EIR Economics

Hunt begins for scapegoats for the financial collapse

by Chris White

It seems some people have decided that Federal Reserve Board Chairman Alan Greenspan has become something of a liability in his present job. Over the Easter weekend, it now seems, steps were initiated to cut back the discretionary powers of the Federal Reserve Board's chairman.

The evidence looks like this: On Tuesday, April 5, leaks began to surface that Greenspan would forgo further increases in interest rates until "market stability" had returned. On Thursday, the chairman was supposed to deliver a speech on the subject of the Fed's present interest rate policy; the speech made no mention of that, concentrating instead on the so-called resurgence of "consumer confidence." On Friday, more leaks: Interest rate policy will no longer be in the sole hands of the Federal Reserve Board's chairman, but will, henceforth, be the prerogative of the Federal Reserve's Board of Governors as a whole.

Such tremors within the precincts of the temple of the cult ought to be seen as heralds of more drastic and dramatic changes to soon come erupting forth.

Fundamental to the functioning of the Federal Reserve since its pre-World War I foundation, has been the absolute authority accorded its chairman. To question his competence and authority is, after all, to raise the question of "confidence" in the way interest rate and monetary policies are handled. No such challenge, for example, was ever tolerated against Paul Volcker when, between 1978 and 1983, he delivered the *coup de grace* against the U.S. economy, plunging it into a depression from which it has never recovered.

What is now occurring at the Federal Reserve Board is unprecedented. Well it might be, because what has happened, since Greenspan first raised the Federal Funds rate by 0.25% on Feb. 4, has also been unprecedented. But, there again, there's no precedent for the kind of financial bubble that has been promoted on the broken back of the world's economy over the last few years, in the entirety of the recorded span of human history.

So, it looks like Greenspan has been chosen to be scapegoat number one. Under appropriate circumstances, choosing scapegoats can quickly become the kind of piggish, popular team-sport which fantasy-, foxhole-ridden Americans, bound in their worldview by the dimensions of their television screens, have been conditioned to root for, picking up sides, backing plays, and so on.

Why do we get scapegoats?

That's been in the cards since relatively senior people, for example, Bill Wollman, chief economist at *Business Week,* gave the collapse which developed over the last two months a name. He called it "the Greenspan-Soros debacle." And, there does happen to be enough substance in the formula to give the whole thing the ring of verisimilitude. But, to now turn around and launch a new game, "hunt the scapegoat" or something like that, is not going to solve what has to be solved. Why, after all, do we get scapegoats? Because there's something in our own thinking that we hysterically refuse to look at, insisting instead that some external agency, soon perhaps to be given the name "Greenspan," is uniquely responsible for conditions that many of us tolerated all too willingly, all too long.

Enough has been reported on television and in the print media for just about anyone using their minds to know that to be the case. What kind of world has this one become when one man, in this case, George Soros, can "lose" $600 million in two days, as his Quantum Fund's manager reported had been accomplished between Feb. 10 and Feb. 14? Or, when another, such as Michael Steinhardt, can lose $1 billion and more in a few weeks? Or, when central bankers worldwide are desperately scrambling, as they are, for example, in France, Britain, Spain, Mexico, Venezuela, Argentina, and of course, the United States, to avert the collapse of whole banking systems? Are these all special cases? A collection of hermetically isolated incidents? Or, are all the people who insist that what is going on is merely a necessary market correction, or the result of "internal" market problems, completely out of their minds, raving in some internal version of a Grimm's fairy tale rewritten for the computer age, in denial of what is right out there in front of everyone, that the whole shebang is in the process of coming down?

Will reining in Greenspan now be sufficient to stop that? Of course it will not; it is not stoppable.

Losses are adding up

Put the public losses of the last few weeks in context. Since the beginning of the year, the yield on the U.S. government's benchmark 30-year bond has risen by over 20%, with the increase accelerated by Greenspan's two minuscule, successive increases in the Fed Funds rates. Bond yields and prices move inversely. There are over $3 trillion worth of U.S. government bonds held by financial institutions around the world. Bond trading, at $300 billion per day, as of one year ago, and volumes in both February and March on major exchanges in London, Paris, and Chicago were more than 100% higher than they were during the same months one year before, has been, for the last five to seven years, the core of international activity in financial derivatives. Approximately $200 billion of these bonds were borrowed, bought on margin, to collateralize derivatives operations in the first quarter. U.S. commercial banks, chiefly the "Big 10," have committed nearly $800 billion in loans to permit such operations to proceed.

Well, a 20% increase in the yield of these bonds, wipes about $600 billion off the face value of the bonds held, at least for estimating purposes. One thousand times what Soros lost in two days; 600 times what Steinhardt lost. The bonds are used to "hedge" so-called transactions aimed at "controlling risk," and move against other interest rate-sensitive paper, such as "collateralized mortgage obligations," stripped down into "principal only" and "interest only" sections. The increase in mortgage interest rates over the same period of three months, has been more dramatic than that of bonds, about 25%. That is another $500 billion or so that has disappeared. There has been a concomitant fall in the near-trillion-dollar market in municipal debt instruments, another $250 billion or so. The market in so-called "Brady Bonds" and related Third World country debt instruments, has all but disappeared, for another $100 billion or more.

'Reverse leverage' comes into play

As the financial losses of the last three months get tallied up, it will rapidly become clear that significantly more than $1.5 trillion, probably closer to $2 trillion worth of financial assets, has been wiped out. That's about the same magnitude as the after-tax income of the U.S. population.

But, it is only the beginning. The total "notional value" of derivatives traded is around $12-14 trillion, with the "Magnificent Eight" U.S. banks—Chemical, Morgan, Bankers' Trust, Citibank, etc.—accounting for more than half, and Morgan and Bankers Trust for one-third. Derivatives are leveraged, just like stock transactions used to be before the 1929 crash. "Leverage" is a silly term for a chain-letter pyramid scheme. Put down $1 to borrow $50. Borrow $1 to lend $50.

Estimated losses over the quarter would represent somewhere around 14-15% of total exposure to derivative transactions. That ought to mean that any outfit that is leveraged more than seven times over, or which has financed someone who is in turn leveraged more than seven times over, has during the quarter, seen their collateral, or margin wiped out.

That is "reverse leverage," which the proponents of all this don't seem to have taken into account in their "risk management" systems. For an outfit leveraged 50 times over, a 2% drop, from 50 to 48, is sufficient to wipe out the margin or collateral. For 25 times, a 4% drop; for 15 times, a 6.6% drop. Compare such ratios with the 20% change in bond yields over the quarter.

The near $800 billion that banks have lent to finance margin purchases of securities is nearly three times the paid-in capital of those banks. Lending to finance margin purchases of others does not count as banks and securities houses "trading" for their own accounts. That goes on, separately, and in addition to their lending to others.

The banks will come begging

And then what? Should the federal government prepare to welcome Morgan's Dennis Weatherstone and Citibank's John Reed when they show up with their begging bowls to ask politely for the couple of trillion dollars or so they dropped, somewhere along the way?

In the budget which the federal government is working on for the fiscal year which begins Oct. 1, six months away, the projected gross federal deficit plus the interest payments due on the federal debt over the year will exceed individual income tax receipts for the first time ever.

It is quite easy to see how some people might be tempted to make Greenspan the first scapegoat for what happened in the last three months.

But it isn't going to solve anything.

The problem is not one of the last three months. Nor, of the six and half years since the October 1987 stock market crash. Nor of the more than 15 years since Paul Volcker began his economic wrecking job at the Federal Reserve.

Nor even the 23 years or so since the ill-fated Richard Nixon took the dollar off the gold standard in 1971. It is necessary to go back to the aftermath of the assassination of President John F. Kennedy to put right what has gone wrong.

Look at the idiocy. Here we are, in the middle of the biggest financial collapse in human history, and we've still got idiots solemnly informing us that what is going on is merely a "correction," which is usual when the "markets" make the "transition" from interest rate-driven cycles to earnings-driven cycles. (Oh, for the days when "cycles" came with training wheels on the back!)

You see, productivity, measured as dollars of output per worker, is increasing faster than ever. Some even go so far as to insist, "It's not a recovery anymore, it is a boom."

Productivity is not asset-stripping

And, no one seems to know what productivity is anymore. Of course, dollars of output per worker can be going up, because the number of workers producing the output is going down. That doesn't mean there is any growth going on, or that the "earnings" which proceed from such increases in so-called productivity, also known more properly as looting or asset-stripping, are something real. They aren't.

In whole classes of production, we are producing 30-50% less than we did during the four years from the assassination of President Kennedy to the end of 1967. We used to grow our own food; now we import whole ranges of products, from tomatoes to broccoli, from Mexico and other places. We used to make our own shoes, now we have the Chinese and Brazilians do it for us. We used to make our own clothes. We used to have a capital goods industry which could produce the machinery which permitted other branches of manufacturing to function, and we prized the workers who were thus employed. We used to build roads, and power plants, and maintain the internal waterways of the navigation system. We used to build schools and hospitals, and maintain the cities in which our people lived so that they could function, and have the hope that their children would do better in the future than they had.

Then productivity increases meant increasing the growth of the whole economy through technological improvements which would cheapen the cost of labor, and would create more jobs.

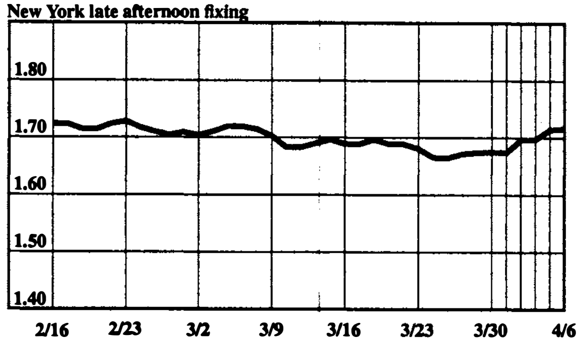
And that is what we must get back to. What is going on in the so-called financial markets is going to make that kind of shift possible, because it is going to wipe out the institutional power which over the last generation and more has imposed usury, looting, and speculation on everybody else. It will help send those who sound off about the "transition from interest rate-driven to earnings-driven recovery" to the kind of place such people really belong, a funny farm all of their own.

But, making Greenspan the scapegoat for mismanaging the mess isn't going to do any of that.

Currency Rates

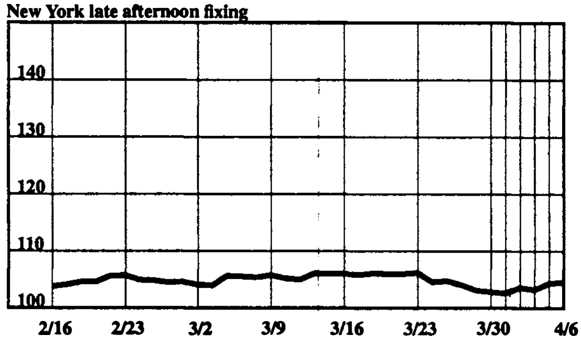
The dollar in deutschemarks

New York late afternoon fixing



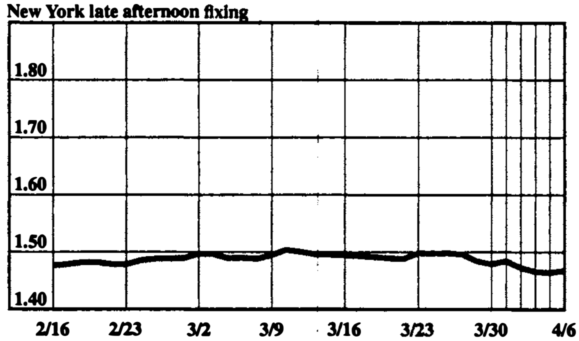
The dollar in yen

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