LaRouche vs. Greenspan: An 18-Year Fight Over Financial Derivatives

Alan Greenspan, an acolyte in the cult of Ayn Rand, was appointed chairman of the Federal Reserve Board in August 1987, shortly before the "Black Monday" crash of Oct. 19. From that perch, he has for 18 years overseen the deregulation of the American financial system, allowing financial derivatives to run wild, overwhelming the physical economy, and bringing the world to the precipice of economic-financial collapse. As the following chronology shows, every step of the way, Lyndon LaRouche and EIR *have been warning of the consequences of these disastrous policies. Up to now, the Congress and the American people have, in general, not listened, preferring to chase the "riches" that have come with the biggest speculative bubble in history. The time in which to implement a change in policy—back to the American System—is running out.*

(The gray tones highlight what actually occurred in the financial system.)

1987

May 26: Lyndon LaRouche warns that "an October crash would be very probable" unless government policies are changed.

Oct. 19: Stock market suffers largest loss in history, as Dow Industrial Average drops 508 points, or 22.6%.

1988

Dr. Wendy Gramm, wife of Sen. Phil Gramm (R-Tex.), is appointed by President Reagan to the chairmanship of the Commodity Futures Trading Commission (CFTC), which is supposed to regulate commodity exchanges. From this post, she nurtures the growth of the derivatives market.

April 12: In a half-hour nationwide TV address, LaRouche likens financial market behavior to a bouncing ball on a downward trajectory.

1989

March 30: Michael Milken of Drexel Burnham is indicted on 98 counts of insider trading and other financial manipulations involving junk bonds, leveraged buyouts, and hostile takeovers. In 1986, he had been raising over $3 billion a week through junk bond sales, and told the *Washington Post],* "The force in this country buying high-yield securities has overpowered all regulation." He eventually pleads guilty to six felony counts and is sentenced to a $600 million fine and ten years in prison.

EIRNS

Lyndon LaRouche's "bouncing ball" image of the economy, on national TV during the 1988 Presidential campaign.

1992

November: Enron successfully petitions the Commodity Futures Trading Commission, headed by Wendy Gramm, to remove energy derivatives and interest-rate swaps from CFTC oversight. This opens the door to a new era of profiteering in the energy markets. Gramm resigns from the CFTC when George H.W. Bush leaves office in 1993; she then joins the board of Enron.

1993

March 9: LaRouche proposes a 0.1% transaction tax on derivatives, and proposes emergency measures to restore the physical economy. "The derivatives bubble, by the very nature of these transactions, is a financial bubble in the tradition of the more primitive, more rudimentary, and far less dangerous bubbles of the 18th Century, such as the John Law bubble in France, and the South Sea island bubble in England in the same period of time. This is the John Law bubble gone mad. The vulnerability to the entire financial system, the chaos and destruction of actual physical processes of production, distribution, employment, and so forth is incalculable in potential, and therefore this thing must be brought under control promptly."

May: Notional principal value of derivatives contracts in the United States is in the range of $16 trillion.

May 23: LaRouche writes: "If you were a visitor from another solar system looking at Earth and looking at the situation here, and taking into account derivatives, would you advise anyone to invest in this planet?

"I think the answer would be, on first impression: No. The significance of the derivatives, is the fact that they can be tolerated. The fact that they *are* tolerated in the way they are tolerated, in the way they are discussed in the financial community, indicates that *no one in their right mind* would invest in this planet, as long as the kind of thinking behind derivatives is hegemonic.

"What are derivatives? It's risk management. It's called capital. What kind of capital? Is it industrial capital? No, absolutely not. Rather, it is a manner of participating in a bubble which sustains itself by taxing the real economy, by sucking the life's blood out of it as premiums to pay these charges on risk management. Because it is the net charges on risk management, as against risk, that is the basis of the system. In order to have a charge which exceeds the risk, you must extract that relative amount from the real economy.

"Where does it come from? It comes from not maintaining infrastructure, water systems, and so forth. It comes from not maintaining industrial capacity; it comes from shutting down a plant in order to get something cheaper, presumably, from a cheap-labor area in a foreign country. It means looting of eastern Europe. It means looting the former Soviet Union. It means looting China through slave-labor projects, such as those in Hainan, or the enterprise zones, where Chinese are being gobbled up in Auschwitz-like patterns. . . ."

June: Rep. Henry Gonzalez (D-Tex.), chairman of the House Banking Committee, derides derivatives as "a fancy name for gambling." He calls for an investigation of George Soros's profiteering in the 1992 turmoil in European currencies. He scores Citibank and other major banks for off-balance-sheet derivatives speculation. "Is there money out there in these international markets for the procurement of goods, for firing the engines of manufacturing and production? No. it is paper chasing paper." He also puts into the *Congressional Record* an article by *EIR* economist John Hoefle, on the size of the banks' off-balance-sheet derivatives.

The History of the Fight Against Derivatives

From EIR*, May 28, 1993:*

The fight to institute Lyndon LaRouche's proposal for a one-tenth of 1% tax on financial derivatives comes after intense warfare over this issue by many nations that were fighting to preserve their national sovereignty. In the United States, trading in options on agricultural commodities had been banned in 1936, and the ban was not officially lifted until 1983.

Farmers had opposed the highly destructive effect of options, one of the earliest forms of the derivative market, starting in the 1920s, long before they became as large as they are today; even then, farmers still exercised significant influence within the United States. In 1933, an attempt was made to manipulate the wheat futures market using options, which resulted in an opportunity for farmers to force the U.S. government to ban trading in these options. There were attempts to re-introduce trading in agricultural options during the 1970s, but the plan met with only limited success.

It was only in January 1983, when President Ronald Reagan signed the 1982 Futures Trading Act, that the ban was officially lifted. This was a major feature in the disastrous Reagan-era deregulation of the U.S. economy.

Contrary to the "free enterprise" argument that options markets are essential to agriculture, because they make the market more efficient, American agriculture has demonstrated its ability to function and thrive without options trading for the three and a half decades since the ban in 1936 through 1983.

Moreover, America had, for a short time, a small financial transaction tax, and the fight to impose a larger financial transaction tax was very intense in the late 1980s.

Throughout the 1950s and early 1960s, the United States had a low-rate transaction tax—called a stamp tax—on the issuance and transfer of stocks and debt. The tax was repealed in 1965.

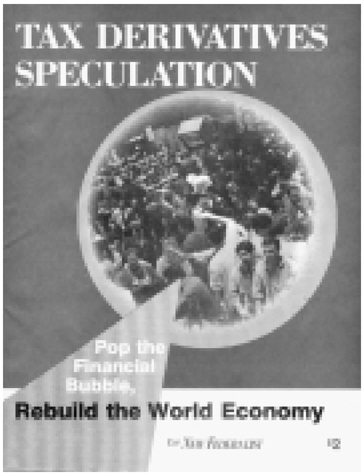
Rumblings from Congress

However, in the late 1980s, the fight broke out more intensely for a transaction tax of a greater size. In 1987, Speaker of the House Jim Wright of Texas called for a transaction tax on the financial markets. Wright's proposal called for a 0.5% tax on both the seller and the buyer in the same transaction, thus, effectively, amounting 1%. For six months, there was a heated public debate over Wright's proposal. Wright was soon driven from office in what is generally agreed to be an overblown scandal. The Oct. 16-19, 1987 stock market crash confirmed Wright's warnings of the instability of the financial markets.

Also in the 1989-90 period, during discussion of the 1990 Budget Reconciliation Act, Sen. Lloyd Bentsen, then chairman of the Senate Finance Committee and later Secretary of the Treasury, raised a proposal for a transaction tax on selected financial instruments on the floor of the Senate.

In February 1990, partly in response to the furor over this issue, the Congressional Budget Office, in its report "Reducing the Deficit: Spending and Revenue Options," had a section entitled "Impose a 0.5% Tax on the Transfer of Securities." Its analysis of the tax reported that "the tax would have to be broad-based, applying to stocks, debt, options and trades by Americans on foreign exchanges.". . .

—Richard Freeman



July: In a mass-circulation pamphlet, "Tax Derivatives Speculation; Pop the Financial Bubble, Rebuild the World Economy," published by the *New Federalist* newspaper, LaRouche warns of "the prospect of a derivatives bubble which grows like a cancer at the expense of its host, and shrinks its host, at the same time its appetite is growing, while the means of satisfying that appetite are collapsing."

July: A report, "Derivatives: Practices and Principles," is released by the Group of 30 top executives from money-center banks (Dennis Weatherstone, chairman of J.P. Morgan, Inc., heads the group, which includes former U.S. Fed Chairman Paul Volcker). The report asserts that there is no cause to worry about derivatives.

August: Feruzzi, the multinational food giant, reveals $3 billion of derivatives losses.

Sept. 8: *EIR*'s John Hoefle testifies on the dangers of derivatives before a House Banking Committee hearing on NAFTA, at the invitation of Chairman Henry Gonzalez.

Oct. 28: The House Banking Committee holds first-ever hearings on derivatives. *EIR* submits written testimony, entitled "Tax and Dry Out the Derivatives Market; Don't Regulate It."

December: Big derivatives losers are Germany's Metallgesellschaft, $1.34 billion; Malaysia's Bank Negara, $3 billion.

1994

February: Fed raises interest rates slightly, for the first time in five years, which is seen as an attempt to slow speculative bubbles. The result is a bloodbath in speculative markets. Hedge funds lose billions; the mortgage-backed securities market disintegrates. Rumors fly that there is trouble at Bankers Trust.

Long Term Capital Management (LTCM) hedge fund is started up by Robert C. Merton and Myron S. Scholes.

Feb. 1: Greenspan tells the Bankers Club in London that the rapid growth of trade in derivatives reinforces the requirement for central banks to oversee monetary policy and payments systems to protect the integrity of the financial system, "whether written in law or not."

Feb. 2: LaRouche comments on Alan Greenspan's Feb. 1 remarks defending extra-legal practices by central banks to deal with derivatives:

EIRNS/Claudio Celani

"The problem is that we've got a bunch of yuppies in Europe and in the United States, who are sitting at their personal computers or similar devices, and making money out of thin air, but at the expense of real business and real people. We're destroying the economy by a kind of cancer of speculation, which acts just like a metastatic, malignant cancer, eating at the whole of our economy: We gobble up assets; we sell off assets; we strip assets; we downsize—all for the purpose of feeding this margin of profit into this game called derivatives, and similar kinds of speculation.

"These people are fanatical.

"What's the issue? The issue is, first of all, like most prosecutors that I've known in this country, the Fed officials lie all the time. Why should anybody be surprised about that? They're looting the American people! Are they going to say that?"

April: Crisis surfaces at the venerable Kidder Peabody investment house; in August, GE dumps it.

Derivatives losers over the Spring months, include hedge funds: George Soros, $600 million; Julian Robertson, $875 million; Michael Steinhardt, $1 billion; Askin Securities, $600 million; Vaircana Ltd., $700 million. Others: Bankers Trust, $250 million; Gibson Greetings, $23 million; Cargill, $100 million. Public funds and entities include: City Colleges of Chicago/Cook County, $19.2 million; Eastern Shoshone Tribe of Wyoming, $700,000.

May 25: Bank of England Executive Director Brian Quinn praises derivatives before a conference co-sponsored by the Futures and Options Association and the Futures Industry Association: "The ingenuity of the specialists who design and price derivatives products . . . seems boundless. . . . Derivatives do not entail any new risks. . . . If the presence of derivatives makes prices of financial assets more volatile, does this necessarily mean the financial system is inherently less stable? The instinctive answer to this question seems to be 'yes.' However, academic work—while inconclusive—suggests that, if anything, the opposite is the case."

May 26: Greenspan testifies before the House Finance Subcommittee hearings on derivatives: "There is nothing involved in federal regulation per se which makes it superior to market regulation. Today's markets and firms, especially those firms that deal in derivatives, are heavily regulated by private counterparties who for self-protection insist that dealers maintain adequate capital and liquidity."

June 7: At a "Forex 94" conference in London, British Central Bank chief Eddie George declares that worries on derivatives are vastly exaggerated. What he fears much more than derivatives is any kind of stable foreign exchange rates: The establishment of a single European currency would increase unemployment in Europe and could lead to waves of migration of unemployed people across the borders of EU member states. He warns against any attempt to re-establish an international system of fixed exchange rates like Bretton Woods.

June 13: LaRouche releases his "Ninth Forecast," published in *EIR* on June 24 ("The Coming Disintegration of Financial Markets"). In it, he underlines the derivatives risk:

"It comes as no surprise that the name of the Bank of England's Eddie George is added to the list of which it must be said that 'whom the gods would destroy, they first make mad.' During the course of the current London meeting of the International Monetary Conference, Eddie joined the ranks of those greed-maddened public fools of finance who insist that the danger from the now metastatically cancerous financial bubble in derivatives speculation is being exaggerated by some critics. . . .

"The presently existing global financial and monetary system will disintegrate in the near term. . . . 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 Federal Reserve System is key to the derivatives bubble of today. Without corrupt, virtually treasonous complicit officials at the Fed, the speculative mania which has ruined our nation and much of the world besides would not have been possible. . . .

"The cancer of speculative derivatives burgeons—an ugly growth. Worse, to exist, the cancer must loot the healthy tissue in at least equal degree. Thus the monster grows, while the human being is sucked to death so. Excise the tumors, kill the cancer without killing the healthy tissue. The task is destroy the parasite, to save its victim. . . ."

July 14: Felix Rohatyn, senior partner of Lazard Frères, argues in the *New York Review of Books* for the freedom of the "global private capital markets": "A genuine worldwide market in stocks, bonds, currencies, and other financial instruments has emerged, tied together by modern data-processing and communications technology, and operating 24 hours a day. . . . The cold-blooded selection process by which world capital is invested will determine the economic progress of many nations."

November: Securities and Exchange Commission (SEC) and CFTC investigate Bankers Trust, which fires its derivatives executives.

December: Orange County, California, one of the nation's richest, files for bankruptcy after losing $1.7 billion in the derivatives market.

Derivatives losses become a byword across the country, ranging from Minnesota Orchestral Association, $2 million; to Odessa College, Texas, $11 million; to Piper Jaffrey Mutual Funds, $700 million. Florida, Ohio, South Carolina, Colorado, and Maine are also hit.

SEC/CFTC and Bankers Trust reach agreement, in which the government takes control of the bank, and Bankers Trust pays a $10 million fine.

Dec. 7: The Joint Economic Committee of Congress calls Greenspan to testify, and grills him on derivatives. Committee Chairman Kweisi Mfume (D-Md.) remarks: "The action that the Fed took with respect to Bankers Trust is a welcome one, but I personally am not convinced that this Federal action alone constitutes an adequate Federal response for the very significant amount of financial exposure that our country seems to be facing, as a result of derivatives."

Greenspan insists that no Federal regulation of derivatives is called for. "I do think we are in a period of evolving both private market and supervisory procedures in this regard. We are dealing with a very rapidly growing market in which there are very complex techniques involved in creating various products to unbundle risk. It is not easy to determine what the optimum amount of disclosure is, because if you're talking about full disclosure in all respects and all regards, then everyone is going to have to disclose very elaborate mathematical models with extraordinary detail involved in it, which would not serve anybody's purpose."

EIRNS/Claudio Celani

1995

February: Barings Bank, one of the oldest, most prestigious institutions, connected to Britain's royal family, fails over Asian derivatives deals.

July 28: In an *EIR* Feature on "Why Most Nobel Prize Economists Are Quacks," LaRouche writes:

"The October 1987 stock-market collapse signalled the coming end of the 'junk bond' phase, and inaugurated that 'financial derivatives' bubble which has made the early doom of the existing monetary system inevitable. . . .

"The increase of the size of the bubble increases the rate of growth of fictitious accumulations required to prevent the bubble from shifting into a reversed-leverage phase. The increase of the rate of growth of fictitious accumulations required, obliges the central banking systems to feed increased money-flows into the bubble's speculative base, otherwise, the fictitious accumulations are slowed, and the bubble as a whole then shifts into a reversed-leverage phase. The increase of the accumulated debt-capitalization used to fund the inflows of currency into the bubble's speculative base, causes an increased tax (of various sorts) upon the economy which the central banking system is looting to support the speculative base of the bubble. . . ."

Dec. 2: At conferences in Italy and Germany, LaRouche releases his "Triple Curve" Typical Collapse Function schematic (**Figures 1 and 2**). He describes it as follows: "This figure is a summary of three curves which are characteristic of the process of monetary and financial disintegration of the world economy."

1996

June: Pennsylvania State Rep. Harold James (D-Phila.) introduces House Bill 2833, to levy a state tax at the rate of two-tenths of 1% on the transfer or sale of "any bond, stock, security, future, option, swap, or derivative." James urges immediate adoption of the bill, both for revenues to back state medical and other urgent services, and to discourage speculation. Similar bills are proposed in Louisiana, Alabama, and New Hampshire, but all are eventually beaten back.

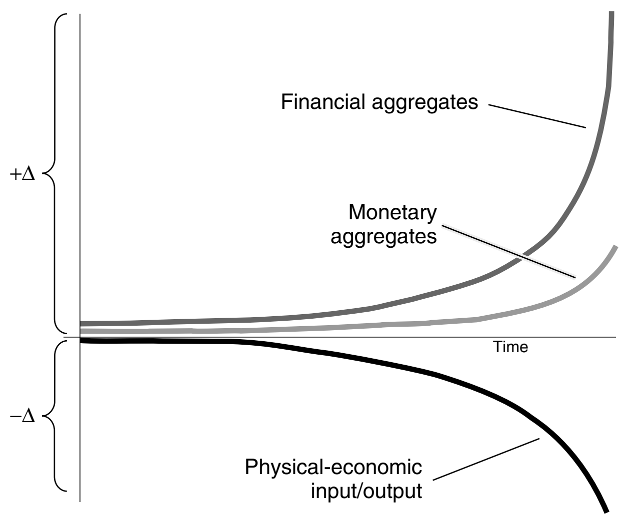
September: RhumbLine, a Massachusetts-based asset management company, racks up derivatives-based losses from January 1995 through September 1996, including $12 million in losses for the Massachusetts state employees and teachers fund; and $150 million for the AT&T pension fund.

1997

January-September: The notional principal value of off-balance-sheet derivatives holdings of U.S. commercial banks rises 26.5%, to a record $25.7 trillion, more than 62 times their equity capital.

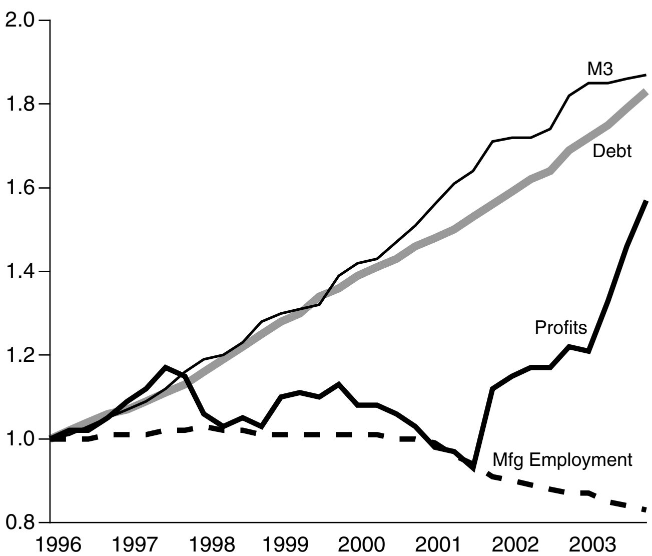
Jan. 4: LaRouche calls for a New Bretton Woods system, in a speech to the FDR-PAC in Washington: "The United States must act, together with other powers, to put the world into bankruptcy reorganization. *Every financial system, every banking system in the world, is presently bankrupt!* Particularly those that are involved in derivatives. Therefore, the United States must take leadership, international leadership, in proposing a new Bretton Woods, which would be a good term for it, which is what I've proposed—that we're going to go back to the principles of the Bretton Woods system in its best years, and the United States, as the principal prospective partner in such agreement, will try to get every nation that's willing to go along with this idea, to assemble and do it. And, those that *don't* wish to go along with it, that's just

FIGURE 1
LaRouche's Typical Collapse Function



The "triple curve" schematic, introduced at a Rome conference in 1995, forecast accurately what would happen to the global economy.

FIGURE 2
Changes in Triple Curve Components, 1996-2003
(Indexed to 1Q/1996 = 1.00)



Sources: Federal Reserve; Bureau of Economic Analysis; Bureau of Labor Statistics; *EIR*.

tough, we're going to go ahead with it anyway."

April 16: Enron official and International Swaps and Derivatives Association director Mark Haedicke, testifying before a House Subcommittee on Risk Management and Specialty Crops hearing on the CFTC, demands that Congress explicitly legalize certain derivatives actions which are illegal under existing law. Noting that the law "flatly prohibits off-exchange futures contracts," making them "illegal and unenforceable as a matter of law," Haedicke insists that legalization were necessary, for Enron and its peers to obtain "the full benefits of future innovations in risk management techniques."

April: In her confirmation hearings to become chairman of the CFTC, Brooksley Born warns that Wendy Gramm's exemption of energy derivatives from CFTC oversight "could lead to widespread deregulation," which "would greatly restrict Federal power to protect against manipulation, fraud, financial instability, and other dangers." This would "pose grave dangers to the public interest."

July: Greenspan writes three letters to the Financial Accounting Standards Board, vehemently opposing its proposal that derivatives contracts be listed on corporate books. In his third letter, released on July 31, he writes: "The FASB proposal may discourage prudent risk management activities and in some cases could present misleading financial information." He says that his letter was endorsed by the heads of 22 "major companies in a number of industries that use derivatives [and] have expressed serious concerns about the FASB's proposed rules changes." These 22 corporate leaders are mostly bankers.

Oct. 14: Long Term Capital Management (LTCM) hedge fund's founders, Robet C. Merton and Myron S. Scholes, are awarded the Nobel Prize in economics, for "a new method to determine the value of derivatives." (See **Figure 3.**) In the words of the Royal Swedish Academy of Sciences which announced the prize, they "developed a pioneering formula for the valuation of stock options. . . It has . . . generated new types of financial instruments and facilitated more efficient risk management in society."

FIGURE 3

Black-Scholes Formula for Derivatives

Black and Scholes' Nobel Prize-winning formula for a European call option can be written as

$$C = SN(d) - Le^{-rt}N(d - \sigma\sqrt{t})$$

where the variable d is defined by

$$d = \frac{tn\frac{S}{L} + \left(r + \frac{\sigma^2}{2}\right)t}{\sigma\sqrt{t}}$$

The value of the call option C*, is given by the difference between the expected share value—the first term on the right-hand side—and the expected cost—the second term—if the option right is exercised at maturity. The formula says that the option value is higher, the higher the share price today* S*, the higher the volatility of the share price (measured by its standard deviation) sigma, the higher the risk-free interest rate* r*, the longer the time to maturity* t*, the lower the strike price* L*, and the higher the probability that the option will be exercised (the probability is evaluated by the normal distribution function* N*).*

A year after receiving the Nobel Prize, the two economists' huge hedge fund, LTCM, went bankrupt, threatening to bring down the global financial-monetary system.

1998

March: Greenspan opposes CFTC head Brooksley Born's proposal to study U.S. derivatives trade.

April 2: At a meeting in Rome on the New Bretton Woods, LaRouche says: "The system is essentially bankrupt. The international financial system is bankrupt. There is only the prosperity of fools in the system. We have in the world presently, dominated by so-called derivatives, about $140 trillion equivalent of short-term gambling debts. In the recent years, especially since 1982, and most emphatically since 1987, the growth of derivatives has taken over and eaten up the banking system itself."

May: CFTC calls for closing the derivatives exemption issued by previous chairman Wendy Gramm.

July: House Banking Committee hearings designed to beat the CFTC into submission. Enron board member and former CFTC chairman Gramm testifies that no further regulation of over-the-counter derivatives is necessary.

September: Long Term Capital Management (LTCM) fails, having transformed around $3 billion in investment capital into $100 billion in bank credit, and then issuing further financial bets with a nominal value of at least $1.2 trillion. Other estimations of the derivatives obligations of LTCM place them at up to $3 trillion.

Sept. 23: The New York Federal Reserve calls the heads of the 16 largest banks of the world together, overnight, in order to start an immediate joint rescue operation for LTCM. The Fed moves to bail out its creditors, with a $3.6 billion rescue fund.

Oct. 1: Greenspan tells the House Banking Committee, don't study and don't touch derivatives. "The structure of counter-party interrelations is the main means of regulation."

Nov. 6: LaRouche writes in *EIR* on "The Roots of Today's Mass Hysteria." "How could most of the leading banks and related institutions of this planet, have been, for so many years, such pathetic suckers for such an obvious swindle as that so-called 'derivatives' bubble which now threatens, at almost any moment, to do to the world's financial system what the Weimar hyperinflationary bubble did to the 1923 Reichsmark? Speaking clinically, the problem is that, for more than a decade, the world's leading financial institutions, and the governments, including most officials of the Executive Branch and the Congress of the U.S.A., have behaved as lunatics, on financial, monetary, and economic policy. That behavior of those institutions is a case of mass hysteria."

Dec. 16: *EIR*'s Hoefle presents written testimony, "Don't Just Regulate the Derivatives Market, Eliminate It! Assert Financial Sovereignty Over the Financial Markets," to a Senate Agriculture Committee hearing on over-the-counter derivatives.

1999

January: Speculator George Soros, commenting on the panic over Brazil's debt and sky-high interest rates, tells a news conference, "I don't think there is a great deal of time, really. . . . Interposing a wall of money would stabilize the situation."

2000

Dec. 15: Congress passes the Commodity Futures Modernization Act, legalizing the exemption of energy derivatives from CFTC regulation. Sen. Phil Gramm played the key role in ramming the legislation through. It is signed into law on Dec. 21. According to a CFTC press release, the law "is a significant step forward for U.S. financial markets. This important new law creates a flexible structure for regulation of futures trading, codifies an agreement between the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission to repeal the 18-year old ban on trading single stock futures and provides legal certainty for the over-the-counter derivatives markets. . . ."

2001

June 20: Senate Banking Committee conducts a hearing on "The Condition of the U.S. Banking System." Greenspan gives an opening statement, saying that great improvements have been made in "risk management" and control systems. *EIR*'s Hoefle submits written testimony, describing the risk from derivatives:

"Picture a dog with a very bad case of fleas, the dog representing the productive sector of the U.S. and the fleas representing the worst elements on Wall Street. During the 1970s and 1980s, the fleas built up huge trading empires, trafficking in the flesh and blood of the dog. The fleas were so successful that the once-powerful dog began to dramatically weaken, and no longer produced enough blood to allow the fleas to continue trading in the manner to which they had become accustomed. Being clever critters, the fleas came up with a solution which pleased them all: They began trading in blood futures. Since they were trading in futures rather than actual "product," they were no longer limited by the amount of blood they could suck from the dog. The level of trading expanded dramatically, and the fleas became rich beyond their wildest expectations. Right up to the point that the dog died.

"That, in essence, is the nature of today's derivatives markets, and the global financial system as a whole. . . ."

2002

Nov. 19: Greenspan addresses the Council on Foreign Relations on the potential for a taxpayer-funded bailout of the derivatives market:

"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 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. Such a public subsidy should be reserved for only the rarest of occasions. If the owners or managers of private financial institutions were to anticipate being propped up frequently by government support, it would only encourage reckless and irresponsible practices."


Alan Yue

2003

Feb. 4: The Office of Federal Housing Enterprise Oversight, headed by Armando Falcon, issues a report on the "systemic risk" of the securities and derivatives activities of Fannie Mae and Freddie Mac. The White House responds by demanding Falcon's resignation.

Dec. 19: The giant Italian food company Parmalat goes bankrupt. It had increasingly shifted its operations out of productive activity and into derivatives.

2004

Jan. 3: LaRouche issues an article (published in *EIR* on Jan. 16), "Parmalat and LTCM: Pricking the Big, Big, Big Bubble." He writes: "The signs are piling up virtually by the day, that the collapse of the Parmalat bubble may not be a relatively minor, Enron-style debacle; but, a larger version of that type of crisis, of the Long Term Capital Management hedge fund, which already shook the foundations and rafters of the world monetary-financial system during August-September 1998."

Jan. 13: Greenspan speaks in Berlin, demanding further, radical deregulation and globalization of the world financial system. He attempts to calm European worries about the exploding U.S. trade and currency account deficits, and the collapse of the dollar. *EIR*'s Dr. Jonathan Tennenbaum intervened, saying that Greenspan's policies were leading to "the collapse of the greatest financial bubble in modern history." Eighty percent of the U.S. population "do not see the great prosperity you talk about," Tennenbaum said. "Lyndon LaRouche has pledged to put an end to the system of independent central banking. You, Mr. Greenspan, will be the last chairman of an independent central bank in the United States. What do you say about that?"

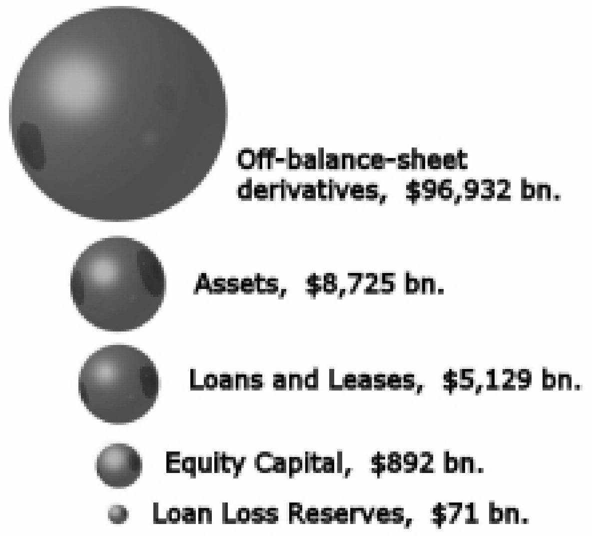
Greenspan replies: "I can't deny the possibility that the whole system might collapse." Credit derivatives "have been quite extraordinary in being able to take a very major potential problem in finance—and I will give you one specific example—and defuse what could have been the makings of what could have been a very major financial crisis."

Elaborating on the method of "solving" one bankrupt bubble by creating another much larger one, Greenspan let some cats out of the bag: "I refer to the fact that between 1998 and 2000, world-wide and in all currencies, the equivalent of $1 trillion of debt was taken out by the telecommunications industry, a significant part of which went into default. Had we had the type of financial system which we had in the earlier postwar period, with the rigidities you referred to, because banks are largely leveraged institutions, we would have had a very major collapse in banking. In the event, however, because credit derivatives moved the risks from banks who initiated the credits, to those far less leveraged institutions, which were insurance companies, reinsurance, pension funds, etc. not a single major international financial institution was in trouble. These have been very major instruments for *smoothing out the system*. . . .

"And you presume that as a consequence of all of these issues, that we are sitting on some massive financial bubble, which is going to blow up in our faces. You are not the only one who says that. . . .

"How do we know that the total system will not collapse? Well, the answer to that question . . . is that no one has the omniscience and certainty to say, without qualification, that you are wrong. I shall merely say that the evidence that most of us who evaluate the data with respect to trying to answer that question, have overwhelmingly come to the conclusion, that that is extraordinarily unlikely to happen."

FIGURE 4
U.S. Commercial Banks, June 30, 2005



Derivatives dwarf banks' other assets: This is a snapshot from an animation which is posted at www.larouchepub.com/animations.

December: Deutsche Bank's 2004 year-end annual report states that the bank holds derivatives positions, mostly interest rate derivatives, of a nominal volume of $21.5 trillion. That is about ten times the GDP of the German economy.

2005

Jan. 14: *EIR* reviews the "astounding growth of derivative side bets," as reported in the U.S. Comptroller of the Currency's Dec. 21, 2004 report. J.P. Morgan Chase had $43 trillion in derivatives as of Sept. 30, 2004, an amount roughly equal to the annual gross world product, and four times U.S. GDP. Citibank had $17.5 trillion, and Bank of America $17.1 trillion. Banks' derivatives holdings have increased at about 25% a year for the past three years, more than doubling since the end of 2000, when they stood at $40.8 trillion, according to the FDIC Quarterly Banking Profile for the third quarter of 2004.

March 3: U.S. Senate Minority Leader Harry Reid (D-Nev.) states that "Greenspan is the biggest political hack we have here in Washington," in a CNN interview.

May 5: Standard & Poor's downgrades $453 billion in outstanding debt of GM and Ford to "junk."

May 10: Banks known for their giant derivatives portfolios—including Citigroup, J.P. Morgan Chase, Goldman Sachs, and Deutsche Bank—are hit by panic selling, as the effects of the GM/Ford blowout hit the markets.

May 18: Bank of England Deputy Gov. Andrew Large warns, "Credit risk transfer has introduced new holders of credit risk, such as hedge funds and insurance companies, at a time when market depth is untested." Large states that the growth of derivative instruments has "added to the risk of instability arising through leverage, volatility, and opacity."

Oct. 12: Phillip Bennett, CEO of Refco, Inc., a leading futures-trading firm, is arrested for securities fraud, for allegedly cooking Refco's books to mislead investors who bought nearly $600 million worth of the company's stock when it went public in August. In February 2005, Refco had $150 million in equity suporting $49 billion worth of assets—i.e., 0.3% of assets. As of February 2004, Refco had $69 billion in off-balance-sheet derivatives contracts; in Febaury 2005, $127.5 billion; and in May 2005, $150 billion.

Oct. 17: Refco files for bankruptcy protection.

Glossary of the Global Financial Casino

Hedge Fund: A form of mutual fund used by wealthy individuals and institutions to engage in aggressive speculative activities prohibited for ordinary mutual funds. Hedge funds are restricted by law to no more than 100 investors per fund, and these investors are presumed to be sufficiently knowledgeable to understand the risks. Most hedge funds have extremely high minimum investment amounts ranging from $250,000 to well over $1 million.

Derivative: A financial contract whose value is derived from the performance of assets, interest rates, currency exchange rates, or indexes. Derivative transactions include a wide assortment of financial contracts including structured debt obligations and deposits, swaps, futures, options, caps, floors, collars, forwards, and various combinations thereof.

Credit Derivative: A contract between two parties which uses a derivative to transfer credit risk from one party to another, in exchange for a fee. For example, an investor who owns bonds issued by General Motors might buy a credit derivative from his investment bank, which will pay off should General Motors default on the bonds. In return, the investor pays the investment bank a fee, which the bank considers sufficient to run the risk that it will have to pay. If there is no default, the bank makes a tidy profit.

Collateralized Debt Obligation: CDOs are securities backed by pools of assets, mainly non-mortgage loans or bonds. In exchange for interest charges, buyers of the CDOs bear the credit risk of the collateral, which means that if any of the loans or bonds in the pool are not repaid, the holders of the CDOs take the loss. CDOs are made up of tranches, with various maturities and risk characteristics, with the equity tranches carrying the most risk, and therefore paying the highest interest rate to the buyer.

Capital Structure Arbitrage: A form of arbitrage which exploits differences in the pricing of a company's stock price and its debt. These bets are growing rapidly because of the development of the credit derivatives market.

Over-the-Counter Derivative Contracts: Privately negotiated derivative contracts that are transacted outside of organized exchanges.

Exchange-Traded Derivative Contracts: Standardized derivative contracts transacted on an organized exchange, and which usually have margin requirements.

Off-Balance Sheet Derivative Contracts: Derivative contracts that generally do not involve booking assets or liabilities (for example, swaps, futures, forwards, and options).

Swap: A deal in which two counterparties agree to swap the cash flows from different financial instruments, such as securities paying fixed and variable interest rates. A Credit Default Swap is a form of credit derivative in which the buyer pays the seller in exchange for an agreed-upon payment should the specified "credit event," such as a default or the breaking of a loan covenant, occur.

The reader is advised that the technical descriptions above do not begin to do justice to the insanity of the processes they describe. Credit derivatives, for example, do not really provide protection against a default, since the institutions which issue them are often in precarious financial positions themselves, and sell the derivatives because they are desperate for the cash flow. In the current environment, a credit derivative is mainly used to provide the accounting fiction that certain mostly worthless assets on a company's books still have value. The derivatives market, overall, is designed to *hide* the bankruptcy of the system by providing virtual assets to paper over gaping holes in the system, as well as garnering cash flow from selling mafia-like protection to companies ravaged by market manipulations. One of the chief agencies of such manipulations are the hedge funds, which act as front men for the Anglo-American central banks and their sibling financial institutions.

—*John Hoefle*