Greenspan's dangerous hidden agenda

by William Engdahl

Since Feb. 4 of this year, Federal Reserve Board Chairman Alan Greenspan and the Federal Reserve Open Market Committee have acted to raise short-term "Fed funds" interest rates no fewer than six times, the latest on Nov. 15 when Fed funds rates rose a notable three-quarters of a percentage point to 5.5%. There has been an enormous misunderstanding of what Greenspan and the Fed have been doing and why. That misunderstanding has been deliberately cultivated by Fed officials themselves, for reasons which shall soon be identified.

When the Fed announced the Feb. 4 rate rise, then only a tiny, cautious quarter-point increase to 3.25%, they stated that this was part of a "preemptive move to kill incipient inflation in a growing U.S. economy." Yet to date, despite repeated scares on financial markets over the ensuing 10 months over each bit of official data suggesting consumer price rises, commodity price pressure, or higher employment wage pressure, there is no sign of significant inflation in the real economy. Why the alarm?

Bailing out the banking system

First, we must ask why the U.S. central bank would risk deliberately detonating the most severe collapse in the U.S. government bond market since 1927. To answer this, we must go back to the darkest days of late 1989 and early 1990 when the largest American banks—Wells Fargo, Chemical, Chase, and the largest, Citicorp—were technically insolvent owing to staggering losses from misguided real estate speculation, junk bond leveraged-buyout lending, and other foolish acts of the speculative binge of the 1980s.

Beginning in 1990, the Federal Reserve, following emergency closed-door consultations with senior Treasury officials, bank regulators, and the administration, embarked on what became the most aggressive credit easing in the 75-year history of the central bank. Fed funds rates, the rate charged Federal Reserve member banks for "overnight" loans, were lowered in rapid successive steps over the coming months from over 9% down to an historic low of 3% by September 1992, where they remained until Feb. 4, 1994. Simultaneously, the Fed eased bank reserve requirements and took unpublicized, extraordinary measures in cooperation with the U.S. Treasury to improve the financial liquidity of Citicorp and other major banks.

The operation was undertaken to prevent a chain-reaction U.S. banking system collapse which would have detonated a global financial collapse of untold magnitude, as banks across the globe with credit lines to U.S. banks were hit by the U.S. collapse.

But what the banks did with the five years' time and the very low interest rates the Fed extended, is what haunts us today. The mislabeled debate over the so-called "credit crunch" can only be understood when it is known what actually took place.

Banks in 1990-94 were unwilling to extend further loans to businesses, home-buyers, car-buyers, and others because the banks were, in effect, "under water" already with insolvent loans to those parts of the economy. Further, by 1992, under new international central bank rules, the Basel Bank Capital Adequacy rules, for each new loan to business or private persons, the bank must find 8% in reserves to back it up. That is, for a $100 loan, it must set aside $8 in cash or equity reserve against the danger of a future default on that loan.

Ironically, these Basel rules were promulgated partly to dampen the international speculative frenzy of the 1980s. But those same Basel capital set-aside rules decreed that a bank's holdings of government bonds held "zero risk," and thus required no capital set-aside by the bank. This point is essential to what ensued after 1990.

Under the Fed commitment to bring ever-lower U.S. interest rates to the banks, the banks ceased making traditional business loans during the depressed economic conditions after 1989, and began instead to buy U.S. Treasury bonds. And they did this for the most part by borrowing from the Fed funds market at, say, 3%, in order to buy Treasury bills, usually of three- or five-year duration, which yielded the bank 6-7%, risk free with no reserves required. While rates stayed down at least, it was risk free.

Enter the hedge funds

But this was only the beginning. From 1991, the holdings of U.S. banks, on their own account, of U.S. Treasury paper, exploded to record levels, topping $600 billion. The banks were going from bank lending to becoming, in effect, bond brokers. To all of this, Greenspan and the Fed turned a benevolent eye, while the banks chalked up risk-free record profits to recover from their huge loan losses of the previous decade. So long as the Fed funds rate remained at the very low 3% level, all was fine for the banks.

But something else was also taking place. This, too, related to the Basel Bank Capital rules. When the major central banks of the Bank for International Settlements first hammered out new capital rules in 1988, one issue they left unresolved for future discussion was how to treat certain bank "off-balance-sheet" transactions, among them derivatives. In 1988, derivatives were largely the domain only of American banks, poorly understood by other central bankers, and the size of the business was small, such that no consensus on

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Financial traders in Düsseldorf, Germany. The speculative fever that originated in the United States spread to markets around the world, hitting the bond markets the hardest.

treating derivatives was reached at the time the Basel rules were put forward. This, too, came back to haunt central bankers.

So, under the Basel rules, a bank could engage in off-balance-sheet loans to a hedge fund, which in effect amounted to a high-risk gamble that, say, a George Soros or Michael Steinhardt could win big, by betting against the pound sterling or some other financial asset value.

The name hedge fund is misleading. Though they have been in existence since the 1960s in the United States, they have little to do with "hedging." Rather, they are a vehicle for legally avoiding U.S. securities regulation. Most are incorporated offshore, such as Soros's Quantum Fund, which resides in the Netherlands Antilles tax haven, far away from the Internal Revenue Service and other U.S. officials. Because they limit their partners to very wealthy investors and have fewer than 100, they are legally exempt from U.S. securities oversight. These hedge funds have exploded to prominence over the the past four years, notably since Soros publicized his winning of $1 billion within weeks after the September 1992 collapse of the pound sterling. Hedge funds are then unregulated, offshore investment pools which tend to take high-risk gambles leveraged 40-50 times their own capital via derivatives.

The ability of banks to make off-balance-sheet loans to these hedge funds has been called the "Basel loophole," and the hole became huge by 1993. Large U.S. banks like Citicorp or Chase began extending billions in loans to Soros and other hedge fund speculators in 1992, all off-balance-sheet. They reasoned that their risk was zero because they took part of Soros's government bond portfolio as collateral in the event Soros should guess wrong.

What this incestuous alliance between the banks and hedge funds did, was to magnify and inflate a speculative bubble in U.S. and European government bond markets beyond anything in past history. By one estimate, in the three years from 1990 to the end of 1993, under the Fed's low interest rates, such speculation created a mind-boggling $1.7 trillion increase in paper asset valuation, mostly in government bond speculation.

This inflation of financial assets, created in the wake of the Fed's effort to bail out a bankrupt banking system, was the real inflation about which the Fed governors became alarmed as early as the spring of 1993. At that time, several Fed governors warned publicly of the risk of a "Japanese-style asset bubble" being created in the United States and warned that rates must likely rise. The immense size of the derivatives-led leveraging by these offshore hedge funds, outside of any regulatory oversight of American banking officials, in a real sense had made the central bank and the sovereign monetary institutions of the United States itself subject to the most ominous financial blackmail in U.S. history, were the speculative bubble to continue to expand.

Despite the Fed's verbal warnings, however, the speculative fever continued to the point that it spread from the United States, like a cancer, to the bond markets of Germany,

France, the U.K., and even emerging markets like Mexico and Malaysia by year-end 1993.

This Basel "loophole," which counted banks' bond assets as "zero risk," is also why the 1990-93 speculation centered on bonds, not stocks, and why, when the bubble began to be deliberately deflated on Feb. 4 by the Fed, the collapse has been in those same bond markets, and not at that point in stocks.

Trying to slowly deflate a bubble

While European central banks were forced to intervene to the tune of tens of billions of dollars in a fruitless effort to maintain a narrow European Rate Mechanism currency parity in the European Union countries in the summer of 1993, the hedge funds and the big New York and London banks which had extended them gambling lines to topple the ERM, were reaping untold profits, all leveraged many-fold, via the marvel of derivatives, which often require only a 5 or 10% "downpayment" or "margin." So, for a $50 million real margin, Soros and others could speculate to the sum of $1 billion. If he won, he won big. Such wins were the story of 1992-93 in financial markets.

The big U.S. banks scrambled like lemmings in a mad rush to extend off-balance-sheet credit lines to the biggest hedge funds when they saw the wins. The banks' hope was not a simple loan return, but that their own derivatives traders gain access to the innermost trading strategies of the "infallible" hedge funds, in order that the bank could make huge derivatives profits, also off-balance-sheet, to regain profitability.

Had the incestuous process continued much longer, as the Federal Reserve officials realized, a future speculation collapse orders of magnitude more serious than anything in the 1980s, threatened not only to undo Greenspan's bank bailout of 1990-93, but also to ignite a far more devastating global financial collapse.

In an effort to defuse this time bomb, Greenspan and the members of the Federal Open Market Committee on Feb. 4 made an unusual public announcement. They decided for the first time in five years to raise Fed funds, albeit by a minuscule quarter-point to 3.25%, "to dampen incipient inflation in the economy."

By the end of 1993, the Fed was assured that its bank bailout strategy, in narrow accounting terms, had "succeeded" in allowing banks to restructure and face the future. The prime agenda then became how to deal with the Frankenstein's monster which the Fed's bank bailout policy of low interest rates had allowed to grow, namely, the incestuous alliance between banks and hedge funds in creating a $1.7 trillion explosion in financial assets.

The response in financial markets to the cautious Feb. 4 rate rise was titanic. Bond markets across Europe underwent massive selling, despite the prospect of further lowerings of European interest rates to combat the worst economic recession since the Second World War. U.S. bond markets went into free-fall by late February and early March. Selling in the Frankfurt German bond market alone became so intense, with $10 billion worth of German government bond futures or derivatives being sold by one distressed seller in several days in early March, that rumors circulated in New York that Bankers Trust, the U.S. bank most heavily involved in derivatives, was having liquidity problems owing to loans to a hedge fund. All this forced the governor of the New York Federal Reserve to issue an extraordinary denial, to calm jittery markets.

Most of the market drama in these past months has been due to the highly leveraged hedge funds, which were faced with devastating losses on the same derivatives that a few months earlier had given them an average of 90% or more profits. The phenomenon in financial markets is termed "reverse leveraging."

Hedge funds like the multibillion-dollar Steinhardt Partners began selling their German, Britain, and other bond derivatives and even bonds, but most often there were no buyers. Step by step, between Feb. 4 and the end of September, the Fed further raised interest rates, and step by desperate step, the hedge funds tried to unwind their exposure to bond markets, from Europe to the United States.

"Derivatives and the globalization of financial markets have created an unprecedented situation," a Frankfurt banker recently told this author. "What derivatives and these hedge funds have done, is to compress and amplify the predictable effects of central bank interest rate changes. Moves in interest rates which in the pre-derivative past would have taken 3-4 years to work through, today have been done, thanks to computer trading and gearing of derivatives markets, into perhaps 3-4 months."

This is why a tiny quarter-point rate hike on Feb. 4 almost sank the global bond markets. At several stages until approximately the end of the second quarter this past June, the unwinding of hedge fund derivatives positions, including in the dollar, threatened a systemic crisis. The Fed was forced to tread a tightrope between convincing broader financial markets it was serious about "controlling inflation," or risking a far greater panic selloff of bonds. At the same time, it could not let up the pressure on deflating the most explosive speculative element in the game, the highly leveraged hedge funds.

As well, were the Fed to move too aggressively, it risked turning what it saw as a "controlled deflation" of the asset bubble, into an uncontrollable financial meltdown. Financial market sources say there were more than a few confidential talks in the period, among Fed officials and the major banks, pension fund managers, institutional investment managers, and Wall Street brokerages, to convince them not to dump their portfolios of Treasury bonds, despite paper losses. As one participant characterized it, "American regulators have developed their version of Japanese-style financial market 'administrative guidance.' "

Drying out the hedge funds

The point was conveyed to the major institutional investors, whose combined assets far exceeded those of the hedge funds, that the "victim" of this dramatic interest rate tightening was to be the unregulated hedge funds. "The hedge funds will be the ones to pay the price," reported a senior European banker who had just returned from extensive client talks with a broad grouping of U.S. bankers, pension fund managers, and Wall Street firms. "There is a clear consensus among U.S. financial and central bank circles, that the huge, unregulated power of the hedge funds will not be allowed to continue. It had simply become a systemic danger to all. They have closed ranks to defend their existence," he said.

Indeed, there is evidence that the "Chinese water torture" of rising Fed interest rates has begun to take a huge toll on hedge funds. "Since August, hedge funds have been almost absent from the major markets," noted one Luxembourg banker who tracks these developments for his bank. Two weeks ago, reports circulated that Soros, the largest hedge fund operator who reportedly counts the Queen of England among his investors, had incurred added trading losses of $400-600 million on guessing the dollar trend wrongly. On Nov. 21, Soros announced he was liquidating a major real estate venture he had entered two years ago in Britain.

The informed expectation among central bankers and major financial market participants with whom this writer has spoken in recent days, is that the latest rise by the Fed has all but finished the threat from hedge funds to the financial system for the present. With the exception of Soros's Quantum Fund, most hedge funds allow investors to take funds out only at the end of the calendar year, Dec. 31. Unless the hedge funds are able to recoup their huge losses for the first 11 months of this year, the expectation is that some of the larger hedge funds will find themselves in bankruptcy courts early in 1995.

To this extent, Fed Chairman Greenspan's "correction," which he set in motion last February with the first rate rise in five years, has apparently lessened the threat from highly leveraged hedge funds as well as, perhaps for the moment, derivatives.

The problem, however, is one inherent in the very mandate of the Federal Reserve, embedded in the original congressional act of 1913 which made the Fed a private body, whose mandate was to maintain the solvency and stability of the U.S. private banking system. It is purely secondary to the Fed whether this also enhances the general health and welfare of the population, or the growth of the real economy.

This is the inherent flaw of the mandated monetarism of the Federal Reserve. The impact of the interest rate increases has indeed smashed the most speculative elements such as the hedge funds. But at a price which has so raised interest rates in the United States and Europe and elsewhere that economic investment in real infrastructure and technology is even more remote.

Debt has swamped the real physical economy

by Anthony K. Wikrent

In a memo to his associates on Nov. 17, 1994, U.S. physical economist Lyndon LaRouche warned, "It would be a potentially dangerous omission in the analysis of the [financial] bubble, to leave out of account the relationship among three principal features of the structural interrelationship between the real *physical* economy, and the leveraged monetary-financial superstructure. Only when we take into account the physical parameters of consumption and production in physical terms per capita, per household, and per square kilometer, does the explosiveness of the global monetary and financial systems come into view.

"Greenspan et al. are operating essentially in the monetary-financial domain, with virtually no competent regard for the relationship of leveraged income-streams from the real economy, to the magnitude, and rates of change of magnitude, of financial and monetary aggregates," LaRouche continued. "Thus, the very mechanisms by means of which Greenspan may be seeking to deflate most of the hedge funds, as an ameliorative measure, can trigger the very explosion which he deludes himself he is working to bring under control.

"The problem here is properly reduced to its axiomatic terms," LaRouche explained. "The use of the axiomatic assumptions of monetary theory—any variety of monetary theory—to shape economic, monetary, and financial policies now, will tend to accelerate the crash of the system as a whole. That is the tragedy of the system—in Schiller's definition of tragedy."

It was precisely the failure to identify these axiomatic assumptions of policy outlook among the U.S. Federal Reserve and other government institutions, that led U.S. President Bill Clinton and the Democratic Party into the electoral disaster on Nov. 8. "Silly talk about the 'recovery' . . . was Clinton's great folly," LaRouche observed on Nov. 8. "There obviously *is no recovery,* there never was one." What we shall attempt to do here, is to provide for the reader some of the evidence that there is no economic recovery.

In **Figure 1,** we use data series from the U.S. Department of Commerce's Bureau of Economic Analysis and Bureau of the Census, to provide an approximation of the rate of profit of the U.S. economy as a whole. By "rate of profit," we do not mean the rate at which a financial investment generates a