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Finding a cure for derivatives, the market cancer

by Chris White

This *Feature* presents some materials related to the background of so-called financial derivatives, and to jailed economist Lyndon LaRouche's proposed 0.1% sales tax on each such transaction (see page 34).

For clarity's sake at the outset, the following ought to be understood, as background to our assessments of current and recent volume of trading in derivatives, and the effect of the proposed tax. This, because in addition to the revenue-raising potentials of the tax, LaRouche also insisted that the imposition of such a tax would contribute to bringing out-of-control, speculation-driven markets under proper executive control. The imposition of the tax would help reveal the problems to be encountered in doing such a cleanup. Here are some of the problems, and thus some of what has to be brought under control:

1) The bulk of such trading, as is profiled below, the so-called "over-the-counter" segment, is blatantly illegal under present U.S. law. Under standing provisions of the Commodity Exchange Act, it is illegal for banks, or anyone else, to deal in futures contracts outside of commodity exchanges. This is never mentioned publicly by any of the partisans of derivatives. "Over-the-counter" derivatives are only traded safely at this time because of the work of the former chairman of the Commodity Futures Trading Commission, Wendy Gramm (wife of the loud-mouthed priest of financial orthodoxy Texas Sen. Phil Gramm), who was given the right to "waive" existing law.

2) All treatments of derivatives, generated from within the financial and regulatory communities, distinguish between exchange-based and "over-the-counter" trading between banks, as if they were completely separate activities. The distinction is fraudulent. "Over-the-counter" derivatives—for example, a swap between a floating-rate Swiss franc-denominated instrument and a fixed-rate dollar instrument—are consummated and put into effect through exchange-based trading of currency, bond, and interest rate futures and options. The degree to which the growth of the $1 trillion per day foreign exchange market, or the $300 billion per

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America's vast, rotted-out industrial and transportation infrastructure surrounds the great financial centers, such as New York's Lower Manhattan here, where it's considered cheaper to ruin the economy, than it would be to save it.

day market in U.S. government securities, is conditioned by trading generated as a result of illegal inter-bank "swaps," is unknown.

For these reasons, it is impossible to estimate, to any acceptable degree of accuracy, what the size of the legal market is which would be subject to the tax. And obviously, one would not want to legitimize what is already outside the law, by subjecting such crimes to a tax.

3) Leaving the matter of crime aside, trading volumes, and the rate of turnover of the contracts traded—i.e., the actual, not the notional maturity of the instruments traded—are likewise unknown. This makes *EIR's* previously relatively high estimates of the effect of the proposed tax, and our presently relatively low estimates, equally suspect. They should be understood as hypothetical extremes. The more so, given the fact that the bulk of such trading is flatly illegal. For example:

- No reporting of derivative exposure by banks includes instruments with maturities of 14 days or less; yet the purpose of bank swap arrangements, for example, is to transform nominal medium- and long-term maturity instruments into short-term instruments, such that daily trading subserves a contract which is renegotiated every three months.
- No consolidated accounting exists of activities by bank holding companies and all their subsidiaries, or by so-called non-bank financial companies—e.g., GE Capital Corp. and General Motors Acceptance Corp (GMAC). Volume estimates are based either on particular banks' activities, or on activities of holding companies as such. The reports for both cover different time-frames. They are neither complete, nor are they compatible. Non-deposit-taking lending institutions (non-bank banks in the present parlance) are not covered at all, because they are not regulated.

Without considering the provisos stated above, the derivatives market, or series of markets, is estimated at some undetermined part of $16 trillion—the same order as the total financial and tangible assets in the U.S. economy as a whole, according to the Federal Reserve's balance sheet of the U.S. economy. How could such an immense market have come into existence in defiance of existing law?

How does Jack Kervokian continue to get away with murder in the name of "assisted suicide"? The two questions are not so different. With trillions of dollars of liabilities accumulated illegally, it would not be credible to simply say that someone must have been asleep at the switch.

Investigate the Federal Reserve

To find out the truth, it would be sufficient to mount a real investigation of what the Federal Reserve has been doing since 1978, and, specifically, what the Federal Reserve Bank of New York has been doing. The Federal Reserve is supposedly responsible for monetary policy, and through its discount window operations helps set the interest rates which govern the yields sought by the derivatives operators.

Such an investigation ought to focus on three areas:

1) Narrowly, how has the Federal Reserve has interpreted its regulatory mandate over stock index futures markets, and

how and why was the Federal Reserve given such a mandate in the first place?

2) More broadly, what does the Payment and Settlement Committee of the Federal Reserve Bank of New York actually do, and what role does the Federal Reserve play in its work?

3) What is the effect of Federal Reserve involvement in derivative-driven markets on credit generation, the banking system, and the economy as a whole?

4) What is the extent of criminal collusion between the Federal Reserve Bank of New York and the eight commercial banks which account for 90% of the activity in "over-the-counter" derivative transactions? The Federal Reserve Bank of New York is owned by the same banks which have systematically been violating the Commodity Exchange Act.

The broader purpose of a cleanup to reimpose order is straightforward:

1) So long as present methods of organizing credit flows within the economy and financial system are continued, there will be no prospect of economic recovery, nor a feasible job creation program, nor any capital- and technology-intensive renewal of the economy.

2) Derivative markets—options, futures options, options indexes, swaps, strips—whether on or off exchange, given the rate of growth in their international volume and turnover, especially in currencies and bonds, have become key in setting financially "acceptable" rates of return, thus interest rates, and thus overall credit flows.

3) Bush administration policy and Alan Greenspan's Federal Reserve commitments to avoid at all costs the spillover of the savings and loan banking crisis into the nation's commercial banks, by increasing spreads between bank lending and borrowing, made the problem much worse than it would otherwise have been. Returns from commercial and industrial loans cannot match the derivative-enhanced yield on the tax-free 4-5% spread they have been given in recent years.

4) To organize a recovery is to create *new wealth.* New wealth can only be created by putting Americans back to work in modern infrastructure construction projects, necessary to support expansion in employment and economic activity, and in technologically progressive capital goods industries, to increase productivity. This increases the tax base without increasing tax rates, and thereby reduces the deficit. Every 1 million jobs created at $30-40,000 per year gross will add between $5 and $6 billion to the Treasury's personal taxation revenue stream directly, and will obviously have quite dramatic additional indirect effects.

5) Unfortunately, the time-frame for achieving project viability, and the discounted present cash value of the returns on such investments, cannot compete with the derivative money-go-round. Therefore, either derivatives and their users submit to an exercise of national will, or the country submits to the continued rule of those who employ derivatives, in violation of its very laws.

Derivatives: What are they?

by Anthony K. Wikrent and Chris White

The textbook definition of a financial derivative is a financial instrument, the value of which is based on the value or values of one or more underlying assets or indexes of assets. Derivatives can be based on equities (stocks), debt (bonds, bills, and notes), currencies, and even indexes of these various things, such as the Dow Jones Industrial Average. Derivatives can be sold and traded either on a regulated exchange, such as the Chicago Board of Trade, or off the exchanges, directly between the different counterparties, which is known as "over-the-counter" (OTC). The textbook explanation of the purpose of derivatives is that they serve to reduce the risk inherent in fluctuations of foreign exchange rates, interest rates, and market prices. Derivatives traded on exchanges also are said to serve as a "price discovery" mechanism.

According to the Bank for International Settlements' October 1992 report, *Recent Developments in International Interbank Relations,* "swaps" are the largest type of derivatives, as measured by the *notional prinicpal amount* outstanding (**Table 1**).

A generation or so ago, the matter of what derivatives are might have been adequately summarized by contrasting the difference between investment, on the one hand, and gambling or speculation, on the other.

The instruments which "underlie" derivatives—stocks, bonds, commodities, money—represent a claim, usually through ownership, on wealth produced in the economy. Such claims can be purchased. Thus, shares in a company can be bought, as can bonds issued by governments or corporations, or hard commodities produced by agriculture, forest industries, or minerals extractors and refiners.

The instrument so purchased provides a means by which the wealth produced may be turned into money. In the case of stock, this may take the form of the company's dividend payment, the part of after-tax profits distributed to shareholders, or it might take the form of capital gains realized through the appreciation of the stock's value. Formerly, such monetization, or potential for monetization, would have been more or less directly related to the economic performance of the company, in contributing to an increasing overall rate of wealth generation through productivity-enhancing increases in the powers of labor. So too are bonds directly related to