London prepares for derivatives horror

by John Hoefle

A "nightmare" is looming in the international derivatives markets, which "could knock over some very big institutions," the London *Sunday Telegraph* warned in its City Editor's Comment on March 9. The Comment, by Neil Bennett, noted that, "if and when world stock markets fall," a "domino effect" could hit large banks with "vast" derivatives losses.

The column, titled "The $55 Trillion Horror" (see page 31), claimed that "the total value of derivatives in the world today is $55 trillion . . . twice as large as the world's Gross Domestic Product." That figure, albeit huge, is a dramatic understatement of the actual size of the international derivatives exposure.

Over the past several years, Lyndon LaRouche and his associates have repeatedly warned that the global financial system is bankrupt, and that a chain-reaction implosion of the derivatives market is inevitable, unless emergency reorganization measures are taken. LaRouche's warnings have been echoed by a number of continental European financiers and economists, while the City of London—the base of operations for the international financial oligarchy which created the derivatives bubble—has insisted that the system was not in danger.

What the *Sunday Telegraph* statement signals, is that the British Establishment insiders know that the conditions are ripe for a major international financial crisis to erupt at any moment. It is an admission, from the heart of the beast, that LaRouche was right, and that all of their vaunted regulatory and market-discipline measures, which were supposed to prevent such a crisis, have failed. It is an admission, that the system is out of control.

LaRouche's Ninth Forecast

"The presently existing global financial and monetary system will disintegrate in the near term," LaRouche warned in his Ninth Forecast, published in *EIR* on June 24, 1994. "The collapse might occur this spring, or summer, or next autumn; it could come next year; it will almost certainly come during President William Clinton's first term in office; it will occur soon. That collapse into disintegration is inevitable, because it could not be stopped now by anything but the politically improbable decision by leading governments to put the relevant financial and monetary institutions into bankruptcy reorganization."

Chain reaction

The *Sunday Telegraph* points to the danger of a "reverse leverage" collapse, a British fund manager told *EIR*, comparing the situation to a volcano. While only agreeing to talk on background, "precisely because the situation is so risky, anything you say, can have an effect," the fund manager did stress the importance of the remarks Federal Reserve Chairman Alan Greenspan made in Florida on Feb. 21.

"There have been occasions when we have been on the edge of a significant breakout," Greenspan said to a meeting of the Atlanta Fed in Coral Gables. Thus far, he said, the Fed's response has "turned out to be adequate to stem the atomic erosion."

"We can all guess what he meant by the term 'atomic erosion,' " the fund manager said.

"It is perfectly understandable that such an article would be published in a newspaper that is close to the British Tories," an influential European told *EIR*. "They fear that a major financial crisis could be an added element in pushing the Tories out of power, between now and Britain's general election," scheduled for early May. "My reading of that article," the source continued, "is that there is a fear among such people that such a crisis could occur at any time, and they want to avoid creating the circumstances for it to happen so soon."

"It's a cry, an appeal for some kind of regulation of all deregulated markets," the European source stated. "Of all the markets, the derivatives one is the most deregulated. In fact, I wonder where they ever got this figure of $55 trillion. It is very hard to come by figures for derivatives trading." The article reflects a "general unease about the financial markets, that we are seeing around the world," he said. "The most public indications of this, are the statements of Greenspan, who clearly is worried about dangers in the markets. Obviously, people feel there is a need for some kind of regulatory mechanism."

"There is no question that Mr. LaRouche was the first to warn us of this problem, some years ago," responded a Japanese Finance Ministry official, briefed on LaRouche's reading of the *Sunday Telegraph* article. "He was right, and we were wrong," the official said of LaRouche. "This is why we've more recently made every effort to warn Japanese banks against derivatives," he said, "and, in fact, the ratio of derivatives to total assets of Japanese banks, is the lowest ratio for banks of any major banking nation in the world. . . . But you are right, we're just talking about different stages in the disease of 'financial AIDS.' "

"The Tokyo meeting last week [March 4] of the Group of Six Pacific financial officials was called for precisely this

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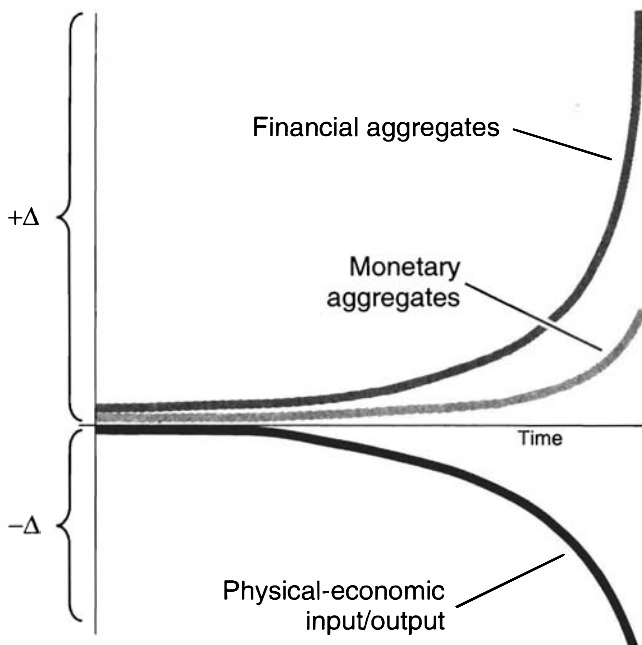
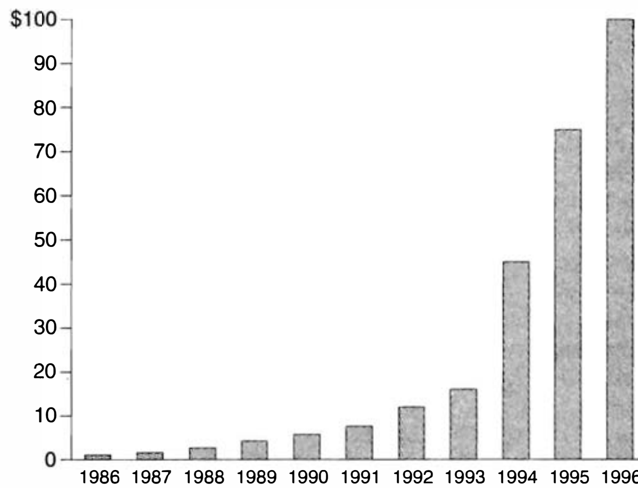
FIGURE 1
A typical collapse function



LaRouche's well-known triple curve, illustrating the collapse, shows financial aggregates climbing ahead of monetary aggregates—while the physical economy races down the drain.

FIGURE 2
World derivatives growth: the cancer takes over
(notional principal amount outstanding at year end, trillions $)



reason" of the fear of an imminent crash, said the head of the leading Japanese bank in Beijing, who has long subscribed to *EIR.* "The problems of Japanese banks, of course, are well-known. . . . I don't think Chinese banks have much of an exposure in derivatives, but what really worries me is Southeast Asia. Look at this Thailand real estate bubble. There is so much hot money flowing in and out of Southeast Asia, that I'm afraid no one has any idea of the amount which banks there might hold in derivatives."

A South Korean Foreign Ministry official reported sheer terror in Seoul about the global financial mess. "The government here is totally paralyzed by the [$3-billion] bankruptcy collapse of Hanbo Steel," he said, "and the knowledge that South Korea is not alone with banking problems. South Korean banks may be in big trouble with bad Hanbo and other industrial loans, but they are highly regulated and are not allowed much activity in derivatives. What is really frightening is the message we got from that Group of Six meeting of the big banking nations: There is danger of a general crisis, and Korea has to do its part to clean up its house."

They should have listened to LaRouche

Four years ago, in the spring of 1993, Lyndon LaRouche warned of the dangerous nature of the derivatives bubble, which, if allowed to continue, would inexorably lead to a chain-reaction disintegration of the global financial system. LaRouche issued, and circulated widely, a proposal for the U.S. government to impose a 0.1% tax on derivatives transactions, as a way to bleed down the bubble, while raising badly needed tax revenue. The experts rejected the proposal.

In June 1994, Lyndon LaRouche issued his Ninth Forecast, warning that a "collapse into disintegration" of the global financial system were inevitable, unless the system were put into emergency reorganization (see box and **Figure 1**). That forecast was circulated widely among leading political and economic strata, and the public.

Rather than draw down the derivatives bubble, the international financiers chose to dive deeper into speculative waters. At the beginning of 1993, when LaRouche issued his first warning, there were some $12 trillion in derivatives worldwide (see **Figure 2**). During that year, according to the best available figures, world derivatives exposures more than doubled, and any chance of bringing the derivatives bubble under control had vanished. By the end of 1996, *EIR* estimates, world derivatives exposure totalled some $100 trillion, a more than eightfold increase over 1992. Taking into account the fact that most derivatives trades, like other bets in the international casino, are relatively short-term, *EIR* estimates that global financial turnover now exceeds $1 quadrillion ($1,000 trillion) a year.

Hooked on derivatives

In November 1996, the Bank for International Settlements (BIS), based in Basel, Switzerland, released a survey of derivatives exposures at 67 banks and 12 securities firms, in 11 countries. That survey, conducted by the Basel Committee

TABLE 1

Derivatives exposures in selected countries

(currencies in billions)

	Amounts outstanding				Growth during 1995			
	1994		1995		National currency		U.S. dollars	
Country	**National currency**	**U.S. dollars**	**National currency**	**U.S. dollars**	**Amount**	**Percent**	**Amount**	**Percent**
United States	20,301	$20,301	23,129	$23,129	2,828	13.9%	$2,828	13.9%
Japan	857,040	9,867	1,225,454	11,532	368,414	43.0%	1,665	16.9%
France	62,447	11,695	45,935	9,374	–16,512	–26.4%	–2,321	–19.8%
United Kingdom	4,259	6,655	4,753	7,367	494	11.6%	712	10.7%
Switzerland	6,978	5,327	7,273	6,321	295	4.2%	994	18.7%
Germany	4,831	3,117	6,104	4,258	1,273	26.4%	1,141	36.6%
Canada	3,357	2,460	4,449	3,321	1,092	32.5%	861	35.0%
Netherlands	2,177	1,250	2,560	1,596	383	17.6%	346	27.7%
Sweden	7,621	1,026	8,513	1,278	892	11.7%	252	24.6%
Belgium	16,201	508	20,302	689	4,101	25.3%	181	35.6%
Italy	701,010	432	765,960	483	64,950	9.3%	51	11.8%
Grand Total	**na**	**$62,638**	**na**	**$69,348**	**na**	**na**	**$6,710**	**10.7%**

Source: Basel Committee on Banking Supervision, International Organization of Securities Commissions.

on Bank Supervision and the International Organization of Securities Commissions, showed an aggregate $69.3 trillion in derivatives exposures at those institutions at the end of 1995, compared to $62.6 trillion in 1994. (That the 1994 number does not agree with the data in Figure 2, shows the difficulty in obtaining accurate derivatives information. Further, the BIS survey does not presume to show global derivatives exposures, but just exposures at the selected institutions.)

According to the BIS survey, the 20 United States commercial and investment banks on the list had $23.1 trillion in derivatives—one-third of the overall total—followed by $11.5 trillion for nine Japanese institutions, and $9.4 trillion for French institutions (**Table 1**).

Derivatives holdings rose in all countries during 1995, except France, where the decline was precipitous. The derivatives holdings of the eight French banks on the list plummeted 26% for the year, measured in French francs, reflecting not an outbreak of sanity but, instead, the near meltdown of the French banking system, led by the hopelessly bankrupt Crédit Lyonnais, whose doors have been kept open through a series of government bailouts. The derivatives exposure of Crédit Lyonnais fell 47% measured in French francs, and 42% measured in dollars, in 1995 (**Table 2**), followed closely by Crédit Commerciale, Crédit Agricole, Socíété Générale, and Paribas. What these figures indicate, is that a highly coordinated, international rescue effort was mounted by governments and central banks, to contain the French crisis, and prevent it from triggering a chain-reaction disintegration of the global financial system.

The situation with the U.S. banking system is no better. The derivatives holdings of Chase Manhattan Corp. alone, $4.8 trillion at the end of 1995, were larger than six of the countries on the BIS list, while J.P. Morgan's holdings were larger than five of the countries.

By Sept. 30, 1996, Chase's derivatives holdings had risen to $5.7 trillion, against $21 billion in stockholders' equity, and $323 billion in assets (**Table 3**). Chase's derivatives portfolio is 268 times its net worth, and Morgan and Bankers Trust are even worse. A loss equivalent to just 0.4% of its derivatives portfolio would wipe out Chase's entire equity, compared to 0.2% for Morgan, 0.3% for Bankers Trust, and 0.8% for Citicorp.

Cracks in the system

That tiny margin between existence and disintegration, is a dominant feature of the international financial system today, and is what has the financiers, the regulators, and the politicians terrified. One false move, and poof! the whole thing blows.

It is against this *systemic crisis* that the recent comments of Federal Reserve Chairman Alan Greenspan about the dangers of "atomic erosion" and the "irrational exuberance" of the stock market must be measured. The hyperbolic growth of the Dow Jones Industrial Average (**Figure 3**), in recent years, is indicative of the insanity pervading the markets. The Dow goes up, while the economy goes down.

Greenspan is not the only banker running scared. Last fall, IMF Managing Director Michel Camdessus warned of the "fragility" of the international banking system, and predicted that a banking crisis would soon erupt; Camdessus was recently in Thailand, trying to contain just such an outbreak. The World Economic Forum meeting in Davos, Switzerland

TABLE 2
Derivatives holdings of selected major international banks
(currencies in billions)

	Amounts outstanding				Growth during 1995			
	1994		1995		National currency		U.S. dollars	
Country	National currency	U.S. dollars	National currency	U.S. dollars	Amount	Percent	Amount	Percent
Chase Manhattan	1,367	$1,367	4,834	$4,834	3,467	253.6%	$3,467	253.6%
JP Morgan	2,471	2,471	3,447	3,447	976	39.5%	976	39.5%
Bank of Tokyo Mitsubishi	103,965	1,197	304,893	2,869	200,928	193.3%	1,672	139.7%
Citicorp	2,665	2,665	2,590	2,590	-75	-2.8%	-75	-2.8%
Swiss Bank Corp.	2,632	2,009	2,970	2,581	338	12.8%	572	28.5%
Société Générale	17,479	3,274	12,460	2,543	-5,019	-28.7%	-731	-22.3%
Industrial Bank of Japan	163,320	1,880	220,070	2,071	56,750	34.7%	191	10.2%
Credit Suisse	2,096	1,600	2,254	1,959	158	7.5%	359	22.4%
Fuji Bank	171,194	1,971	200,929	1,891	29,735	17.4%	-80	-4.1%
Paribas	11,436	2,142	9,197	1,877	-2,239	-19.6%	-265	-12.4%
National Westminster	892	1,394	1,206	1,869	314	35.2%	475	34.1%
Banque Nationale de Paris	10,249	1,919	8,890	1,814	-1,359	-13.3%	-105	-5.5%
Union Bank of Switzerland	2,250	1,718	2,049	1,781	-201	-8.9%	63	3.7%
Bankers Trust NY	1,982	1,982	1,702	1,702	-280	-14.1%	-280	-14.1%
Salomon Inc.	1,470	1,470	1,659	1,659	189	12.9%	189	12.9%
Deutsche Bank	2,186	1,410	2,367	1,651	181	8.3%	241	17.1%
Sumitomo Bank			174,727	1,644				
Merrill Lynch	1,169	1,169	1,610	1,610	441	37.7%	441	37.7%
BankAmerica	1,376	1,376	1,581	1,581	205	14.9%	205	14.9%
Barclays	954	1,490	1,012	1,569	58	6.1%	79	5.3%
HSBC	1,048	1,638	985	1,527	-63	-6.0%	-111	-6.8%
Sanwa Bank	108,406	1,248	158,910	1,495	50,504	46.6%	247	19.8%
Lloyds	739	1,154	926	1,435	187	25.3%	281	24.4%
Lehman Brothers Holdings	1,086	1,086	1,209	1,209	123	11.3%	123	11.3%
Goldman Sachs	995	995	1,091	1,091	96	9.6%	96	9.6%
Crédit Lyonnais	9,758	1,827	5,160	1,053	-4,598	-47.1%	-774	-42.4%
NationsBank	511	511	1,007	1,007	496	97.1%	496	97.1%
Morgan Stanley	835	835	985	985	150	18.0%	150	18.0%
Royal Bank of Canada	949	703	1,245	929	296	31.2%	226	32.1%
ABN-AMRO Bank	1,229	706	1,482	924	253	20.6%	218	30.9%
Canadian Imperial Bank of Commerce	805	569	1,179	880	374	46.5%	311	54.7%
First Chicago	622	622	815	815	193	31.0%	193	31.0%
Indosuez	4,991	935	3,856	787	-1,135	-22.7%	-148	-15.8%
Commerzbank	608	392	1,112	776	504	82.9%	384	98.0%
Tokai Bank	74,206	854	71,304	671	-2,902	-3.9%	-183	-21.4%
Long-Term Credit Bank of Japan	74,915	863	69,170	651	-5,745	-7.7%	-212	-24.6%
Dresdner Bank	733	473	919	641	186	25.4%	168	35.5%
Skandinavska Enskilden Banken	3,090	416	3,707	557	617	20.0%	141	33.9%
Crédit Agricole	3,758	704	2,568	524	-1,190	-31.7%	-180	-25.6%
Bank of Montreal	544	403	667	498	123	22.6%	95	23.6%
Bank of Nova Scotia	502	372	654	488	152	30.3%	116	31.2%
Toronto Dominion	476	353	616	460	140	29.4%	107	30.3%
Bayerische Vereinsbank AG	447	288	651	454	204	45.6%	166	57.6%
Svenska Handelsbanken	2,271	306	2,732	410	461	20.3%	104	34.0%
Union Européene de CIC	1,551	290	2,004	409	453	29.2%	119	41.0%
Rabobank	575	330	637	397	62	10.8%	67	20.3%
Crédit Commerciale de France	3,225	604	1,800	367	-1,425	-44.2%	-237	-39.2%
Westdeutsche Landesbank	534	345	510	356	-24	-4.5%	11	3.2%

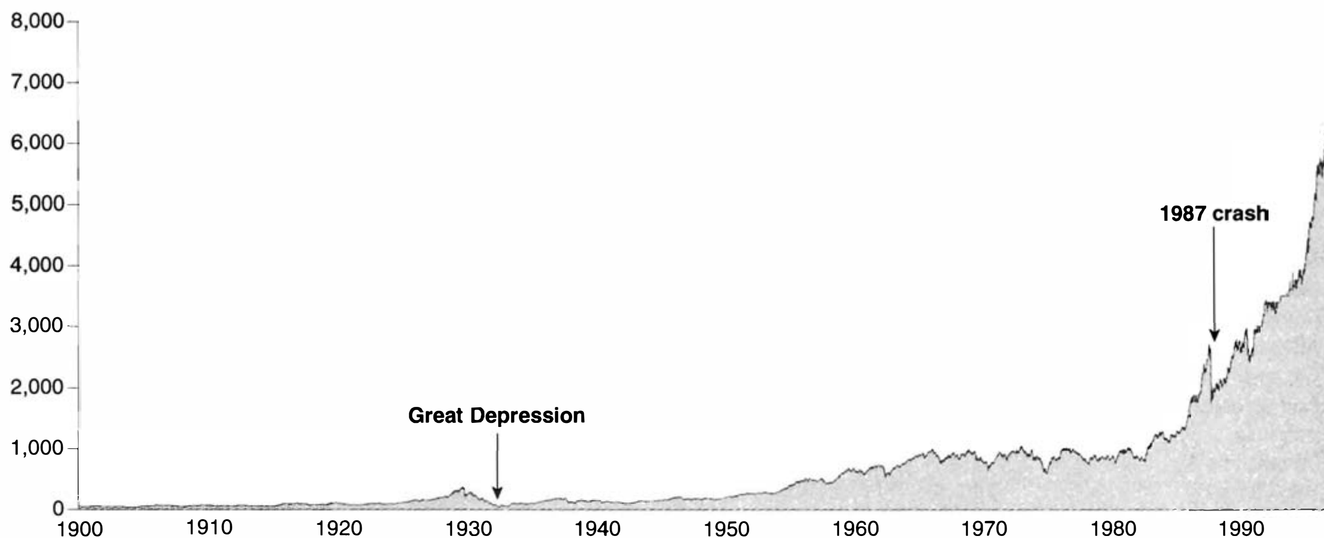
Source: Basel Committee on Banking Supervision, International Organization of Securities Commissions.

TABLE 3
Derivatives holdings of major U.S. banks, as of Sept. 30, 1996
(billions $)

				Derivatives as multiples of:		As percentage of derivatives:	
Holding company	**Equity**	**Assets**	**Derivatives**	**Equity**	**Assets**	**Equity**	**Assets**
Chase Manhattan	21	323	5,660	268	18	0.4%	5.7%
JP Morgan	11	212	4,509	407	21	0.2%	4.7%
Citicorp	20	272	2,557	125	9	0.8%	10.6%
Bankers Trust NY	5	121	1,906	358	16	0.3%	6.3%
BankAmerica	21	243	1,808	88	7	1.1%	13.4%
NationsBank	13	188	1,325	100	7	1.0%	14.2%
First Chicago NBD	9	107	1,024	113	10	0.9%	10.4%
Republic NY	3	51	289	90	6	1.1%	17.5%
First Union	9	134	147	17	1	5.9%	91.0%
Bank of New York	5	52	119	23	2	4.3%	44.1%
Top ten banks	118	1,701	19,344	164	11	0.6%	8.8%
All U.S. banks	**370**	**4,458**	**20,385**	**55**	**5**	**1.8%**	**21.9%**

Sources: Comptroller of the Currency; company reports.

FIGURE 3
Dow Jones Industrial Average weekly closings, 1900-97



at the end of January, was dominated by warnings of "future crises," "big shocks," and "domino effects." German bankers have recently warned publicly that the markets are "out of control" and "incredibly endangered." The Italian daily *Corriere della Sera,* reporting on attempts by the Italian fiscal police to impose new regulations on derivatives, warned that derivatives might "become a sort of atomic bomb, destined to explode and provoke the chain-reaction collapse of the Western financial systems."

Four options on the table

Lyndon LaRouche has identified four general categories of response to the impending financial disintegration, among those aware of the crisis.

First, there are those, including people in the Clinton administration and elsewhere, who are preparing plans to deal with major financial shocks, such as a stock market crash.

Second, there are those, such as Sam Nunn and company, who recommend saving the system at all costs. Their plan,

LaRouche said, is to "try to save Wall Street at all costs. Forget the nation, forget pensions, forget everything else. Just try to save Wall Street. That's nuts. That's the worst possible thing."

The third option is to put the welfare of nations and their populations first. We must, LaRouche said, "concentrate on saving the United States, our people and their pensions first, and Wall Street last. That is my thinking, and we're doing serious study in that direction."

Fourth, there are people like the friends of Sir George Bush, who know the system is collapsing, and have fled the financial markets and put their money into raw materials, precious metals, strategic minerals, petroleum, food, and real estate, so that when the crash comes, they will wind up on top of the rubble.

Phil Gramm is nuts

An example of the lunacy of trying to save the system at all costs, is the attempt by Sen. Phil Gramm (R-Tex.) to reverse regulations adopted Jan. 26 by the Securities and Exchange Commission, to force U.S. corporations to disclose more information on their derivatives exposures. At a hearing of the Securities Subcommittee of the Senate Banking Committee on March 4, Gramm complained that the SEC regulations "will induce firms to use derivatives less."

Speaker after speaker at the Gramm-chaired hearing complained about the "demonization" of derivatives.

To add to the insanity, Gramm and his cohorts insisted that the derivatives "industry" should be left to regulate itself, and that the derivatives debacles at Orange County, California, Procter & Gamble, and Gibson Greetings, were "isolated" events. Such claims choose to overlook the role of such august institutions as Merrill Lynch and CS First Boston, in luring Orange County into their derivatives trap, and the role of Bankers Trust, in fleecing Procter & Gamble and Gibson Greetings. The actions of Bankers Trust, one of the world's leaders in derivatives, were so egregious, that Procter & Gamble filed suit against the bank under the Racketeer Influenced and Corrupt Organizations Act (RICO), and the federal government took over the bank and decapitated its management, so to speak.

What the examples cited by Gramm and his foolish colleagues really prove, is that the so-called experts cannot be trusted to regulate themselves, and that, if left unchecked, they will steal their customers blind.

What is urgently needed, is a coordinated emergency effort by sovereign nation-states, to put the global financial system into bankruptcy, and to focus their resources upon rebuilding the world's productive capability, to grow our way out of this disaster. What is required, is a new Bretton Woods conference, through which nations annihilate the power of the oligarchs and their International Monetary Fund, and commit themselves to a series of great infrastructure projects, such as the Eurasian Land-Bridge.

Documentation

Sunday Telegraph sleepless over derivatives nightmare

The following, authored by Neil Bennett, was published in the "City Editor's Comment," in the March 9 London Sunday Telegraph, *under the headline "The $55 Trillion Horror Story." British punctuation is the original.*

I had dinner with Tony Dye last week, the PDFM fund manager, who has famously taken a £7 billion bet on a market crash. With the markets hitting new highs almost every day now, he is naturally looking a bit green around the gills, but his conviction of impending doom remains as strong as ever.

In the wake of NatWest's derivatives scare, he conjured up a scenario that would give small children nightmares. The total value of derivatives in the world today is $55 *trillion.* That is $55,000,000,000,000 to the layman—a tidy sum, and twice as large as the world's gross domestic product.

Every bank has vast derivatives liabilities. Barclays, for example, admitted in its results, that it had derivatives worth £922 *billion* at the end of last year, up more than a quarter on 1995.

Barclays and its peers say the risk of these vast positions is minimal, because they are all matched and hedged. If the financial markets crash, the losses from one set of contracts will be offset by the profits on another.

The trouble is that not every operator in financial markets is so prudent. Some are running very risky positions indeed. If and when world stockmarkets fall, some wouldn't be able to pay their losses. That would mean all those prudent, hedged banks were not hedged at all because their counterparties were going bust. Suddenly, even large banks could be staring at vast losses.

In any bank, the line between prosperity and ruin is thin. Barclays supports all its lending and derivatives wheeling and dealing with a capital base of just £11 billion. If a domino effect rippled through the world's derivatives markets, it could knock over some very big institutions.

This is where the nightmare turns nasty. Who would bail the banks out? Governments and central banks of course. But governments are already the world's largest debtors, which does not make them ideal candidates to rescue the financial system. They could only do it by printing money. That is the sure path to hyperinflation and sky-high interest rates. The value of money would be destroyed, and savings and pensions along with it.

Of course, this is just a nightmare, and a fanciful one at that. Let's just enjoy the bull market while it lasts.