

Speculation takes over the U.S. economy

by Anthony Wikrent

Chris White, the previous speaker, has shown how the post-industrial policy of the past 30 years has led to the present crisis. This post-industrial policy has radically altered the relationship of money and finance to the real economy. This question of finance is a stumbling block for many people. It is a stumbling block that has been dropped on their heads, inflicting severe brain damage, causing them to ask, when you explain to them the plan for economic recovery, silly questions such as, "How do you pay for it?" You can say it's a mental block.

The oligarchs have prevented governments from exercising the sovereign power to create and issue credit. All financing must be done by the creation of more debt, borrowed from—guess who. Investments in scientific and technological progress have not, under this post-industrial regime, created a rate of return high enough to pay off this debt, and yield a profit. Rather, debt is issued to fund more debt, creating a series of speculative bubbles, each larger than the one before. And, as each speculative bubble reached the point of collapse, it has been rolled into the new bubble succeeding it. That is how the oligarchs—and in the United States, I think of margarine, and call them oleogarchs; they're just wannabe oligarchs—have been able to postpone the day of reckoning for so long. With deregulation, the private *fondi* have been given carte blanche to use debt financing for whatever they see fit, including rolling over their collapsed speculative bubbles into new ones.

Not only have governments been prohibited from issuing credit, but "deregulation" has also prevented governments from imposing restraints on debt financing, to make sure it is limited to areas of socially useful, and economically productive activities. Today, the financial markets bear no resemblance to those of 20 or 30 years ago, and practices that would have been unthinkable then, are now accepted as common practice.

The foreign exchange market

A clear example of this process can be seen in the foreign exchange market. In the 1950s and most of the 1960s, there were basically three reasons for someone to buy a currency other than their own. First, if you were traveling, it made sense to buy some of the currency of the country you were traveling to. Second, if you were buying something from another country—if you were an importer—you would have

to change your national currency into another. Similarly, third, if you were an exporter, selling something to another country, you would want to change the foreign currency you were paid with, into your national currency.

In 1970, the year before the collapse of the fixed exchange rate system, foreign exchange trading around the world was about \$12 billion a day, or \$2.9 trillion a year (based on 244 business days a year). World trade that year totaled \$593 billion—that's imports plus exports. So, there was about six times more foreign exchange trading than there was actual foreign trade.

After President Richard Nixon took the dollar off the gold standard in August 1971, forcing the world into a system of floating exchange rates, foreign exchange trading increased eightfold in just three years, to around \$100 billion a day. From 1970 to 1981, foreign exchange turnover increased twenty-fivefold—ten times faster than price inflation, and four times faster than the increase in the value of world trade.

Since 1986, the Bank for International Settlements has had a number of its member central banks survey the foreign exchange trading in their respective countries, once every three years. That survey was taken again this past April. Neither the BIS nor the U.S. Federal Reserve have released the results yet, but foreign exchange managers, at such institutions as Morgan Guaranty, believe that the figure will easily be over \$2 trillion a day. That would be nearly \$500 trillion a year. Even assuming world trade increases 6% a year, as predicted by the World Trade Organization, world trade this year would be \$8.4 trillion. Foreign exchange is now at least 60 times larger than world trade (see **Table 1**).

The U.S. Federal Reserve was the first to attempt to measure foreign exchange, in 1977. That year, the Fed surveyed trading at 44 banks, probably representing around 98% of all foreign exchange activity in the United States at that time, and found that there was \$4.8 billion in daily foreign exchange trading in the United States. Multiplied by 244 working days in a year, that is about \$1.2 trillion. In that

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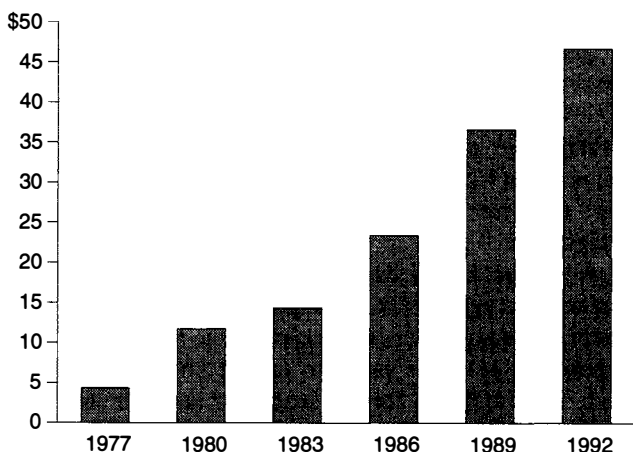
TABLE 1
U.S. merchandise trade versus foreign exchange

Year	Annual U.S. merchandise trade (billions \$)	Annual U.S. foreign exchange (billions \$)	Number of dollars of foreign exchange for each dollar of merchandise trade
1977	\$ 271.6	\$ 1,179.0	\$ 4.3
1980	465.5	5,449.0	11.7
1983	475.5	6,820.9	14.3
1986	609.5	14,274.0	23.4
1989	856.7	31,451.6	36.7
1992	1,002.1	46,921.2	46.8

FIGURE 1

The U.S. foreign exchange bubble

(dollars of foreign exchange for each dollar of trade)



year, the United States exported \$121 billion of merchandise, and imported \$150 billion. So, for every dollar of the \$271 billion in physical trade, there were over four dollars in foreign exchange trading (see **Figure 1**).

The Federal Reserve conducted another survey in 1980, this time of 90 banks, and found foreign exchange trading had increased to \$22 billion a day, or \$5.4 trillion a year. Merchandise imports and exports that year amounted to \$465 billion. So, for every dollar of trade, there were over ten dollars of foreign exchange.

By 1992, there was slightly over \$1 trillion in U.S. merchandise trade, but there was almost \$47 trillion in foreign exchange.

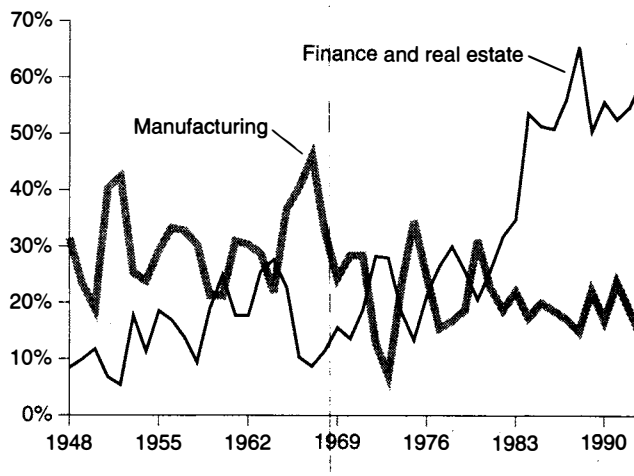
New financing headed off course

If we look at the total amount of new financing raised in the United States, we find that the financial system was already headed off course by the 1960s. Since 1948, the Securities and Exchange Commission has tabulated, each year, the amount of all new issues of stock, all new corporate bonds, all new bonds issued by local and state governments, and all new bonds issued by the federal government. Figures for the amount of new financing going into the private sector is further identified by the broad economic category that new financing was provided to: manufacturing; extractive industries, including mining, petroleum, and natural gas; public utilities; transportation, such as railroads, airlines, trucking, and ship lines; and financial and real estate ventures.

Figure 2 shows the percentage of new financing each year that was provided to two sectors: manufacturing, and real estate and finance. To give you some idea of the numbers involved, \$2.2 billion in new financing went to manufacturing in 1948, while \$594 million went into finance and real estate. The percentage going to manufacturing varied be-

FIGURE 2

Percent of new financing, by use



tween 20% and 30% throughout the 1950s and into the 1960s. But the percentage of new financing going to financial and real estate ventures was in a general upward trend throughout the 1950s and 1960s. In fact, 1960 is the first time that more financing was provided to real estate and financial ventures, than was provided to manufacturing—\$2.5 billion went to real estate and finance, while \$2.2 billion went to manufacturing. However, this occurred only in seven of the 32 years from 1948 to 1980. New financing for real estate and finance never exceeded the new financing for the entire physical economy, i.e., manufacturing, plus mining, plus utilities, plus transport, from 1948 through 1982. When Ronald Reagan was elected President in 1980—forget it. It's not even a contest. By 1984, over half of all new financing was going to financial and real estate ventures every year.

Figure 3 shows the amount of new financing raised for three categories, finance and real estate, manufacturing, and total physical economy, from 1970 to 1993. You can clearly see the extraordinary change that occurs during the Reagan-Bush years, beginning in 1984, when the amount of new financing for finance and real estate ventures exceeded not only manufacturing, but the entire physical economy sector.

Unfortunately, not all new financing raised for manufacturing or the other sectors of the physical economy, went for anything good. **Figure 4**, for example, compares the amount of money spent each year for buying other companies, called mergers and acquisitions, to the amount of money spent on buying new plant and equipment. The significance of this is that new plant and equipment are what is needed to build new productive potentials for future economic activity, whereas in mergers and acquisitions, what is being bought is already-existing productive capacities. In other words, you are looking at the misuse of finance in the economy.

The two big dots on the left at the bottom of **Figure 4** represent \$1.5 billion in mergers and acquisitions in 1960, and \$3.3

FIGURE 3
Where new financing went
 (billions \$)

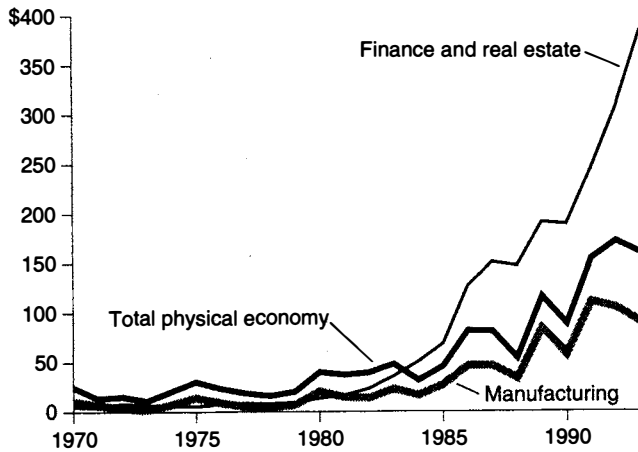


FIGURE 5
Spending for mergers and acquisitions, versus research and development
 (billions \$)

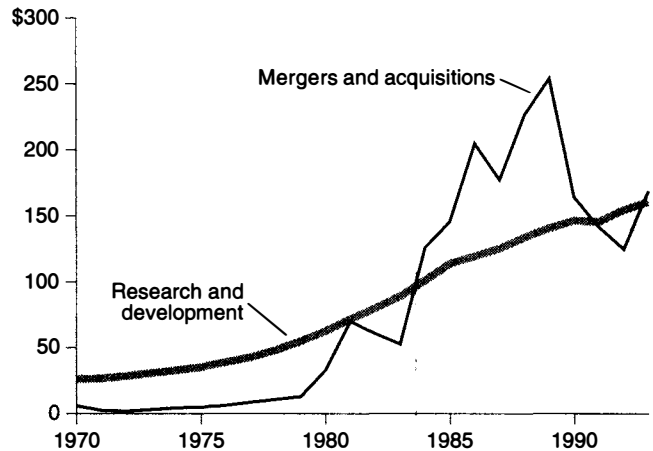
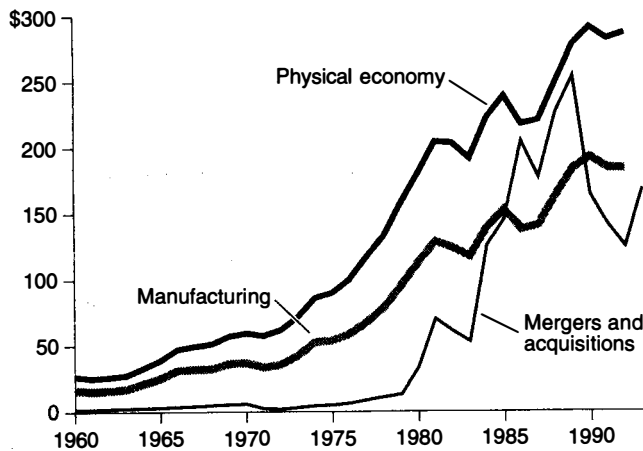


FIGURE 4
Spending for mergers and acquisitions, versus new plant and equipment
 (billions \$)



billion in 1965. Note how the amount spent on mergers and acquisitions, surpasses the amount spent for new plant and equipment expenditures by manufacturing in the middle of the so-called Reagan boom. The collapse in 1989 has to do with the end of the leveraged buy-out craze, caused by Drexel Burnham Lambert and Michael Milkin going out of business. Actually, leveraged buy-outs were only about one-tenth of all mergers and acquisitions, even at the end of the 1980s.

In the line representing new plant and equipment expenditures for the total physical economy, that is, manufacturing, mining, utilities, and transportation, by 1986, the amount spent—I should say, misspent—on mergers and ac-

quisitions is almost as much as what is being spent for new plant and equipment in the entire physical economy.

Figure 5 compares spending on mergers and acquisitions to spending on research and development. This includes the total amount of research and development by every sector in the United States—the military R&D programs funded by the Pentagon, R&D funded by NASA, R&D undertaken by private companies, R&D conducted by universities and other such institutions, and R&D by state and local governments, even the R&D by the federal government on such stupid questions as why people want to escape from prisons, or whether having mens and women's toilets discriminates against homosexuals. Research and development is very crucial, at least proper R&D, because this is how we as a species investigate the nature of our universe, and hopefully create new scientific knowledge and breakthroughs.

Futures markets change

Besides the obvious damage, such as the collapse of the productive tax base, that has been done to the economy by the misapplication of finance, the financial markets themselves have become grossly distorted (see **Figure 6**). For example, for over 100 years, futures contracts were based on actual physical commodities, mostly agricultural goods. But within 12 years of the end of fixed exchange rates, futures contracts based on such things as the interest rate on U.S. 10-year Treasury Notes, or the valuation of the Japanese yen compared to the dollar, or on a particular index of stocks, came to dominate the futures markets.

In 1973, there were about 25 million futures contracts traded in the United States, 20 million of them based on agricultural commodities, and about another 4 million based on precious metals, mostly gold (see **Figure 7**). Financial

FIGURE 6

Financials dominate futures markets

(millions of contracts traded)

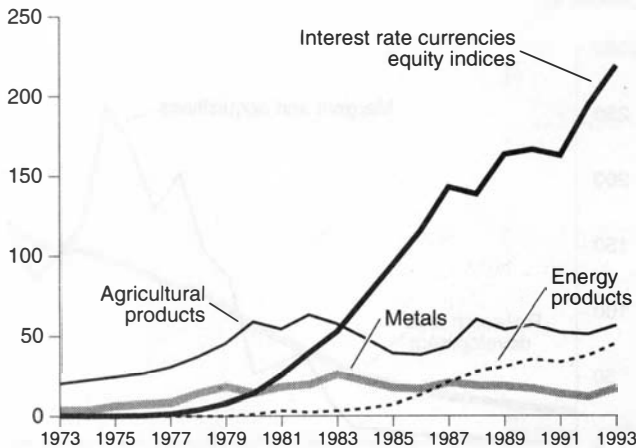
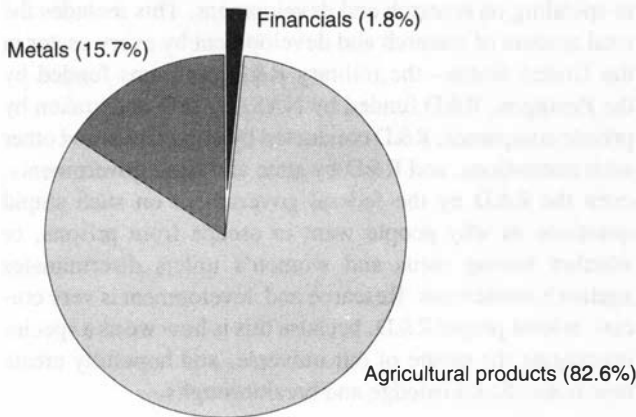


FIGURE 7

Types of futures contracts traded in 1973

(percent of total)



futures based on currencies, interest rates, or stock indexes, traded only 425,000 contracts that year.

In 1983, some 28 million contracts based on interest rates were traded, 12 million based on currencies, and 13 million based on equity (or stock) indices, for a total of 53 million financial futures contracts traded, which is just slightly under the 58 million agricultural futures traded that year (see **Figure 8**). By 1984, there were more financial futures contracts being traded than agricultural futures.

In 1993, there were 339 million futures contracts traded. Roughly 174 million were based on interest rates, 31 million were based on currencies, and 15 million were based on equity indices (see **Figure 9**). That is, 65% of futures contracts traded in 1993 were financial futures. The number of

FIGURE 8

Types of futures contracts traded in 1983

(percent of total)

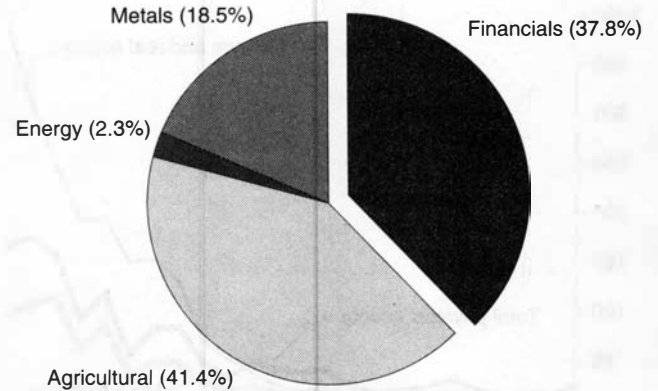
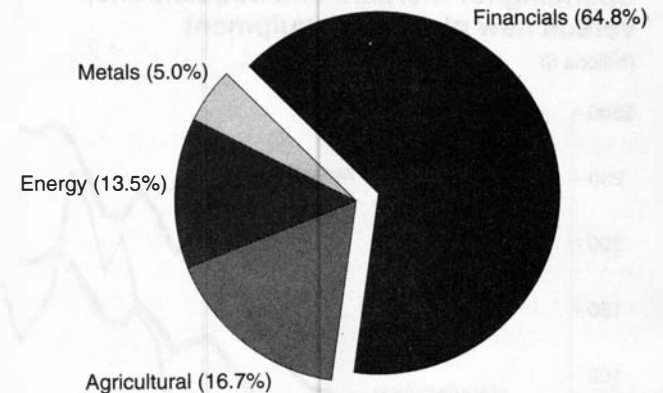


FIGURE 9

Types of futures contracts traded in 1993

(percent of total)



contracts traded, based on agricultural products, had actually fallen slightly from 1983, to 57 million.

I would point out that the first financial futures contracts, which were based on currencies, were created in 1972 by a fellow at the Chicago Mercantile Exchange, Mark Powers, who was advised by University of Chicago paganomist, Milton Friedman.

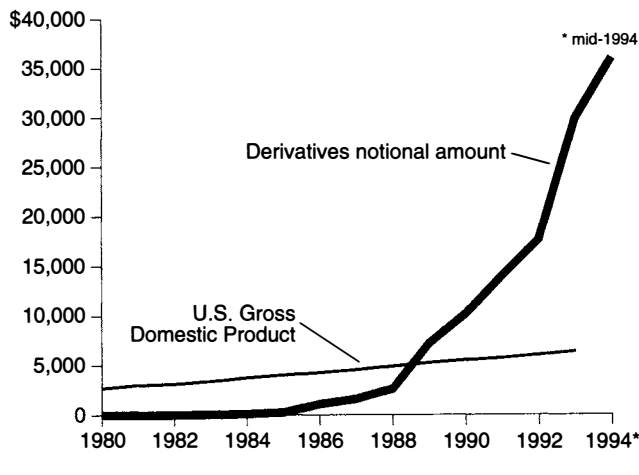
In 1973, the Chicago Board Options Exchange was created, with assistance from a junior partner at Goldman Sachs by the name of Robert Rubin, today our secretary of the treasury. If Bill Clinton is getting rotten information and advice on the economy, I have a hunch where to start looking for the source. By 1981, the volume of options trading had reached 92% of the total volume of all stocks traded on the New York Stock Exchange.

This incredible growth in options trading was made possible by some people associated with, again, Milton Friedman.

FIGURE 10

Derivatives compares to U.S. Gross Domestic Product

(billions \$)



Two of Friedman's students at the University of Chicago, Myron Scholes and Fischer Black, developed a mathematical model in the mid-1970s, for relating the changes in prices of an option, to prices in the actual stock or commodity underlying the option. Options and futures traders were powerfully attracted to the Black-Scholes model because its complex mathematical formula led them to believe it was a scientific law of the universe. Where, before, the only way to forecast prices of options and futures was to employ the intuitive knowledge of a trader who had amassed years of trading experience, now, with the Black-Scholes model, any trader with a computer could calculate prices.

The explosion of derivatives trading

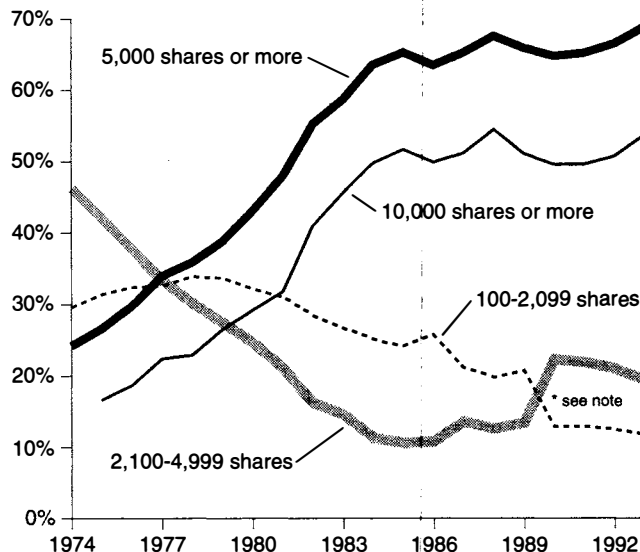
It was the various applications of the Black-Scholes model that made possible index arbitrage, and computer-directed program trading. The idea is that a change in the price of a stock or bond, or commodity, must be reflected in a change in the derivatives price, and that changes in the price of a derivative must be reflected in changes in the underlying stocks or commodities. If you can buy the lagging half of the equation before it catches up to the leading half, and then sell it once it has caught up, you can make a profit, with no risk. At least, this is what these speculators and financial rocket scientists believe. Hundreds of millions of dollars have been spent on computers to conduct such index arbitrage, as it is called.

These statistical computer models have been applied to the pricing and trading of all types of financial paper, resulting in the explosion of derivatives trading *EIR* has documented the past few years. (See Figure 10 for derivatives compared to U.S. Gross National Product.) It is this derivatives trading, directed by computers, that moves most of the stock market these days.

FIGURE 11

Autopsy of stock trading on the Big Board, by size of transaction

(percent of all trading volume)



Note: The jump in 1990 of the category "100-2,099 shares" reflects a change in the New York Stock Exchange's category that year, from an upper limit of 1,000 shares, to 2,099 shares.

The stock markets have, traditionally, been the means by which entrepreneurs would raise money for financing new economic activity, by offering shares of ownership to investors, rather than having to borrow debt financing. By the way, U.S. tax laws, which allow interest payments to be deducted, favor debt financing, rather than equity financing.

Figure 11 shows what has happened to the stock markets. In 1975, only 27% of all the shares traded on the New York Stock Exchange involved transactions of 5,000 or more shares, while 42% of all trades involved transactions of 100 to 900 shares. By 1980, this ratio had been reversed.

Now, transactions of 5,000 or more shares account for almost 70% of all trading on the New York Stock Exchange. Just think of a stock that costs \$20—that's a block of stock worth \$100,000. How many people do you know, that have that kind of money to move in and out of the stock market day in and day out? Since 1984, over half of the total volume of trading on the New York Stock Exchange has involved trades of 10,000 shares or more.

Look at what happens to smaller investors, measured by trades of 100 to 3,000 shares: They accounted for almost 50% in 1974, but fell to only 10% by 1984.

So, if you explain our program for economic recovery to someone, and they respond by asking, "How are we going to pay for it?" and you explain the difference between sovereign governments issuing credit, and private financiers issuing debt financing, and they still don't understand, I'll give you odds of ten to one they'll never understand.