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Derivatives cancer is killing off the physical economy

by John Hoefle

The worst financial collapse in the last 650 years is now under way, as a result of the economic policies imposed upon governments by the international oligarchy and their functionaries, the international bankers.

There are no isolated financial problems. The problems in Orange County, the problems in Mexico, the financial crises in state and local governments across the country, the financial crises in corporations and financial institutions, the financial crises with governments around the world, are all symptoms of this international financial collapse.

This process of collapse was defined by Lyndon LaRouche in his eighth economic forecast of Nov. 23, 1991, as a "mudslide," in which huge chunks of the financial system slide into oblivion. "Many people have been looking for a definitive one-day, two-day, three-day financial collapse, perhaps on the markets, with the Dow Jones Index crashing 500 or 1,000 points or more," LaRouche said. "What they are seeing . . . is the great mudslide of 1991."

Huge chunks of the financial system have indeed disappeared. Since the 508-point stock market crash of October 1987—the one the experts said we survived intact—the real estate market collapsed; the Texas banking system disappeared; huge chunks of the savings and loan system were seized by regulators; the junk bond and leveraged buyout markets crashed; the Federal Reserve took over the largest bank in the country and bailed out the banking system—or so they thought.

What has occurred is a string of disasters in which institutions, indeed whole segments of the economy, have disappeared. With all this collapse, one asks, why is the system still standing?

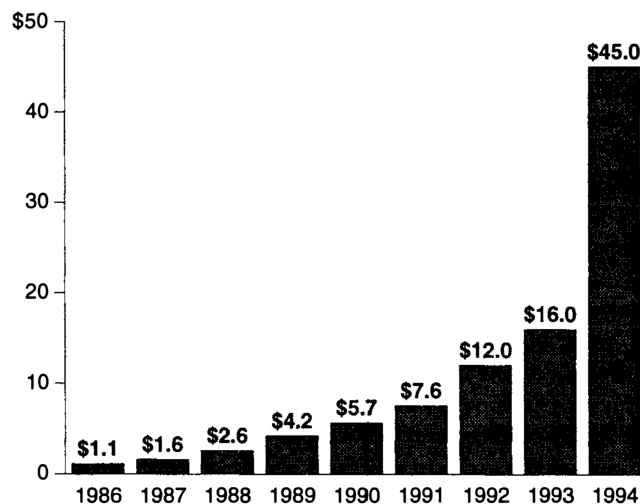
The answer is that the financial system as most people think of it no longer exists; the financial system has been transformed into a huge casino, through the use of derivatives and other forms of speculation and looting.

Figure 1 shows the growth of derivatives worldwide. Derivatives have grown from $1.1 trillion at the end of 1986, to $45 trillion at the end of 1994, a more than fortyfold growth in eight years. The notional principal amount of derivatives—a fancy way of saying "face value"—rose by 47% in 1987, 65% in 1988, 58% in 1989, 38% in 1990, 32% in 1991, 58% in 1992, 33% in 1993, and a staggering 181% in 1994.

Just what are these derivatives? Derivatives are securities based upon the values of other securities, such as stocks, bonds, commodities, interest rate and currency securities, and indices of such securities. Some of these derivatives are so technically complex that even the people trading them don't fully understand them; but they are conceptually quite simple. Derivatives are bets—as in gambling—on future movements of the markets—markets which are routinely manipulated by the bankers—as opposed to investments in the economies which those markets nominally support. Money that goes into the derivatives bubble is taken out of the physical economy. Derivatives are like a malignant cancer, which grows by consuming its host. Derivatives do not hedge against risk. Derivatives *are* the risk.

I should add that the growth of derivatives might be a

FIGURE 1
World derivatives growth
(trillions $)



Sources: Bank for International Settlements, *Fortune*, *Swap Monitor*.

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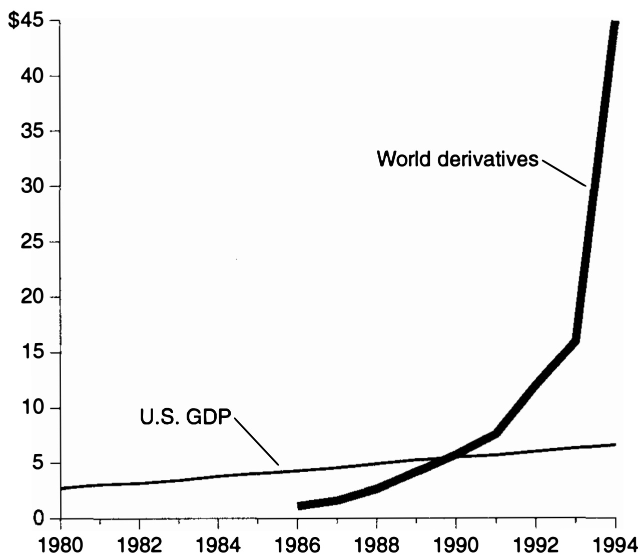
FIGURE 2

World derivatives compared to U.S. Gross Domestic Product

(trillions $)



Sources: Bank for International Settlements, *Fortune, Swap Monitor, U.S. Statistical Abstracts.*

little more gradual than Figure 1 shows. The early figures come from the Bank for International Settlements—the central bank of the central bankers—and are thus prone to understatement, while the latter figures come from market-watching companies. But moving a few trillion dollars in growth from one year to the next doesn't change anything, since it still winds up in the same place.

This extraordinary growth rate has nothing to do with economic growth, as **Figure 2** shows. It's obvious from looking at this graph that the derivatives market is insane. Between 1980 and 1994, the Gross Domestic Product of the United States grew by 143% overall, a rate of growth of 5.6% a year. During the eight years of the derivatives bubble, GDP grew by 65%, or 5.6% a year, while derivatives grew 4,055%, a rate of 56% a year.

The situation is actually even worse than it looks, since Gross Domestic Product—like the Gross National Product statistic it recently replaced—is a profoundly flawed economic statistic, containing all sorts of non-economic activity. In truth, the real economy, the physical economy, has been shrinking during this period.

Origins of the current crisis

To understand how this came about, let's go back briefly to the beginning of the 1980s, and the so-called Reagan-Bush economic miracle. The alleged economic growth of the 1980s was fueled by a massive growth in government, corporate, and individual debt. Total U.S. credit market debt grew from some $6 trillion at the beginning of the decade, to $14 trillion at decade's end. Much of this debt was incurred for speculative purposes: to buy overvalued real estate; to buy companies through leveraged buyouts; and such. This process worked, after a fashion, thanks especially to the huge amounts of dope money which were poured into the real estate market through the banks.

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 failed, and the Texas S&Ls were devastated. The junk bond-fed leveraged buyout market soon followed, killed by its crown jewel, the $26 billion takeover of RJR Nabisco by Kohlberg Kravis Roberts.

The collapse of the real estate and the junk bond markets, combined with the uncollectibility of the banks' loans to less developed countries, threw the U.S. banking system into a bankruptcy crisis. Things were beginning to fall apart.

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—they would not rise again until 1994—to increase the banks' interest profits. It was not enough.

During the first four months of 1990, Michael Milken's Drexel Burnham Lambert, the Campeau Corp., the brokerage Thomson McKinnon, and Columbia Savings—with its $8 billion in junk bonds—all collapsed. By the summer, New York real estate developer Donald Trump joined the ranks of other "golden boy" developers, like Houston's Gerald Hines and Atlanta's John Portman, who had defaulted on loans.

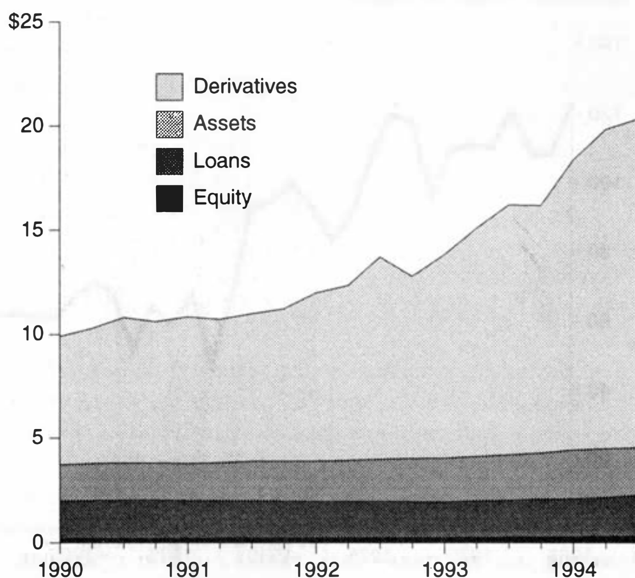
The Fed took dramatic action just before Thanksgiving Day 1990, when it secretly took control of the bankrupt Citicorp, America's largest bank. A couple of weeks later, federal regulators held a secret meeting to discuss how to handle the insolvency of Citicorp, Chase Manhattan, Chemical, Manufacturers Hanover, Security Pacific, and the Bank of New England.

The regulators' decisions soon became obvious. The Bank of New England was closed in January 1991. A merger between Chemical and Manufacturers Hanover was announced in June 1991, as was a merger between NCNB and the ailing C&S/Sovran, forming NationsBank; in August, BankAmerica took over the ailing Security Pacific. In a little over a month, mergers were announced involving 6 of the 12 largest banks in the country. Citicorp, being too big for anyone to swallow, was put on a federal life support system, bailed out in large part with Saudi money, as part of the price of the war against Iraq.

Even while the Feds were bailing out the banks, other parts of the financial system were collapsing. The banking systems of Norway and Sweden collapsed in late 1991 and 1992, resulting in government bailouts.

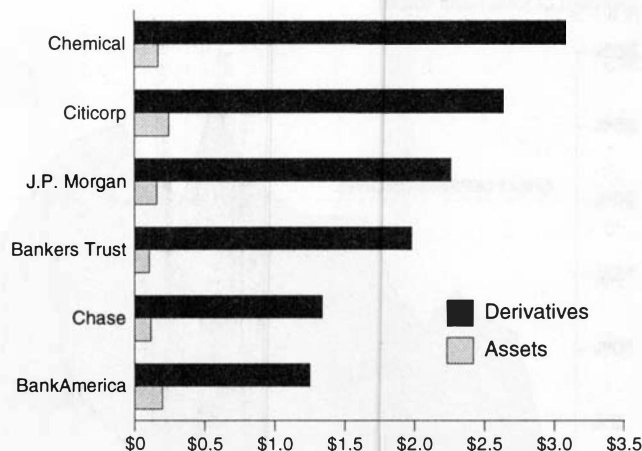
In April 1992, Canadian real estate developer Olympia

FIGURE 3
U.S. banks are addicted to derivatives
(trillions $)



Source: Federal Deposit Insurance Corp.

FIGURE 4
They're not banks anymore
(trillions $)



Sources: Bank annual reports.

& York, the largest real estate developer in the world, was unable to pay its debts; O&Y filed for bankruptcy in June. A month later, a similar liquidity crisis hit the huge Edper group of Canada's Edward and Peter Bronfman.

In September 1992, the U.S. and British banks launched currency warfare against the European Monetary System. With inside information from the Federal Reserve, Citicorp and speculator George Soros made about $2.5 billion, and other U.S. banks profited handsomely. The resultant collapse of the lira, however, caused huge derivatives losses for Italian companies, many of which had borrowed from U.S. banks such as Bankers Trust.

The year 1993 began with the bankruptcy of Bramalea, a real estate developer owned by Edper. In July, the banks launched another round of currency attacks against the European Monetary System, this time bankrupting the Bank of France. Trizec, another Edper real estate firm, tottered. Banesto, a big Spanish bank advised by J.P. Morgan, was put into receivership, and Germany's Metallgesellschaft announced huge derivatives losses.

All during this period, the banks had been rapidly increasing their derivatives exposure, and the bubble which the Fed had created to save the banks, was now in danger of disintegrating and taking the entire system down with it.

Figure 3 shows the effects of this headlong rush into speculation. By September 1994, the U.S. banking system as a whole had some $4 trillion in assets, and another $16 trillion in off-balance-sheet derivatives. Most of these derivatives were held by a handful of big banks (**Figure 4**). As of mid-1994, six banks—Citicorp, Chemical, Morgan, Bankers Trust, Chase, and BankAmerica—held more than $1 trillion in derivatives each. Chemical Bank alone had derivatives of $3.1 trillion—a figure equivalent to three-quarters of the assets of the entire U.S. banking system—compared to just $170 billion in assets.

To deal with this bubble, the Fed reversed its five-year-long policy of cutting interest rates, in February 1994. This change caught many speculators—who had bet on continued lowering of interest rates—off guard, and left them with massive losses. The big hedge funds lost billions of dollars, and rumors of the insolvency of banks like Bankers Trust swept the markets. The market for Collateralized Market Obligations, or CMOs, a form of mortgage derivative, dried up, and took Kidder Peabody, the CMO leader, down with it. The bond markets took huge losses. Bankers Trust got caught cheating its customers.

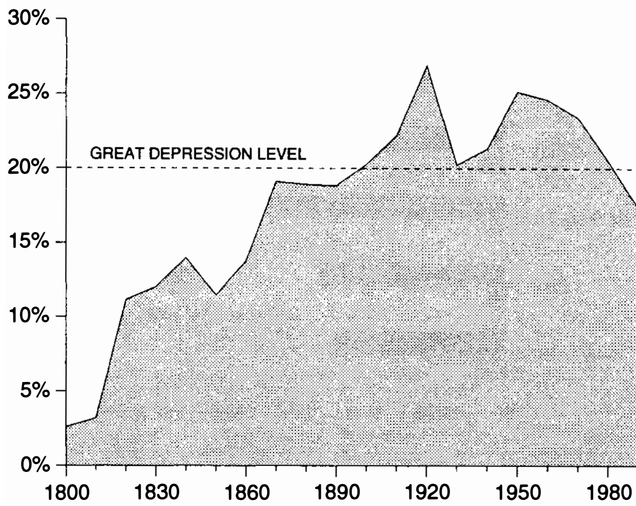
In December 1994, Orange County, California found itself with $2 billion in losses on its derivatives portfolio, and was liquidated by its creditors on Wall Street. Spooked investors fled, causing runs at the Texas state-run TexPool and similar funds across the country.

The crisis then spread across the border to Mexico, where it was temporarily calmed with a $50 billion international support package.

Productive economy dries up

In April 1994, Lyndon LaRouche issued his ninth economic forecast: "The presently existing global financial and monetary system will disintegrate during the near term. The collapse might occur this spring, or summer, or next autumn;

FIGURE 5
Manufacturing workers in the U.S. labor force
(percent of total labor force)



Source: EIR.

FIGURE 6
Collapse of U.S. steel production
(pounds produced per capita)

Source: EIR.

it could come next year; it will almost certainly occur during President William Clinton's first term in office. 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."

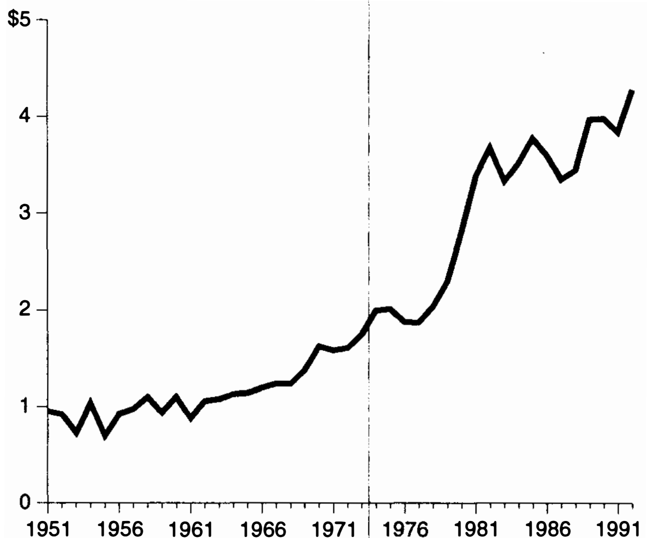
The reason the system will disintegrate, is that it depends for its survival upon an income stream from the real economy, and that economy is collapsing. That is, the productive capacity of the economy, measured in goods produced per capita, per household, and per square kilometer, is shrinking.

Figure 5 shows how the percentage of the labor force involved in manufacturing is declining. The long, steady growth of manufacturing, which enabled the United States to become the industrial engine of the world, peaked in 1920, when 27% of the labor force was involved in manufacturing. That percentage dropped with the depression, but climbed back up to 25% in 1950. It has declined ever since, to the point where it is now below Great Depression levels, back to the level of the 1860s.

An example of the effect of collapse in manufacturing can be seen in **Figure 6.** Since 1965, U.S. per capita steel production has fallen by 50%. Our steel-producing capacity has fallen similarly, to the point where we have neither the capacity nor the labor force to produce the amount of steel needed to build our way out of this crisis.

The U.S. economy is now operating below the break-even point. For every dollar of profit the economy produces, it incurs over $4 of debt, as **Figure 7** shows. It's hard to get ahead that way.

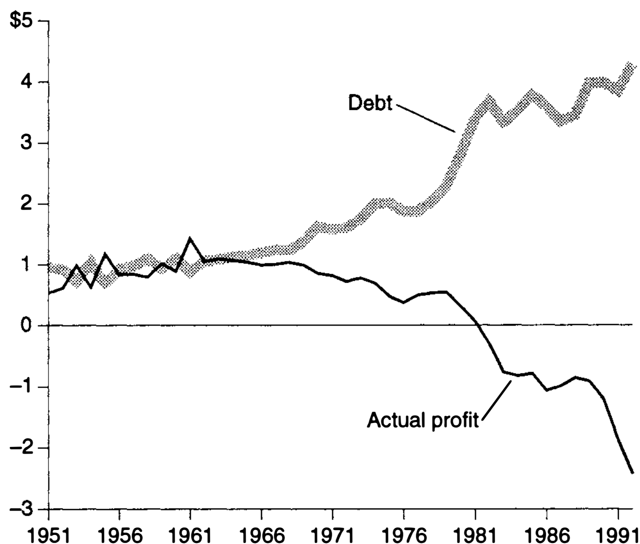
FIGURE 7
Debt service per dollar of profit
($ of debt service)



Source: EIR.

Figure 8 shows graphically LaRouche's proof that the attempts by the Fed and the government to save the bubble

FIGURE 8
Pumping the bubble only makes it worse
(debt or actual profit for every dollar of reported profit)



Source: EIR.

by pumping it up, only made things worse. The greater the so-called profit from the bubble, the more money the real economy loses.

Currently, for every dollar of so-called profit, we lose $2.50 and incur $4 in debt, for a total loss of $6.50 per dollar. That's like going down to the store and buying dollars for $7.50 apiece, and then taking that dollar, and calling it profit. Furthermore, the guy we're borrowing the money from to buy these dollars, doesn't have any money either: He's stealing it from somebody else. That "somebody else" is the rest of the world. We're stealing money from Ibero-America, from Africa, from Asia, from the former East bloc countries, looting their populations and our own, to keep the bubble afloat.

The solution to this crisis begins with recognizing the disease, the decay and inevitable disintegration of the existing central-bank monetary system, LaRouche said recently. Nothing can be done, and nothing should be done, to save the system. You have to tell the patient to give up the diseased organ; otherwise the patient will die.

"What we have to do, very simply," LaRouche said, "is to seize the U.S. Federal Constitution, and the work of Treasury Secretary Alexander Hamilton, the work of Henry Carey, of Friedrich List, and Abraham Lincoln, with both hands, and say, 'This was good; let us eliminate that which replaced it, which is now dying, and let us bring it back into operation.' "

LaRouche's method of physical economy

by Dennis Small

The following is the second part of Small's presentation, continuing from p. 23.

So, how did LaRouche know the Mexican crisis and the derivatives crisis were coming, when all the established authorities insisted otherwise? It's a question of method: not of *what* people think, but the *way* they think. In other words, if someone is always wrong, it is probably because they are thinking wrong; if they are usually right, it is because they are thinking right.

Let's start with some people who are always wrong: the winners of the Nobel Prize in Economics. In fact, one of the criteria for even being considered for the Nobel Prize, with the single exception of France's Maurice Allais in 1988, is to have an economic theory with no demonstrable relationship to actual physical economic reality. That puts you in the running. But then to make it to runner-up status, you have to use your delusional theory to make consistently erroneous forecasts. However, to actually win the Nobel Prize, you then have to go on to apply your policies to at least one country resulting in that nation's economic disintegration. *Then* you win the big one.

Take the case of 1970 Nobel winner Paul Samuelson. He is the guy who came up with the idea that depressions could never again happen, thanks to "built-in stabilizers" which automatically take care of everything. Samuelson is kind of the "What, Me Worry?" of economists.

In his 1955 textbook, which has been used for decades to rinse generations of professional economists, he pronounced: "The modern fiscal system has great inherent automatic stabilizing properties. All through the day and night, whether or not the President is in the White House, the fiscal system is helping keep our economy stable. If in 1980 a recession gets under way while Congress is out of session, powerful automatic forces will go instantly into action to counteract it before there are any committee meetings or the exercise of special intelligence of any form."

Most Nobel winners have followed Samuelson's dictum of doing without "the exercise of intelligence of any form." In 1974, the guru of the fascist Conservative Revolution, Friedrich von Hayek, won the award. Two years later, the University of Chicago's Milton Friedman won it. His view