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Derivatives Write Epitaph For the Financial Markets

by John Hoefle

It has been said that by the time you see the termites eating your kitchen table, your entire house is gone. That is the case with the economy in the United States and internationally. Since the collapse of Enron, a series of revelations are warning that underneath the visible spectacle of large corporations going bankrupt, are tens of trillions of financial termites—derivatives contracts—threatening to bring down the biggest banks in the world. As reported in eye-opening Senate testimony in late January, and in many nervous articles in the world's financial press, derivatives failures in the wake of Enron's implosion are eating the supporting financial structure away. They are ready to collapse at the first strong shock, in what Lyndon LaRouche on Feb. 16 called "a cluster-bust."

The physical economy of the United States—and the world—is collapsing at an accelerating rate. Layoffs have hit record levels, ominously concentrated in manufacturing; corporate profits are plummetting; and corporate and personal bankruptcies are setting records. At the same time, asset values are deflating, and debt continues to grow. The Fed's wall of money has not only failed to save the day, but has made the situation worse.

Under such circumstances, all of the top financial derivatives banks—by far the most exposed is J.P. Morgan Chase, America's second-largest—are bankrupt, certainly in reality and perhaps even by Arthur Andersen's rose-colored standards. There is no safe haven, as the deepening collapse of Japan's economy is ending a decade of massive yen support for the dollar. England is a rotted hulk with a parasite attached, and even the German economy has been largely destroyed.

The desperate nature of the situation can be seen in the rapid growth of the credit derivatives market—bets against interest-rate changes and bond defaults—which now totals half of the more than $100 trillion in derivatives contracts on and off the books of the big banks. Credit derivatives function as a form of insurance policy; someone who owns a bond issued by Acme Loophole Co. can buy a credit derivative which pays off should Acme default on its bonds. Such tricks can appear to work with isolated failures, but when large corporations start falling like dominos, these "hedges" are revealed to be an illusion, worthless pieces of paper backing up other worthless pieces of paper, a monument to monumental stupidity.

Since 1993, LaRouche's movement has distributed millions of pieces of literature, proposed legislation to tax and dry up the derivatives bubble, and delivered Congressional testimony warning that this vast cancer would destroy the financial system. The Federal Reserve and Congress chose to systematically strip away all regulation of derivatives, forcing out top regulators, such as Commodities Futures Trading Commission head Brooksley Born, who disagreed. The American population accepted this as a "free-trade axiom," despite well-known disasters like the bankruptcy of Orange County, California in 1994.

The Cancer Spreads

When LaRouche, in the early 1990s, began demanding action against the derivatives menace, the notional value of such financial bets held by U.S. commercial banks was about $9 trillion, and growing at a rate of about $1 trillion each quarter. As of Sept. 30, 2001, the derivatives *known* to be held by the commercial banks had risen to $52 trillion, over five times the level in early 1993 (the real total may have been far higher). Moreover, the increase in derivatives in the third quarter 2001 alone—$3.5 trillion—was equal in size to the entire asset base of the U.S. commercial banking system back at the end of 1992. We are now adding the equivalent of the entire 1992 banking system to the derivatives markets every three months! And that's just for the

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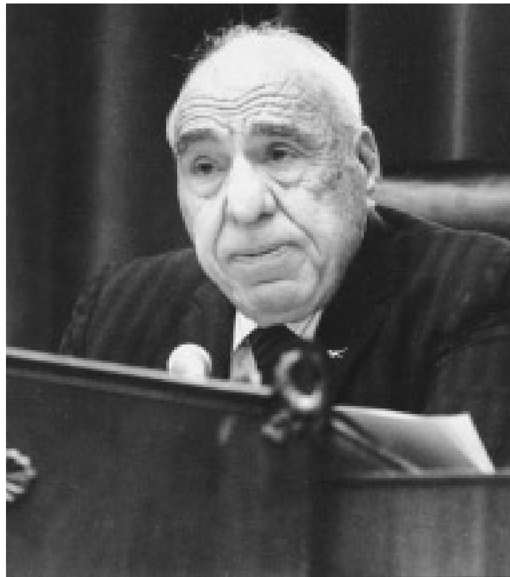

In 1993, only Rep. Henry Gonzalez of Texas (right, chairing hearing of the House Banking Committee on financial derivatives) heard the warnings of Lyndon LaRouche (left, in 1994 press conference) to regulate and dry up the derivatives markets. Now, ten times as large and shaking, they are ready to bring down the banks.

commercial banks. Throw in the investment banks, the insurance companies, the finance companies, the energy pirates, and the Enron-style off-balance-sheet entities, and the U.S. derivatives total is likely well north of $80 trillion, an amount equal to eight years of U.S. Gross Domestic Product at the current level.

One potential derivatives bust drawing sudden attention now, is what the *Wall Street Journal* on Feb. 20 called, "Fannie Mae Enron." Even the White House's proposed Federal budget has a section on the "increased risk" at "Fannie Mae and Freddie Mac," the two huge Federally-backed real-estate mortgage agencies. Already last year, these agencies wrote down $7.4 billion due to derivatives losses; the *Journal* warned that their dependence on derivatives is increasing. Others, fearing a derivatives blowout now, point to the large American Insurance Group (AIG). And the most-exposed institution, J.P. Morgan Chase, wrote down $100 billion in assets in the fourth quarter of 2001.

Many among the general public, and even some among those who read *EIR,* may have believed the claims that the 1990s was a decade of economic growth and prosperity. After all, the stock market boomed, the derivatives markets soared, the money flowed like wine; from the standpoint of the fleas, it was a grand old time, but for the dog, it was a disaster.

The derivatives-based financial system is essentially a looting mechanism in which markets are manipulated for the benefit of the financial oligarchy and its representatives. The extortion aspect of derivatives is similar to the old mafia protection racket, in which a brick is thrown through a shopkeeper's window, followed by a visit from a mafioso offering the shopkeeper protection against further vandalism. This is, essentially, the nature of the currency and interest-rate derivatives markets: Markets are manipulated in order to make them fluctuate wildly, then derivatives are sold as a measure of protection against volatility. Like the shopkeeper, the business which buys derivatives to hedge against volatility is paying tribute to the mob.

Derivatives are also used in financial warfare, as was seen in the so-called "Asian Crisis" of 1997. In response to a derivatives disaster in the City of London in early 1997, the Anglo-American financiers launched a currency war against the "Asian Tiger" economies. Though lucrative for the financiers, it was devastating to the assaulted nations, and to the world as a whole. By bankrupting the fastest-growing sector of the world's economy, the financiers accelerated the physical-economic decline; a similar process hit Russia, already weakened by the International Monetary Fund's (IMF) "shock therapy," leading to the Russian crisis of 1998 and the global derivatives gridlock known as the Long Term Capital Management (LTCM) crisis.

Senate Told: New Shocks Will Dwarf LTCM Bust

LaRouche described the blowout now rumbling just underground of the economy, in a Feb. 13 statement: "Enron was the flagship of a flotilla of Congressionally legalized pirates—sometimes called 'privateers,' which, taken all together, has marked similarities to what biologists recognize as a 'slime mold.' The result was a gigantic financial interbreeding among hedge-funds, totalling to what some of the world's best financial sources have reported to be $100 trillions or more in financial derivatives. Somewhat like the participants in a slime mold, each of the corporate entities involved combined to form a gigantic cluster of variously 'bisexual,' 'multi-sexual,' and even, according to some testimony, 'asexual' counter-party 'hedges.' "

Enron was multiply interlinked with the world's largest derivatives banks, led by J.P. Morgan Chase, Citigroup, Mer-

rill Lynch, General Electric, and the usual suspects, who not only arranged the sale of Enron bonds to the public, but were also partners with the company in a number of the partnerships and special-purpose entities.

In testimony before the Senate Committee on Governmental Affairs on Jan. 24, 2002, University of San Diego law professor Frank Partnoy described Enron as, "at its core, a derivatives trading firm," whose activity "makes Long-Term Capital Management look like a lemonade stand." Partnoy detailed how Enron used derivatives dealings with "its 3,000-plus off-balance-sheet subsidiaries and partnerships" to "shield volatile assets from quarterly financial reporting and to inflate artificially the value of certain of the company's assets." Enron used these measures to "hide speculator losses it suffered on technology stocks, hide huge debts incurred in financing unprofitable new businesses," and "inflate the value of other troubled businesses."

According to Partnoy, "most of what Enron represented as its core businesses were not making money. . . . It appears that some of its employees began lying systematically about the profits and losses of Enron's derivatives operations." "In a nutshell," he continued, "it appears that some Enron employees used dummy accounts and rigged valuation methodologies to create profit and loss entries for the derivatives Enron traded."

Those with long memories in the derivatives world might recall the case of Bankers Trust and Gibson Greetings. Bankers Trust, the prime derivatives sharpie of its day, had sold some complex over-the-counter (OTC) derivatives to Gibson Greetings, the gift-card company. As with many OTC derivatives, only the seller could tell the buyer what they were worth, and Bankers Trust systematically lied to Gibson, telling the company that contracts upon which Gibson had lost millions, were making money. That was in 1994, and Bankers Trust's corruption was revealed in order to provide the pretext for the Treasury and the Fed to take over the bankrupt bank and unwind its derivatives portfolio. The similarities between the Bankers Trust case and the Enron case illustrate how derivatives can be used to fraudulently inflate the value of assets, to help companies seem solvent.

Partnoy shocked the Senate committee by telling them that the 1997 failure of the large LTCM hedge fund—later acknowledged to have caused a near-meltdown of the international financial system—was "a backyard lemonade stand" compared to the Enron bust, and others now occurring. "The financial system, as a whole, is in the process of disintegrating," LaRouche stated on Feb. 16. "We have come to a point that the entire system, from the top down, is in a process of self-disintegration."

LaRouche Warned of Almost Unimaginable Consequences

The global derivatives market officially contains some $100 trillion in off-balance-sheet bets, according to the Bank for International Settlements. *EIR* estimates that the size of the derivatives market is actually some three times the admitted figure, but since $100 trillion is more than enough to wipe out the financial system, the difference is academic.

In the Spring of 1993, Lyndon LaRouche warned that the growing use of financial derivatives would lead to what, to most people, were unimaginable consequences, and proposed a tax of 0.1% on all derivatives transactions, as a way of beginning an orderly dismantling of the market. Few people had then heard of derivatives; in Congress also, the level of awareness was also dim.

One extraordinary exception was House Banking Committee Chairman Rep. Henry Gonzalez, an old-line Texas Democrat who understood the damage that rampant financial speculation was causing to the physical economy upon which human life depends. In June 1993, Representative Gonzalez took to the House floor on several occasions to call for action against derivatives, and included an article on the subject written by this author into the *Congressional Record.* "I wish to acknowledge the source of the contribution of the enormous exposure on what is known as off-balance-sheet accounts of our largest banks . . . the publication known as *EIR,* and, in my opinion, a very eminent writer and expert on banking matters," Gonzalez told the House.

The collaboration between LaRouche and Gonzalez deepened in September 1993, when Gonzalez asked the author to testify at a House Banking Committee hearing on the financial side of the North American Free Trade Agreement (NAFTA). *EIR* testified that "the purpose of NAFTA is to open up Mexico and eventually all of Latin America for unbridled speculation and looting, of the sort that has already devastated the American economy and bankrupted our banking system. When are we ever going to learn that the answer lies not in more deregulation, but rather in the abandonment of the policy of deregulation, and the return to rational rules and regulation?"

Gonzalez, a lone giant in a timid Congress, continued his fight against speculation, convening the House Banking Committee's first-ever hearing on derivatives in October 1993 to, in his words, "unwind this mystery called the derivatives market. . . . My purpose today is to ensure that regulators understand the systemic and operational risks posed by derivative activities."

Gonzalez hauled Federal banking regulators before the hearing and forced the Comptroller of the Currency and the Federal Deposit Insurance Corp., for the first time, to publicly reveal the derivatives exposures of U.S. commercial banks. *EIR* provided written testimony to the hearing on the need for a transaction tax to dry out the derivatives market.

Unfortunately, the Congress chose contributions over reason, and capitulated to the demands of Wall Street, passing NAFTA and continuing to pump out bills further dismantling regulation of the financial markets. It has proved to be a tragic mistake.