

It's the little things that count

by Chris White

It was one year ago this week, March 11, 1993 to be precise, that Lyndon LaRouche put forward his proposal to impose a transaction tax of 0.1% on the so-called notional value of all financial dealings involving derivatives. The purpose of LaRouche's tax, as was conveyed with some force in the pages of this magazine, and in face-to-face discussions with relevant authorities over the intervening weeks and months, was twofold: to reimpose order on wildly deregulated financial markets, and to permit an eventual reorganization of credit flows, so that a real economic recovery might also be set into motion.

The response, especially of those in a position to do something about it, was, usually, "Well, it won't happen until after disaster hits." To which the rejoinder inevitably was, "By then it will be too late."

Now, it seems, the awaited disaster is upon us, occasioned by jazz clarinetist Alan Greenspan's early February flutings of his possible need to take action to head off emerging signs of potential resurgent inflation by increasing interest rates. Soon enough, perhaps, Greenspan will be wishing he had taken up a career as a professional clarinetist, and not the seat he did at the Federal Reserve, from where his ill-tuned notes would transform mere discord into such cacophony.

On Oct. 28, 1993, editors of *EIR* submitted written testimony to Rep. Henry Gonzalez's (D-Tex.) Banking Committee investigations into the risks posed by derivative transactions. On that occasion we asserted: "It is not the risks and dangers which you know to be risks and dangers which prove fatal. They, after all, can be avoided. It is the risks and dangers which you do not know. How can institutions hedge against risk they do not take into account, and cannot take into account, because they do not admit it exists?"

What they refused to understand, we continued, was that an accountant's booking of returns in the form of financial

profits on transactions cannot be confused with the human activity of wealth production which is an economy. If the economy is not organized in such a way as to permit wealth production to proceed, as it has not been, whether worldwide or within the United States, for the past generation and more, then accountants' bookings of profits from financial transactions are not real. They are either just plain non-existent, or they are pure loot gouged, Nazi-style, out of the depleted functioning of the body of human activity.

To talk, as the proponents of derivatives do, of their "improvements" in "risk management," while ignoring the ongoing systemic breakdown of world economic activity, is as insane as a witch-doctor solemnly testifying before the relevant congressional committee that he has discovered the cure for AIDs.

So, from some future vantage-point, hindsight might justly conclude the case to have been. Better it had been if such considerations had prevailed ahead of time, and not the will-sapping apparent force of consensual inertia, which obstructed what should have been done, when it should have been done.

Greenspan changes 'the trend'

The little thing that counted was Greenspan's 0.25% increase in interest rates. Greenspan, you see, changed "the trend."

The financial "engineers" who have promoted the growth of derivatives, with its 16-fold increase since the 1987 stock market crash (it doubled again during 1993), bet on the trend. They are not just crazy; their craziness breeds incompetence too.

They indeed do have their measures of "volatility," their alphas, betas, gammas, and vegas, to measure price and other forms of volatility. Those measures assume the pre-existence

of an underlying trend, that a succession of ups and downs can be reduced to a form of straight-line type depiction of action, seen on an X/Y axis graph. Volatility, of whatever, identified by whatever letter of the Greek alphabet, is measured relative to "the trend." Forward and hedging strategies are adopted on the basis of the assessment of probable limits of volatility relative to the trend. Money is borrowed, against collateral which does not exist, to finance future sales of assets that are not owned, because it is assumed that "the trend" will continue.

The numerical methods adopted do not include, and could not, means to assess whether "the trend" identified coincides with something real—after all, statisticians can correlate and normalize any kind of relationship, e.g., automobile accidents and quality of diet—or how "the trend" adduced changes. Such considerations announce their appearance differently than the warning beeps uttered by a computer.

"The trend" was the lowering of interest rates which has been ongoing for more than three years, which permitted the wolves to borrow to buy bonds, for example, knowing that future sales of the appreciated asset would more than pay for the present borrowing cost of the transaction.

When Greenspan changed "the trend," he changed the assumed basis against which volatility had been calculated, hedges and forward contracts adopted, money borrowed to finance such activities. Everything then went out the proverbial window.

This has not yet registered in the United States so sharply for the public as it has in Europe. Perhaps because the U.S. financial community is so much more stupefied and dependent on reading the charts produced by the oracles of so-called technical analysis. No major "sell signal" has yet been given, as it should be, and no doubt will be, when the impact of current developments crashes through something like the long-term moving average on the analysts' charts, thereby producing belated "confirmation" of the "reversal" of "the long-term trend." That may happen today, or early next week. It takes time, after all, for "the current trend" to catch up with the "long-term trend."

Whenever such a "signal" might be given, back in the real world, where events unfold, outside and beyond the electronically generated X/Y axis charts, which purport to follow "the trend," and permit the management of what is thus unfolding, here follows some of what was unleashed by Greenspan's "little thing."

Billion-dollar losses

A massive sell-off in the bonds of all advanced sector countries, with dumping of British and Japanese government bonds taking the lead, and German, French, and American following up. A spillover into the stock markets, affecting most dramatically those most closely affected by changes in U.S. interest rates, such as Turkey, Malaysia, Thailand, and Hongkong. All leading to the Feb. 15 biggest-ever one-day

increase in volume on international bond markets.

Rumors that Goldman Sachs is bankrupt, has lost \$650 million, that some U.S. hedge funds are bankrupt. Admissions from George Soros's Quantum Fund that it lost \$600 million or so. Rumors that all U.S. hedge funds have lost more than 25% of their "value" in the month of February alone. Rumors about the two U.S. banks which between them account for more than 30% of all derivatives trading generated by U.S. banks (just \$4 trillion or so, two-thirds of the U.S. GNP), J.P. Morgan and its one-time stepchild Banker's Trust.

Two weeks ago, European financial columnists were wondering, "What are the U.S. hedge funds, how big are they, how much is at stake?" By March 3, MAR Hedge and Tass Management had come up with an estimate: Large and medium-sized hedge funds have \$40-45 billion under management, and all such funds about \$100 billion. The funds are highly leveraged, they speculate on margin, borrowing to do so. MAR Hedge estimates such leverage at 10-fold, up to \$500 billion market exposure for the largest funds on their own. And, by the same, actually conservative estimates, since such funds have been permitted to borrow with no margin, or less than 5%, it amounts to \$1 trillion exposure all told.

And, when "the trend" changes, what happens then? The leverage goes into reverse. Deployed to sell for future sales of what they don't own, in a rising market, such funds are flat-footed losing "money" on the sale, unable to meet margin calls without further sales, creditors left with devalued collateral demanding more cash, not mere computer-generated "money," and so on.

Is that what's going on? The increase in futures volume on international exchanges in February says "yes." Trading in the "synthetic" French bond derivative, *Le Notional*, in February 1994 is more than double February 1993, and up 61% on January's trading. Trading in German "bund" futures on London's LIFFE, up 53% over January and 263% over February of the year before. Volume in the Chicago U.S. Treasury bond pit, up 43% from January and nearly double the volume of the year before. Volume in interest rate options and currency futures also soared.

The London Clearing House, which clears the four London-based futures exchanges, has begun to increase the margins required of members, even while trading is in progress, with a \$650 million cash call on March 2.

However this develops, it can safely be assumed that a 0.1% tax on derivatives will not be the means to get solutions adopted. Derivatives will go the way of the 1970s Real Estate Investment Trusts and Energy Partnerships, the leveraged buyouts, and other atrocities of the 1980s, and those responsible will probably be lucky to find themselves in the relative safety of a jail cell.

Whether those left have the sense to take up the matters that the derivatives proponents left out of account, the wealth-producing functions of economy, is another question altogether.