Derivatives Battle of 2003 Is Triggered by Economic Collapse

by John Hoefle

In early 1993, Lyndon LaRouche began warning the world that the headlong rush into derivatives which was then in its early stage, would ultimately blow up in the bankers' faces. At the time, LaRouche issued a pamphlet for mass circulation, calling for a tax on derivatives transactions as a way to dry out this emerging bubble. The bankers, convinced of their own brilliance and ability to manipulate the markets to their benefit (including the use of the Federal Reserve's pipeline into the public tax purse), ignored LaRouche's warning and launched what has turned out to be the biggest speculative bubble in world history. Now that bubble is evaporating, and threatens not only the U.S. banking system, but those of Europe, Japan, and virtually every other nation on the planet.

There have been others who have spoken out against derivatives, notably the late Henry B. Gonzalez, the Texas Democrat who headed the House Banking Committee in 1993 and used his power to force the Comptroller of the Currency to issue public reports on the size of U.S. banks' derivatives portfolio. The bankers couldn't stop Gonzalez from publicizing the issue—including inviting this author to testify before his committee in September 1993—but they had the votes to prevent any real reform.

In 1998, another official, Commodity Futures Trading Commission (CFTC) Chairman Brooksley Born, bravely suggested that her agency would revisit the issue of derivatives regulation—specifically the exemption given to energy and other derivatives by then-CFTC head Wendy Gramm in the final days of the first Bush Administration. Born's actions set off a firestorm of protest and a fierce counterattack, which forced her out of office and neutered the CFTC.

The most recent official attempt to focus public attention on the dangers of derivatives occurred on Feb. 4 of this year, when the Office of Federal Housing Enterprise Oversight—then headed by former Gonzalez Banking Committee staffer Armando Falcon—released a report on the "systemic risk" in the derivatives and mortgage-backed securities market. The next day, Falcon was fired and replaced by Mark Brickell, the former J.P. Morgan and International Swaps and Derivatives Association (ISDA) derivatives expert who had been one of those who testified against Brooksley Born.

Through it all, LaRouche and his movement have continued to fight the increasing virtualization and decreasing productivity of the U.S. economy, and chronicle the destruction wrought by this looting process. While the bankers have been able to hold their system together, they have done so at great cost to the general welfare and even to their own ranks; some of the more prestigious banks in the United States have combined in a series of shotgun marriages designed to put a facade of propriety on their devastated balance sheets. This rescue operation has also included vicious bouts of financial warfare against the non-Anglo-American world; the creation of phony booms in the dot.com, telecom, and energy trading sector; and the unbridled looting of American workers and corporations by the Wall Street speculation machine.

To listen to Federal Reserve Chairman Sir Alan Greenspan talk, one would think that derivatives were among history's greatest inventions, one which spawns wealth like flowers blooming in the Spring. Derivatives accomplish this munificent task, Lord Greenspin tells us, by "spreading risk" to those more able to bear it. Just a few years ago, Greenspan's mutterings were treated with respect approaching worship, but that was when the stock market was still rising. Today, with global stock markets cut in half from their peak and headed further south, his aura of invincibility is in tatters.

The essence of Greenspan's problem can be seen in LaRouche's Triple Curve collapse function (**Figure 1**), which shows the relationship between the rise of speculative bubbles and the collapse of the physical economy, as the increasing looting necessary to keep the bubble growing destroys the productive base upon which the bubble is built. During the

FIGURE 1
A Typical Collapse Function

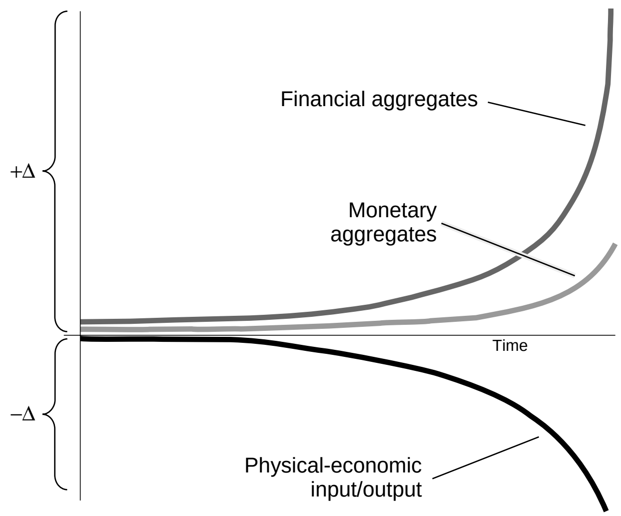
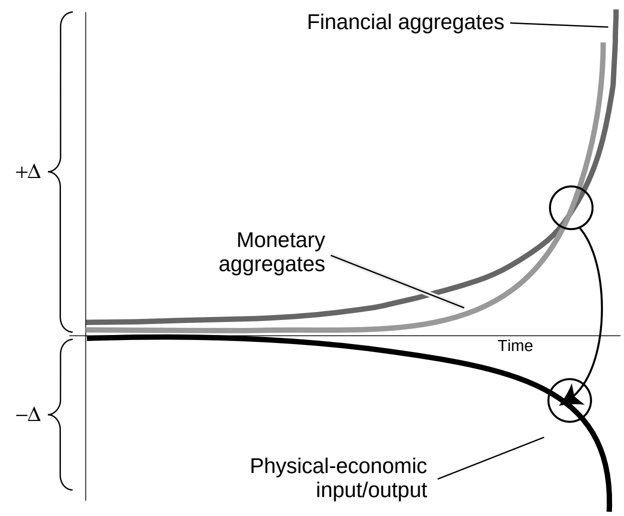


FIGURE 2
The Collapse Reaches a Critical Point of Instability



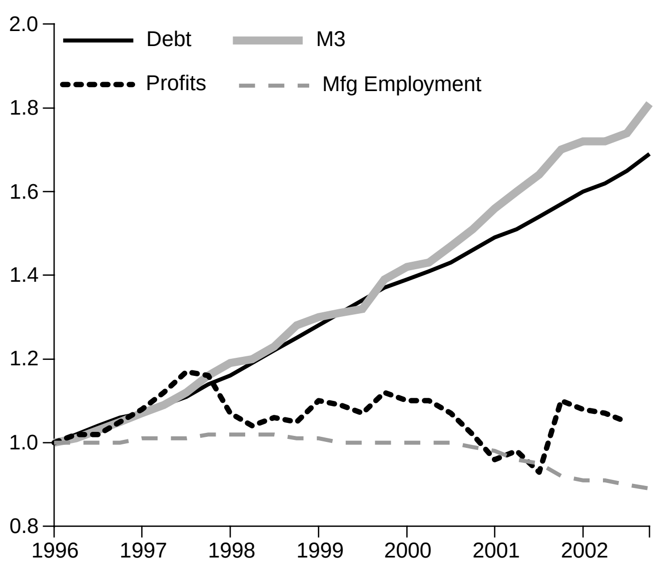
early and mid-phases of the bubble, the growth of the money supply followed the rise in financial aggregates and debt, as money was created to pay for the settling of the rising level of financial claims. That dynamic shifted with the financial crisis of Autumn 1998. Then, with the central banks' adoption of the "Wall of Money" bailout of the system, the rate of growth of the money supply *surpassed* the rate of growth of financial aggregates (**Figure 2**). This is the point, according to LaRouche, where the system switched over into a hyperinflationary mode, and liquidity pumping could no longer keep the financial system growing.

Showing this process using accurate data is difficult, because, as *EIR* has shown, the methods of data collection and analysis have become increasingly incompetent at best, and often deliberately deceptive to hide the damage. Still, the problem can be illustrated even using official data. As an approximation, *EIR* took the official figures for U.S. money supply, credit market debt (a measure of financial aggregates), and corporate profits and manufacturing employment. By indexing the figures to the first quarter of 1996, the trends in the relationships among these components becomes sufficiently clear to make the point, despite the misleading aspects of the data (**Figure 3**). The rise of debt is relatively steady, as new debt is incurred and old debt is rolled over, while the faster rate of growth of money supply since 1999 is clear. By comparison to the growth of the monetary measures, the fall of manufacturing employment may seem a bit flat, but it is actually the most dramatic curve on the chart, because employment can fall only 100%. The data on corporate profits is particularly problematic, as the manner in which profits are calculated is deceptive, and often the numbers reported are wildly fraudulent.

With this phase change, the levers Greenspan has been pushing no longer work. Even were he to lower interest rates to zero, as many have recommended, it will not help, because the value of the dollar ultimately depends upon the strength of the economy behind it, and that economy is dying.

FIGURE 3
The U.S. Economy's Collapse Function Since 1996

(Indexed to 1st Quarter 1996 = 1.00)



Sources: Federal Reserve; U.S. Dept. of Commerce; U.S. Dept. of Labor; *EIR*.

Derivatives Take Center Stage

It is in this context that the public flap over derivatives has broken out. The danger was raised dramatically by Berkshire Hathaway Chairman Warren Buffett in late February; in his annual letter to stockholders, Buffett called derivatives "time bombs," "potentially lethal . . . financial weapons of mass destruction." Buffett's letter is perhaps the most widely read corporate report in the world, and his attack on derivatives immediately became a leading financial news story. Not only were Buffett's comments given wide circulation, but they were also compared to the position of Greenspan, the ardent champion of derivatives.

The Lazard-connected *Washington Post*, in which Buffett is a major shareholder, made the debate explicit on March 6, counterposing Buffett's comments to Greenspan's and saying the two were "at odds" on the matter. The carefully worded article cited derivatives' role in the failure of Barings Bank in 1995, Long Term Capital Management (LTCM) in 1998, and Enron in 2001. The *Financial Times* of London devoted a full page to derivatives and Buffett's warning on March 10, giving the matter wide international circulation.

This was too much for the *Wall Street Journal*, which devoted its lead editorial on March 11 to a defense of derivatives. It attacked Buffett delicately, saying "every great investor makes an occasional mistake," and calling him "grumpy." The *Journal* declared derivatives "little miracles of financial engineering . . . [which make] the financial system less vulnerable to a giant blowout. On balance," it concluded, "the $2 trillion derivatives market is a very good thing."

The *Journal*'s description of derivatives as a "$2 trillion" market is telling, since both the *Post* and the *Financial Times* cited the Bank for International Settlement's figure of $128 trillion for the notional value of over-the-counter derivatives. *EIR* estimates that the market is actually in the $300-400 trillion range. This rather clumsy attempt to downplay the size of the derivatives market suggests that the *Journal* is trying to head off public discussion on the matter; which suggests, in turn, that something very big and nasty is going on in the derivatives world.

Buffett's remarks are, in fact, just the latest in a series of recent public statements which indicate that the failure of one or more derivatives banks is very much on the minds of the central bankers and plunge protection teams.

The matter was put quite bluntly by Greenspan on Nov. 19, 2002, when he cited "the remote possibility of a chain reaction, a cascading sequence of defaults that will culminate in a financial implosion if it proceeds unchecked. Only a central bank, with its unlimited power to create money, can with a high probability thwart such a process before it becomes destructive. Hence, central banks have, of necessity, been drawn into becoming lenders of last resort. . . . Thus, central banks are led to provide what essentially amounts to catastrophic financial insurance coverage." What Greenspan said is that, if a major derivatives bank were to fail, the Fed will bail it out by creating as much money as necessary, and stick the taxpayer with the bill. His position was seconded two days later by Fed Governor Ben Bernanke, who said that the Fed could "produce as many U.S. dollars as it wishes, at essentially no cost."

It is no secret that the Fed is committed to bailing out the derivatives banks, but it is striking that it would admit it so openly. *EIR* believes that, despite Lord Greenspin's "remote possibility" figleaf, the Fed's November comments were an intervention into an existing derivatives crisis, a signal to all that the Fed was standing behind a wounded bank and guaranteeing its payments.

That possibility was hinted at by Germany's central bank, the Bundesbank, which cited the "destabilizing" nature of derivatives in its January 2003 *Monthly Report*. In the discreet language of central banks, the Bundesbank warned that while the system might be capable of handling the failure of one derivatives bank, the danger was systemic. "More problematical than the collapse of individual institutions, however, is a critical situation that affects several institutions at once," the Bundesbank said. "The events of September and October 1998 show that, under such circumstances, the limits of the markets' resilience may soon be reached."

In February 2003, another warning of the systemic danger of the derivatives market was issued, this time by the U.S. Office of Federal Housing Enterprise Oversight, in a document entitled "Systemic Risk: Fannie Mae, Freddie Mac and the Role of OFHEO" (see *EIR*, March 14; or online at www.larouchepub.com). The OFHEO report warned of either Fannie Mae or Freddie Mac, huge derivatives contract holders, default on debt. The day after the report was released, OFHEO head Falcon joined the list of regulators who have been fired after daring to shine the spotlight on the bankrupt derivatives system.

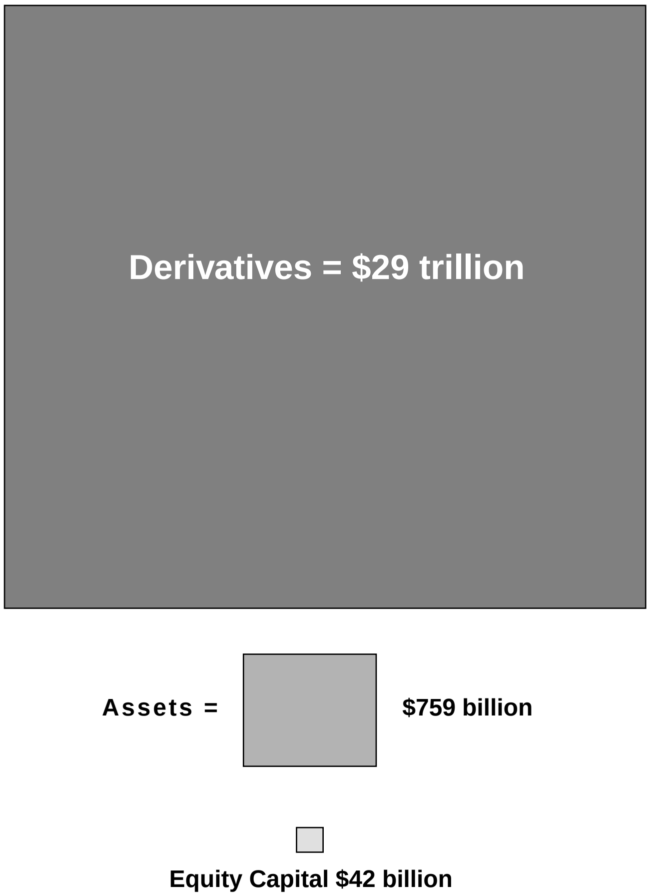
Bailout Under Way?

The firing of Falcon is, ironically, yet another signal of the profound weakness of the derivatives market. The indications are growing, as *EIR* has previously suggested, that one or more major derivatives banks has failed, and that the debate is not over what policy to follow in the future, but how to handle an existing problem.

At the top of nearly every list of problems is J.P. Morgan Chase, which has a larger derivatives portfolio than any bank in the world, and perhaps larger than any single country except the United States. Morgan Chase had $28.9 trillion in derivatives at the end of 2002, dwarfing its asset base and equity capital (**Figure 4**). The bank has become such a casino that its level of outstanding credit derivatives alone, $366 billion, is nearly twice its $186 billion in net loans. The bank has also been one of the main lenders to a whole series of failed companies, starting with Enron, with whom it did a number of deals designed to help Enron fake its balance sheets.

The other big bank which was a partner in Enron and other corporate scandals is Citigroup, whose recent bout of cash-raising and management shuffles suggest that it, too, may

FIGURE 4
J.P. Morgan Chase & Co.
(Dec. 31, 2002)



Source: *EIR.*

have encountered problems sufficient for the Fed to send in the cavalry. Citigroup, with $1.1 trillion in assets, is one of the largest banks in the world, and its $10 trillion derivatives portfolio makes it one of the most endangered. The bank is also reeling from an investigation into fraud in the way its Salomon Smith Barney unit rated corporate stocks, including the suggestion that Citigroup Chairman Sandy Weill arranged a higher rating for AT&T, in exchange for AT&T Chairman and Citigroup board member Michael Armstrong's help in pushing co-chairman and arch-rival John Reed out of the bank. The analyst who changed the rating, Jack Grubman, in turn got the bank's help in getting his kids into an exclusive New York school. Everyone involved denied the story, of course, but the bank seemed awfully anxious to settle the matter and stop the investigation.

Meanwhile, Bank of America has quietly worked its way into second place in the U.S. derivatives sweepstakes, with $12.5 trillion at year-end. Bank of America has $248 in derivatives for every dollar of equity capital, compared to $116 at Citigroup and $682 at Morgan Chase. A loss equivalent to just 0.15% of Morgan Chase's derivatives portfolio would be sufficient to wipe out every single dollar of its capital; the same would happen to Bank of America at 0.40% and Citigroup at 0.86%.

Given the trillions of dollars of market value which have disappeared from the worlds' stock markets over the past three years, the billions of dollars of corporate profits which have proved to be phony, and the trillions of dollars of debt which are more unpayable than ever, it is highly likely that one or more of these banks has encountered crippling derivatives losses and are receiving some sort of Federal bailout. Greenspan himself alluded to this process in testimony before the Senate Banking Committee on Feb. 26, when he said that, were "a very large institution" to get into trouble, it "will be liquidated slowly. . . . There's no need to liquidate very rapidly, and indeed we probably would not want that to happen. But at the end of the day, they will get liquidated."

An early model for the workout of a derivatives bank is the Bank of New England, which failed in January 1991. With $36 billion in derivatives—paltry by today's standards—it took Federal regulators a year to unwind BNE's derivatives portfolio to the point where they could close the bank. Derivatives portfolios are "unwound" using a variety of techniques which involve cancelling, closing out, or offsetting the various contracts in the portfolio. Often this involves a little browbeating by regulators—plus financial guarantees, because few counterparties are willing to trust a bankrupt bank to pay its bills.

There are other, bigger, workout models as well, such as Citigroup, Bankers Trust, and LTCM. In the case of Citigroup, it was secretly taken over by the Fed in late 1989, its loan and derivatives problems feverishly worked out, and the bank restored to the appearance of health several years later, then eventually sold off to Travelers to form Citigroup. Bankers Trust, the "smartest" derivatives bank of the time, blew up in 1994, was bailed out, and eventually sold off to Deutsche Bank. LTCM, the giant hedge fund which blew up in 1998, was bailed out by its creditor banks in a move orchestrated by the Fed.

Now, we can likely add J.P. Morgan Chase and Citigroup to the list, and perhaps Bank of America.

Crashing Too Fast

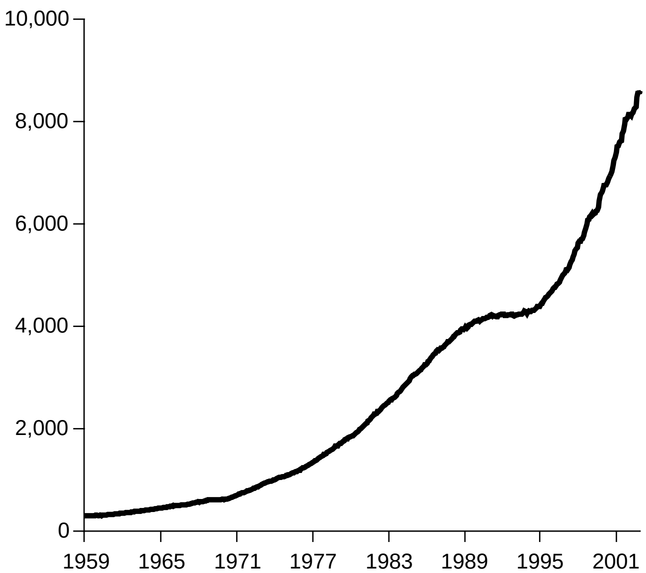
None of these measures will work, as they amount to little more than pouring money down a rathole. For years, the bankers claimed that derivatives hedged the risk, but lately Greenspan has turned to bragging about how they serve to spread the risk to parties better able to bear it, which is a roundabout way of saying derivatives serve to transfer losses and potential losses off the banks' books, and onto someone else's books.

One of the ways this is done is through suckering a counterparty into what seems to be a safe bet, then manipulating the market to give the counterparty a huge loss, and yourself

FIGURE 5

U.S. Money Supply Soars to Feed Bubble

($ Billions)



Source: Federal Reserve

The rapid growth of the U.S. money supply (M3, shown here) is the necessitated by the need to settle the growing number of financial claims which come due every, as the level of unpayable debt and related claims is rolled over.

a large profit. This method has been used repeatedly by the inner core of the Anglo-American bankers club over the years, in raids against various European and Asian nations. Shameless, yes, but immensely profitable in the short term.

Then there is the derivatives protection racket, in which those who control the market collect tribute, in the form of derivatives fees, for selling protection against the volatility they create. This is like the mafia throwing a brick through someone's window and then selling him glass insurance, but on a much larger scale.

The banks have also become major sellers of what are called asset-backed securities, a form of derivative in which assets such as credit card loans are pooled, and securities then sold backed by the assets in the pool. The amount of asset-backed securities outstanding on pools of automobile loans, credit card loans, home equity loans, and the like (excluding the much larger mortgage-backed securities market), has risen five-fold since 1995, to $1.5 billion at the end of 2002, according to the Bond Market Association. Of this total, $398 billion are securitized credit-card receivables; $287 billion are securitized home equity loans; and $222 billion are securitized auto loans; with another $235 billion in collateralized bond and debt obligations.

The ability to package these loans and move them off your books is one of the ways the banks have been able to keep rolling over unpayable credit card debt, thereby keeping the consumer spending bubble going. Still, it does make you wonder if perhaps your pension fund is counting among its assets, a collection of unpayable credit card balances and mortgages, including perhaps your own.

Emergency Measures

The house of cards has begun falling as the gap between what is owed and what can be paid increases, and the bailout methods become overwhelmed. We have reached the point where extraordinary measures—perhaps even the derivatives bailouts signalled by Greenspan—are on the drawing board, following the model of what was done behind the scenes to save the system after the 9/11 attack.

Both the U.S. and British governments have announced contingency plans to protect the financial markets in the event of war. The Treasury's plan, part of Operation Liberty Shield, says that the "financial markets are the engine of our free enterprise economy" and that the department is "determined that the financial markets continue to conduct business even during times of hostilities abroad or adversity at home."

If Washington is so foolish as to attempt a bailout of the derivatives markets under cover of a Mideast war, it will detonate a bomb far bigger than anything Saddam Hussein could dream of throwing at us; this "weapon of mass destruction" will be one of our own making.

Documentation

Fight Over Derivatives Crash, Hyperinflation

Federal Reserve Chairman Sir Alan Greenspan: These increasingly complex financial instruments have especially contributed, particularly over the past couple of stressful years, to the development of a far more flexible, efficient, and resilient financial system than existed just a quarter-century ago. . . .

More fundamentally, we should recognize that if we choose to enjoy the advantages of a system of leveraged financial intermediaries, the burden of managing risk in the financial system will not lie with the private sector alone. Leveraging always carries with it the remote possibility of a chain reaction, a cascading sequence of defaults that will culminate in a financial implosion if it proceeds unchecked. Only a central bank, with its unlimited power to create money, can with a high probability thwart such a process before it becomes destructive. Hence, central banks have, of necessity, been drawn into becoming lenders of last resort.

But implicit in such a role is the assumption that the burden of risk arising from extreme outcomes will in some way be allocated between the public and private sectors. Thus, central banks are led to provide what essentially amounts to catastrophic financial insurance coverage.

—to Council on Foreign Relations, Nov. 19, 2002

Fed Governor Ben Bernanke: The U.S. government has a technology called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes, at essentially no cost.

—to National Economics Club, Nov. 21, 2002

Germany's Bundesbank: The vast majority of OTC [over-the-counter] derivatives transactions take place between internationally operating banks or other financial institutions. The market is very concentrated: Just over half of all transactions in OTC interest rate derivatives takes place among some 60 institutions, of which seven are in Germany. In some areas, there are only a handful of players that account for the majority of turnover. Less than 10% of OTC transactions in derivatives is conducted with end customers outside the financial sector. . . . Derivatives have certain properties which may have a destabilizing impact. . . .

As things stand at present, there are no empirically corroborated findings on the impact that the sudden collapse of a major market maker can have on financial system stability. There are indications, however, that the derivatives markets are sufficiently liquid to allow the unwinding of sizeable positions without causing major dislocations. More problematical than the collapse of individual institutions, however, is a critical situation that affects several institutions at once. The events of September and October 1998 show that, under such circumstances, the limits of the markets' resilience may soon be reached. *—Monthly Report for January 2003*

U.S. Office of Federal Housing Enterprise Oversight: [A default of Fannie Mae or Freddie Mac on its debt] could lead to contagious illiquidity in the market for those [debt] securities, [and] cause or worsen liquidity problems at other financial institutions . . . potentially leading to a systemic event.

Between 1980 and 1995, over 130 of the member nations of the IMF—including the U.S.—experienced significant problems in their banking sectors that took the form of widespread failures, suspensions of the convertibility of bank liabilities, or large-scale government financial assistance to banks. Currency crises—speculative attacks on the value and devaluations of currencies, followed by efforts to defend that value by expending foreign reserves or raising interest rates—occurred in Europe in 1991-93, Latin America in 1994-95, and East Asia in 1997-98.

—"Systemic Risk" report of Feb. 4, 2003

Berkshire Hathaway Chairman Warren Buffett: [My partner Charlie Munger and I] are of one mind in how we feel about derivatives and the trading activities that go with them: We view them as time bombs, both for the parties that deal in them and the economic system. . . . The range of derivatives contracts is limited only by the imagination of man (or sometimes, so it seems, madmen).

The macro picture is dangerous and getting more so. Large amounts of risk, particularly credit risk, have become concentrated in the hands of relatively few derivatives dealers, who, in addition, trade extensively with one another. The troubles of one could quickly infect the others. On top of that, these dealers are owed huge amounts by non-dealer counterparties. Some of these counterparties, as I've mentioned, are linked in ways that could cause them to contemporaneously run into a problem because of a single event (such as the implosion of the telecom industry or the precipitous decline in the value of merchant power projects). Linkage, when it suddenly surfaces, can trigger serious systemic problems.

The derivatives genie is now well out of the bottle, and these instruments will almost certainly multiply in variety and number until some event makes their toxicity clear. Knowledge of how dangerous they are has already permeated the electricity and gas businesses, in which the eruption of major troubles caused the use of derivatives to diminish dramatically. Elsewhere, however, the derivatives business continues to expand unchecked. Central banks and governments have so far found no effective way to control, or even monitor, the risks posed by these contracts.

Charlie and I believe Berkshire should be a fortress of financial strength—for the sake of our owners, creditors, policyholders, and employees. We try to be alert to any sort of mega-catastrophe risk, and that posture may make us unduly apprehensive about the burgeoning quantities of long-term derivatives contracts and the massive amount of uncollateralized receivables that are growing alongside. In our view, however, derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal.

—Letter to shareholders, Feb. 21, 2003, published March 3, 2003

Alan Greenspan: The growth of OTC derivatives over the past 20 years has been spectacular and shows no obvious signs of abating. The latest estimate by the Bank for International Settlements of the worldwide notional amount of OTC derivatives outstanding reached $128 trillion in June 2002, a figure more than 25% larger than that recorded a year earlier. Such derivatives have become indispensable risk-management tools. *—to Banque de France International Symposium in Paris, March 7, 2003*

Former Fed Governor and Commodities Futures Trading Commissioner Susan Phillips: In many ways, derivatives provide stability to our markets, but they are instruments only for people who want to be in that business and have the expertise to do the valuations. We have seen a lot of volatility in markets recently, and if this had happened 15 or 20 years ago, we would have seen a lot of bank failures and failures of brokerages. The use of derivatives has helped shore up the financial system.

—quoted in the Washington Post, *March 10, 2003.*