fixing



The British pound in dollars

New York late afternoon fixing



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New York late afternoon fixing

