EIR Economics

'Derivatives' underlie European currency crisis

by William Engdahl

Complex and unregulated "off-balance-sheet" trading in derivative financial instruments by New York and London banks and financial groups triggered the September 1992 currency crisis in the European Rate Mechanism, which culminated on "Black Wednesday," Sept. 16, in the decision by the British government to abandon the ERM agreement and let the pound sterling float in the open market, followed soon after by Italy.

EIR is in possession of information explaining the least understood aspects of a crisis which savaged entire national economies and currencies in a matter of days, despite the strenuous efforts of the German and other European central banks. The new information throws an entirely different light on the efforts to destabilize the fixed exchange rate stability of the European countries. It indicates that the use of highly leveraged derivatives is by far the greatest single danger to global financial stability today. As one informed European banking source put it, "Without the enormous growth of speculative derivatives trading, the ERM crisis would have never come about."

The role of "derivatives," a poorly understood and alarming new element in international financial markets, was singled out at a recent conference in Frankfurt, Germany. *EIR* has learned that an intensive study of the role of derivatives (currency swaps and futures contracts) in destabilizing Europe last September, is under way, under the direction of the German Bundesbank and the central banks of the other Group of 10 countries. (The G-10 includes Sweden, Switzerland, and Holland, in addition to the G-7 member countries—the United States, Germany, Great Britain, France, Italy, Japan, and Canada.)

In reply to a question from *EIR* regarding the study, Bundesbank President Helmut Schlesinger told an audience of several hundred central bankers and financial figures meeting at the Fourth Session of the G-7 Council, "We are studying the period prior to Sept. 16 in order to determine just why the order of mandatory central bank currency intervention needed was so large. To illustrate, back in the crisis of 1987, European Monetary System central banks made a total of DM 15 billion ($9.4 billion) to stabilize the system. This past September, the figure was DM 60 billion. This is a big change. Our study is to determine just what is behind this enormous growth."

According to a study by the Bank for International Settlements, an umbrella coordinating body of European and other major central banks, global daily trade in all currencies has exploded from $640 billion in 1989 to an estimated $1 trillion today. But of this $1 trillion, a mere 5%, or at most 10%, of all trading volume in international currencies—dollars, deutschemarks, yen—results from routine transactions such as export of goods, where currency conversion is required. The remainder, possibly 95% of the $1 trillion daily, is from speculative so-called derivatives or related "hedging" operations of financial firms and banks.

How it works

Derivatives are trades where actual stocks or bonds are not exchanged, but only agreements by two parties to make payments on a future date at a price related to performance of a commodity or currency. Typically a bank can make a derivative currency deal putting up only 10% of the nominal value of a contract, the margin. Traders like George Soros last September could borrow money to speculate against a French devaluation or the British pound by putting up as little as 5% cash. That is, Soros was able to borrow $1 billion for speculation for $50 million in cash, a staggering 20:1 leverage.

A typical swap operation such as Soros used last fall

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would be taking dollars to borrow, say, Italian lira, then converting the lira into deutschemarks at the fixed ERM rate. Then, as the press played up the Italian political and economic crisis and the assassination of key Italian anti-mafia figures, corporations nervously sold liras and the currency fell from 765 liras in early September to 980 liras only four weeks later, relative to the deutschemark. As the lira fell, Soros would buy cheap liras (28% cheaper) to repay his initial lira debt, for which he had only put up 5%. His rate of profit was in fact 560%, or $280 million. And no government regulator could control his trades as things are currently constituted.

Determining what's out there

"The issue is very delicate," Bank of Italy General Manager Lamberto Dini told *EIR* in Frankfurt. "Regarding the role of derivatives trading in foreign exchange instability, it is still too early to say. The G-10 is in the midst of a fact-finding process to learn exactly what is going on. But so much is clear: American and London banks are by far the largest players in this process. We first must determine what is out there."

According to reports from Wall Street, the major boost to the profits of U.S. banks in the July 1-Sept. 30 period of last year (the third quarter) was from massive highly leveraged speculation against stability in the European ERM. In fact, so large were the trading profits in such currency derivatives during the September crisis, that the subsequent fourth quarter results of many U.S. banks suffered by comparison. J.P. Morgan trading revenue for the third quarter was an impressive $313 million, while fourth quarter totals were a weak $200 million because of relative calm in the ERM currencies compared with September. New York banks' trading profits from speculation against European currencies last autumn were estimated to have risen by 50-100% compared with a year earlier, a windfall of as much as $500 million for the ailing banks such as Citicorp, Chase, and Bankers Trust, whose real estate and commercial loan exposure is weakening persistently as the economic situation worsens.

"The explosion in off-balance-sheet trading in exotic derivatives such as currency or interest rate swaps is what has central bankers alarmed," commented one senior Washington source to *EIR* at the Frankfurt session. "There is a huge behind-the-scenes fight between conservative European bank regulators and their American counterparts. The U.S. position is the most liberal. Banks are allowed to trade derivatives without regulation from authorities, off the books, so to say. Gerald Corrigan and the Fed ruled this to help ease capital adequacy pressures on the larger U.S. banks some time ago. Then they let U.S. banks 'net' their swap or other derivative risk. Europeans largely do not permit this. They hold [that] their banks must assume risk of default in line with the full face value of a currency contract, for example."

The "netting" issue is crucial for understanding why mainly U.S. banks and financial firms have been able to unleash the flood of speculation against European currencies. In a typical currency "swap," one form of derivative, New York Bank A, say, agrees to sell $100 million to Paris Bank B, payable in 90 days at a pre-agreed price or foreign exchange parity. If the French franc has fallen, say 10% by the due day against the pre-set price, Bank A must make up the difference, i.e., loss of the 10% spread. Or if it rises, the trader gains 10% on his contract price. His "net" risk, argue U.S. banks, is only the small difference, often far less than 10%, and not the nominal $100 million face value of the full contract.

For good reason, U.S. banks prefer "net" risk. Today, according to figures of the International Swap Dealers Association in New York, there is an estimated $4.3 trillion in nominal value of "swaps" in force worldwide in the unregulated or "over-the-counter" derivatives market. So-called OTC trades are bilateral deals executed by two parties, most often by striking a computer key. A wrong stroke has been known to cost brokerage firms hundreds of millions of dollars.

Derivative trades are allowed to be unregulated in the United States. In October last year, little-noticed in the run up to elections, Congress passed the Futures Trading Practices Act of 1992. It specified that over-the-counter *swaps* contracts (in interest rates or currencies) are not to be classed as "futures," thus allowing the most explosively growing paper market in the world to be exempt from trading on established exchanges such as the Chicago Mercantile Exchange, where strict rules require expensive up-front margins before buying a futures contract in any commodity or currency, as insurance against default.

Thus the OTC derivatives never appear on the bank balance sheet of Citicorp or such banks, and never require capital reserves in event of default of a counter party. As long as the trader wins, all is well. It's when things go wrong, that the entire $4,300 billion bubble could implode with a force which would pull down companies around the world.

Some days after the ERM crisis, on Nov. 24, Bank for International Settlements General Manager Alexandre Lamfalussy addressed a group of bankers in London, warning, "Why do I and many of my central bank colleagues harbor concerns about the potential for these new activities to cause problems of a systemic nature in the international financial system?" Lamfalussy hinted at the possibility that, as with stock index futures speculation in October 1987 which aggravated the size of the 508-point Dow crash, "activity on derivatives markets might feed back into the underlying cash markets in such a major way as to accentuate the very price volatility against which some derivative instruments are designed to offer insurance."

He further warned that the huge off-balance-sheet derivatives risks of banks has "rendered the nature and distribution of risk in financial market operations more opaque." Given the broad international use of derivative currency swaps and interest

rate and even stock contracts between national financial markets in the past five years, Lamfalussy warned of the ultimate horror scenario: "In the event of a problem appearing in one institution, other firms would react sharply and quickly. They might rapidly and indiscriminately withdraw credit lines, and even try to unwind existing positions. *All of which would increase the possibility of the sudden emergence of a global liquidity 'gridlock'* " (emphasis added).

Lamfalussy added that the computer revolution and deregulation of financial markets during the past 10 years, starting in New York and London, has added to the danger of such a gridlock.

George Soros and the franc

The man who has made headlines for his claim to have grabbed $1.5 billion in the collapse of the pound sterling on Sept. 16, New York speculator George Soros, was also at the Frankfurt gathering. Soros claimed to be concerned that the currency speculators had gone too far. At the time, the French franc was under massive speculative pressure, as March elections promised possible policy changes and a non-socialist government. The entire speculative assault on the ERM began sometime last June, following the June 2 Danish referendum which repudiated the European Community's Maastricht Treaty. It was deliberately fueled by Washington and London to weaken the stability of continental Europe and the economic prospects there.

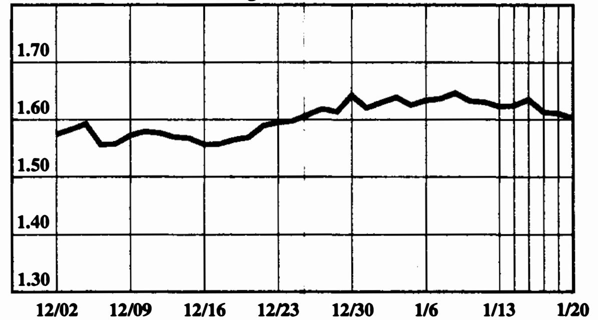
By January, Soros was saying, "If we were to have the free float of the franc today, this would spell the end of the ERM; it would also likely mean the end of the European Community itself. . . . The responsibility lies with the Germans and their high interest rates." Some people in the French government foolishly concluded that the powerful Soros, who is reported to invest for a secretive group including Israeli investors and Marc Rich, the fugitive commodities trader, was backing off. More informed accounts are that he realizes it is unlikely that he can start the same panic in the media against the franc and the French economy that he could against Britain and Sweden. He reportedly is preparing his next speculative assault, using derivatives, against Germany.

But the unspoken secret of the phenomenal success of New York banks and speculators like Soros is not their clever financial computer models, but rather the fact that they are trading on insider information reportedly leaked by the New York Federal Reserve. This is the conclusion of financial sources in Europe. They report that already last June, New York financial investment houses were operating on "good information" that the ERM would collapse into complete anarchy and lead to "free-floating currencies by the end of 1992 or early 1993." Some London banking sources speculate that discovery of unethical leaks from the New York Federal Reserve to key players like Soros or banks like Citicorp or Bankers Trust could be behind the sudden resignation this month of New York Fed Governor Gerald Corrigan.

Currency Rates

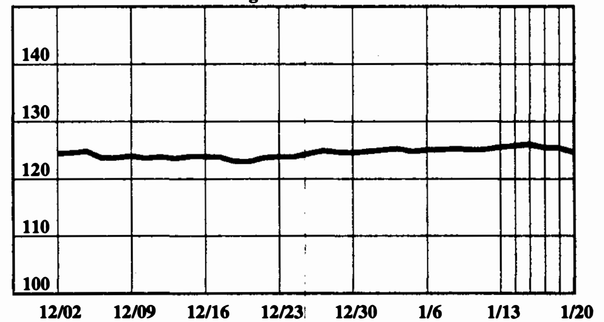
The dollar in deutschemarks

New York late afternoon fixing



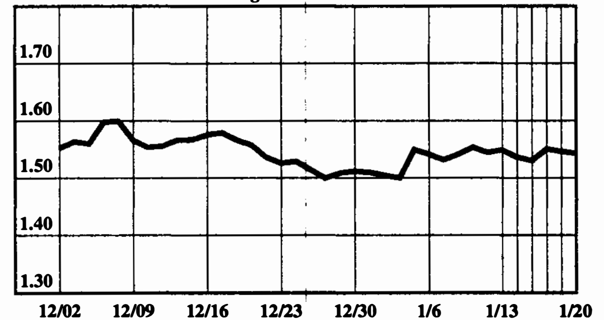
The dollar in yen

New York late afternoon fixing



The British pound in dollars

New York late afternoon fixing



The dollar in Swiss francs

New York late afternoon fixing