# Regulating derivatives isn't such a good idea

by Chris White

International banking regulators produced another set of reports on the "risks" associated with derivative financial instruments the week of May 3. Among them are the Bank for International Settlements, which is recommending that banks' capital reserves be increased to offset derivative risks, and the U.S. Securities and Exchange Commission, which is seeking public comment on the question of whether or not securities dealers ought to set aside additions to capital for the same purpose.

Meanwhile, the General Accounting Office of Congress and the Commodities Futures Trading Commission, run until recently by Sen. Phil Gramm's wife, Wendy, continue to work on their forthcoming studies.

The offerings made public from the "regulators" so far miss the point, and will actually make things worse. It would be much better, from the standpoint of "managing risk" and restoring control, to simply tax the derivatives, as Lyndon LaRouche has proposed. The tax proposal meanwhile came under fire from the head of Switzerland's National Bank, who left no doubt that such measures were the last kind of thing he wanted to see.

Derivatives are financial instruments based upon agreements by two parties to make payments on a future date at a price related to the market performance of a commodity or currency. Futures contracts, swaps, and options are all derivatives.

The regulators are, in effect, proposing to legitimize the practice that has developed in recent years, in the name of controlling it. That is a recipe for additional disasters not so far ahead.

Remember when the regulators began to get involved with the savings and loan crisis? In the name of dealing with "excesses," they doomed taxpayers to fund a multi-hundred billion dollar bailout of commercial and investment banks, which were given, at knockdown prices, the still viable assets of failed S&Ls.

Or, what about the "leveraged buyout" binge of the late 1980s? Regulatory hair-pulling and breast-beating didn't do too much to avert what was already foredoomed to come to pass in that case, either. Nor, interestingly enough, have any of the U.S. regulatory agencies given a public accounting of what was involved, and what they discovered, when they unwound Drexel Burnham Lambert's derivative positions after the collapse of the Michael Milken junk-bond empire. Nor have they accounted for why it took so long. Such a report might just help to clarify what it is that international regulatory agencies have begun another of their ritual dances around.

## The real issue: What is wealth?

What they are avoiding is indicated, in typical tongue-in-cheek style, in the London *Economist*'s April 10 "International Banking Survey." There, Sykes Wilford, managing director of Chase Manhattan's risk-management group, is reported thus: He "likes to show clients a certificate dating from June 1863 when London bankers working for the Confederate States of America raised a dual-currency loan with a coupon linked to future cotton prices."

That little cameo encapsulates what is at issue between the regulators and the advocates of taxation. What is wealth, and how is it produced? Is wealth the monetized price of slave-labor-produced raw materials, or other products? Is the function of credit issuance to guarantee a "right of return" to monetary pricing structures ultimately based on raw materials and other commodities produced by cheap labor or slave labor?

The regulators are ultimately bound to answer such questions in the same way one can assume Sykes Wilford and the *Economist* would. And they will therefore ensure that their "regulation" leads down the primrose path to a worse debacle than the ones they loaded us up with in their earlier handling of the S&L and leveraged buyout binges. It's like the alcoholic whose last drink is always his next drink. At some point, he's so far gone that there won't be another drink, ever.

You wouldn't expect such a sodden mind to ever take up the question of why it might be that mankind, of all the species, is the only one capable of increasing its power to produce wealth. The results are shown in the increasing density of activity of increasing numbers of members of the human race. Technology-driven increases in the productive power of labor, to the extent they are permitted to occur, cheapen the cost of producing both goods and new qualified labor, producing more of both.

That is a process which is very different than the hunt for profit in the form of money. Money profit is ultimately related to the physical transformations through improvements in human labor power, and quality of thinking, which produces wealth. The bridge between the two is provided by credit, which should secure investment in current improvements against anticipated cheapened future wealth production capabilities made possible by present investment. The money cost of credit, interest rates, is the current evaluation of the expected threshold for future profit, or return, on such economic investments.

In the U.S. Constitution, Article I, Section 8, responsibility for the creation of money and credit is allotted to the U.S. Congress. It is a sovereign function of national government, included because providing for the present and future requirements of the nation and its population, in the sense of the Constitution's Preamble, can only be a function of government, not private particular interest. In assuming the function of sovereign credit issuer, government creates the climate in which banks can do what they used to do: lend, at low rates, into a stream of developing economic projects. That was before Donald Regan took over the Treasury Department in 1980, and began to promote what he and Citibank's Walter Wriston called "creative financing," otherwise known as usury, money breeding money.

The regulators treat money breeding money as if it were economic growth. It isn't. If you don't have economic growth, you can't monetize surpluses, because there aren't any. You can cannibalize population and historical capital improvements on behalf of present anticipation of required future money income. And if you do that, as we have been doing for more than a generation, the cases of Babylon and Rome, among others, signpost our ultimate destination. The problem is not the regulators' view of derivative risk. It is their ludicrous idea of what constitutes the security for what they call capital. Not improvements, but paper backing up paper, or data entries backing up data entries.

The only way to regulate derivatives is to change the direction of the flow of credit in the economy. LaRouche's tax would do that, by lowering the anticipated rate of return on the instruments; the capital reserve proposal would not. It would set the scene for a further dilution of all so-called financial assets—although someone will soon cook up something called "virtual capital," against which derivatives can be reserved virtually risk-free.

## What went wrong

In the old days, a stock was a stock, and a bond was a bond. A stockholder, if his company was profitable, received his dividends and hoped for improvements in the stock's value. The bondholder collected his interest. Both were paid out of the economic activity of the corporation. Then in August 1971, the dollar was floated; with a floating currency, prices of, for example, commodities in international trade, were no longer fixed, but would vary with the floating currency. Then, in the fall of 1979, Federal Reserve Chairman Paul Volcker began to increase interest rates above what was then the normal pre-tax rate for corporate profits. The combination of high interest rates and floating currencies ended the medium- and long-term investment in capital improvements, for no such project could develop the income to outperform interest cost, and bankrupted manufacturing and raw materials producers. The result: a shift of financial resources into usury and speculation paid for by the lives of people around the world.

Stocks and bonds became speculative instruments. And along came a slew of new "products" from the "financial services industry." Not actually new, but illegal; the new products, like "options," had earlier been banned by U.S. statutes like the Commodity Exchange Act of 1936. Now not stocks, but the option to buy a stock at a certain price, or a future such transaction, or an index of such options.

The defenders of such derivatives claim ludicrously that such instruments embody the lessons learnt from the succession of financial and economic crises of the 1970s and '80s. They hedge risk. These people choose to ignore the reality that, as untrammelled usury has destroyed regions of the world and sectors of the economy—Africa in the 1970s; Ibero-America in 1982; S&Ls in 1983-84; industrial corporations, LBOs in 1985-88—real estate investment, money chasing more money has grown to replace what has been destroyed. The eightfold increase in derivative instruments from 1987-91 is a cumulative measure of the wreckage of the potentials for economic growth in the 10-15 years before as financial assets were rolled out of one collapsing sector and into the next "growth" area, until all that was left was the financial assets, over $16 trillion, the same ball-park as the Federal Reserve's estimate of the financial value of all the assets in the U.S. economy, whether physical or financial, still demanding the same level of cumulative return.

All of it is going to end up worth as much as Sykes Wilford's Confederate certificate. The question is, what will replace it?