Click here for Full Issue of EIR Volume 20, Number 43, November 5, 1993

Tax and dry out the derivatives market

by Chris White and Richard Freeman

The following is an abstract of testimony presented by EIR *to House Banking Committee hearings on derivatives on Oct. 28.*

On March 9 of this year, *EIR* and its founding editor Lyndon LaRouche proposed that a transaction tax be imposed on the sale of all financial instruments classified as "derivatives." The tax would be levied at a rate of 0.1% on the notional value of the transaction. Collection, and reporting, would be the responsibility of the institution performing the sale.

The purpose of the proposed tax is twofold. Firstly, to reestablish control over the explosive, eightfold growth in these financial instruments which has been registered in the years since 1987, the year of the futures and options index-driven stock market crash.

"Control" is itself a twofold proposition. First in priority is the necessity to reestablish political accountability over the workings of the private institutions which comprise the so-called marketplace, institutions which have used the slogans of "deregulation" and "freedom of the market" to leave a trail of wreckage around the globe. Second, is the common sense requirement to restore some sense of order to financial markets which not only feed on volatility, but promote such volatility as in their own interest, as was underlined recently by an official from Chase Manhattan Bank.

In its second aspect, the proposed tax would be a short-term revenue generator for the treasury. It would collect approximately $75-100 billion the first year, and lesser amounts in subsequent years. But the primary purpose of the proposed tax would be to take a surgeon's knife to a cancer which is sucking out the life-blood of the economy, and cut it out.

This ought to be done, before it is too late. The reasons for such required action are economic as well as political. There will be no possibility of any real economic recovery as long as the kind of obscene, speculative, and usurious excesses typified by the derivatives racket are allowed to continue.

Since the "financial community" has shown itself incapable of reforming itself, and equally incapable of understanding what might be the problems associated with the extension of the kind of practices associated with derivative instruments, it is evident that such a reform can only come from outside the financial community.

Derivatives are unconstitutional

Under Article 1 Section 8 of the U.S. Constitution, in particular the General Welfare provision thereof, and the Article's concluding injunction, "To make all Laws which shall be necessary and proper for carrying into Execution the foregoing Powers," Congress has the power to impose such a tax as LaRouche has proposed.

The proof that the financial community lacks the comprehension required is elementary. No discussion of derivatives, among regulatory agencies or financial institutions, considers the economic impact of what has been done. The arguments and counter-arguments are always restricted to the financial domain as such.

On the one side, there are those who extol the benefits of "new, sophisticated methods of hedging risk," those who stigmatize critics as "naive" and "unsophisticated." On the other side, there are those who wonder if something has not been unleashed which might easily get out of control, with disastrous results. Ought we not, they ask, consider how to regulate these new practices, to make sure they do not get out of control?

© 1993 EIR News Service Inc. All Rights Reserved. Reproduction in whole or in part without permission strictly prohibited.

Both are disastrously wrong. It is not the risks and dangers that you know to be risks and dangers which prove to be fatal. They, after all, can be avoided. It is the risks and dangers which you do not know. How can institutions hedge against a risk they do not take into account, and cannot take into account because they don't admit it exists?

From this standpoint, the whole discussion promoted by the financial lobby is at best incompetent, and at worst an outright fraud. A witch doctor can indeed claim to know how to cure AIDS; that does not mean everybody should take his claims at face value. Indeed to do so would properly be called insane. Derivative instruments are not a disaster waiting to happen, they are the latest symptom of a disaster which was set in train a generation or so ago.

The incompetence, call it that, can be shown in two ways. First, take the case of agricultural commodities. It is well known that the world suffers a cruel shortage of basic foodstuffs. In fact, the Food and Agricultural Organization of the United Nations, and other agencies, show that some two-thirds of the world's population are at, or below, subsistence levels where basic nutrition is concerned.

This is demand for food. Not though, where the markets are concerned. The so-called markets are not interested in demand, but in what they call "effective demand." If you haven't got the money, you can't pay for it, so it doesn't count. So the prospect of a 25% reduction in corn supply, because of this year's flood, which translates into a 12% reduction or so, worldwide, does not immediately translate into price increases.

But, from some proponents of the North American Free Trade Agreement, we learn that Mexico does not need so many farmers or *campesinos,* because Mexico should not be producing staple foods, such as corn or wheat. Mexico should purchase such foodstuffs from the United States.

Those farmers and campesinos are being dispossessed. Their lands taken over, ascribed an asset value, to become the asset underlying a derivatives market in secondary mortgages, now being set up by the Mexican Finance Ministry, with help from the Farmers Home Administration (FmHA), the Department of Housing and Urban Development (HUD), and the Savings League.

Insured and securitized mortgages are supposed to be safe, are they not? The risk is taken out. The instrument can be hedged against a variety of other instruments, to cover for currency exposure, interest rate risk, and so on. And, what of the country that is to be reduced below penury in that way? Are we to say that the political instability and chaos which follow the enforcement of such policies are beneficial because we desire such an increase in volatility?

The World Bank recommends the same approach be adopted by Palestinians. Shock therapy advocates promote the same proposal as the solution to Russia's agricultural backwardness. Don't produce staples. Buy them from us, and instead, produce specialty goods, like asparagus, bell peppers, and tomatoes for export to our markets.

What hedge can offset what is thus set in motion? If Sodom had its salt-sellers, we have our derivative dealers.

This type of approach is derided by the proponents of the primacy of the market as pure sentimentality, as the illegitimate insertion of considerations of morality into the workings of the market. Leave the market to its own devices, and these matters to their proper sphere, they insist. This attitude is moral insanity in the process of becoming outright criminality, on a scale never before witnessed in human history.

Why so? Because there is a difference between wealth creation and money profits. If you do not permit wealth production to occur, the so-called money profits which are booked from commercial and financial transactions, and hedged against, as to interest rate and currency risk, do not actually exist, except in the form of loot gouged out of a shrinking capacity to produce physical wealth. That is what the financial community doesn't understand, and cannot therefore hedge against.

It is why the derivatives bubble will go the way of the real estate investment trusts, the oil patch speculation of the 1970s, and of the Third World debt, real estate crisis, leveraged buy-outs, and S&L disasters of the 1980s. This succession is not accidental. It is not something that can be prevented by uttering the magical phrases we have come to expect such as "you don't understand, we have learnt the lessons from those unfortunate events, we are now much better equipped to deal with such things than we ever were before. Now we have derivatives, they enable us to handle such risks, by hedging against their occurence."

The production of wealth

Wealth production is not the same as the accountant's creation of money income and money profit.

Wealth production is human activity; no other species on this planet, or anywhere else that we know of, is capable of doing it. Man reproduces his own society by applying scientific advances to increasing the productive powers of labor, through technology. Increased productive powers of labor permit greater numbers of people to exist at improved standards of living. It is an older method than the written prescription of the Book of Genesis, "Go forth and multiply, replenish the earth and subdue it." It is as recent as the Constitution's Preamble, "to form a more perfect union, establish justice, ensure domestic tranquillity, provide for the common defense, promote the general welfare, and provide the blessings of liberty to ourselves and our posterity."

It is the measure of the viability of any form of human society. And, conversely, any society which turns its back on the yardsticks provided by that measure will go the way of the Sodoms and the Gomorrahs, the Babylons and the Romes. There are no hedges against the working of the Creator's law, no put options or short sales which will forestall His reckoning.