How to save the markets, but lose the nation, with 'financials futures'

by Marcia Merry Baker

It is now becoming common to hear warnings about the potential for a crash in the financial markets (stock exchange, commodities, derivatives, banking system) somewhere soon. Among the latest, was that of Commodity Futures Trading Commission (CFTC) chairman Brookesly Born, who warned at a Feb. 27 press conference, that "financial scandals" not unlike those at Barings Bank PLC and Sumitomo, will ensue in the United States, if Congress deregulates U.S. trading in "financials futures," as is now proposed in Senate Bill 257.

On Feb. 26, Federal Reserve Chairman Alan Greenspan uttered the word "bubble." In his semi-annual report to the Senate Banking Committee, Greenspan referred to "excesses" in the financial markets, saying that, when investors get "irrationally exuberant," they create "bubbles, which eventually burst."

But in addition to warnings, attention was focussed in February, through selected leaks to the media, on the role of the President's Working Group on Financial Markets, and its readiness to handle a financial meltdown. On Feb. 24, the Italian daily *Corriere della Sera* printed an article on "Secret Anti-Crash Plan for Wall Street." This was a follow-on to Feb. 23 *Washington Post* coverage, "Plunge Protection Team; White House Group Plans to Ensure Any Market Free Fall Is Contained." The subject of these reports, was: Who belongs to the Working Group, and how well will they operate on short notice?

But all this poses an even bigger question: What are we trying to do? Are we trying to save the markets, or, save the nation? This is the overriding issue, the metric for making decisions on every, apparently separate, policy question.

The bipartisan bill introduced on Feb. 4 in the Senate, to de-regulate much of the U.S. speculation that goes under the rubric "trade in financial products," is a clear example of the kind of thinking that wants to throw the baby out with the bathwater—and the kitchen sink, too.

Since 1974, when the original 1934 Commodities Exchange Act, governing agriculture and other commodities futures trade, was amended to facilitate speculation in non-agriculture futures, the volume of speculation in these "financials" products has soared. **Figure 1** shows this in terms of the relative numbers of various types of contracts traded annually. The trend of the volume of trading in non-commodity "financials" markets, far exceeds anything even nominally related to the physical economy, and mirrors the decline of the entire U.S. economy over the past 25-30 years, as we have thoroughly documented elsewhere (e.g., *EIR*, Jan. 1, 1996). From the 1970s to date, rates of investment flows going into U.S. real estate speculation, mergers and acquisitions, and similar activity have soared, while investment in the agricultural and industrial sectors has lagged.

Just what are 'financials products'?

The statistics for the graph are provided by the CFTC. They document the huge volume of financials futures and options traded on U.S. exchange markets. In 1996, more than one-quarter billion financial futures and options contracts were traded. These markets include the Chicago Board of Trade, the Chicago Mercantile Exchange, the Mid-America Commodity Exchange, the New York Mercantile Exchange, and some other markets. "Financial contracts" comprise investments in futures and options in interest rate instruments (primarily Treasury bond options), currencies, equity index options, and so forth. They are side-bets on purely financial instruments. In 1970, "financial contracts" did not even exist.

Financial contracts comprise almost two-thirds of all exchange traded futures and options; they are not even side-bets against a real commodity, but are pure financial paper. From 1960 through 1970, futures trading was based primarily on agricultural contracts, for forward contractual arrangements for delivery or settlement of goods. But over the 1970s, '80s, and '90s, financial contracts came to dominate the futures and options markets, after the era of the Bretton Woods system of pegged exchange rates ended in 1971.

Based on a financial contract's average notional value in 1993, the 255.5 million financial contracts traded in the United States in 1996 had a notional value of $167 trillion.

On a global scale, you see the same process, as much of the world has been sucked into the "casino economy" of trillions of dollars of speculation in derivatives, currency exchange rates, etc. The stock markets, and the Dow Jones average itself, are just the most visible part of the global bubble, to the average person.

In opposition to this speculation frenzy, state-level legislative actions have been introduced in Pennsylvania and New Hampshire this year, to raise revenue from transaction taxes on securities transfers, as part of a general mobilization to

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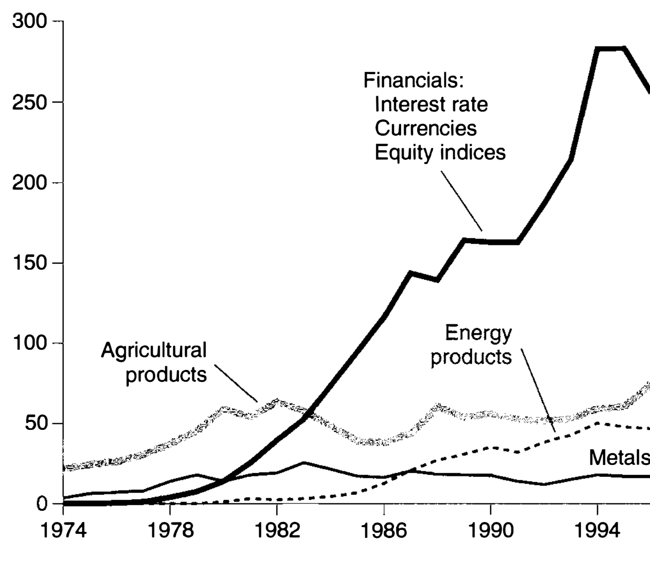
FIGURE 1
Financials dominate U.S. futures markets, 1974-96
(millions of contracts traded)



Source: Commodities Futures Trading Commission.

penalize speculation, and to protect and restore real economic functions. The "legislative intent," as described in the preamble to the New Hampshire bill (House Bill 569-FN-A-LOCAL), is to "provide a disincentive to financial speculative activity destructive to the economic well-being of the citizens of this state."

How crazy can you get?

In the face of all this, why do the backers of the Senate bill say that deregulation of futures markets is necessary? The most frequently cited reason, is to allow the United States to "compete" with speculation on less-regulated exchanges abroad—in other words, more fuel for the fire. The bipartisan backers of the deregulation proposal include Republicans Phil Gramm (Texas); Richard Lugar (Indiana), chairman of the Senate Agriculture Committee; and, on the Democrat side, Tom Harkin (Iowa), Bob Kerrey (Nebraska), and Patrick Leahy (Vermont).

On Feb. 11 and 13, the Senate held hearings on the merits of its deregulation initiative (S. 257, "Commodity Exchange Amendments Act of 1997"), which has a counterpart in the House. Witnesses included Gay Evans, Senior Managing Director of Bankers Trust International, PLC in London, and chairman of the International Swaps and Derivatives Association, Inc., who praised the proposed deregulation as part of needed "modernization" of futures trading in the United States. Others did likewise, including the Chicago Board of Trade officials themselves.

The new legislation mandates changes that, in the jargon of speculators, would give U.S. commodity exchanges "an enhanced competitive advantage" against foreign exchanges, by allowing "sophisticated investors" to trade freely. The proposed changes would allow U.S. futures exchanges to design "unregulated products," without regulation, as long as these financial "products" are offered to "institutional and sophisticated" customers (managers of pension funds, mutual funds, and the like), and not the retail trade among the general public.

Federal Reserve Board Chairman Greenspan gave his stamp of approval to the Congressional deregulation drive, in a speech on Feb. 21 in Coral Gables, Florida, to the annual Financials Markets Conference hosted by the Federal Reserve Bank of Atlanta. Although he repeated his now-familiar caveats about "instability" in speculative markets, saying, "There have been occasions when we have been on the edge of a significant breakout," he nevertheless ended his prepared remarks, "I would note in conclusion that the bipartisan legislation recently introduced in the Senate manifests a willingness to contemplate such fundamental changes in government regulation" as removing regulatory control over derivatives and futures speculation.

At the Feb. 18 meeting of the President's Working Group on Financial Markets, there was discussion of the S. 257 deregulation bill. The Group includes Treasury Secretary Robert Rubin, Greenspan, SEC Chairman Arthur Levitt, Jr., and CFTC chairman Brooksley Born.

The dissenting position is most often stated by Born. At the Senate February hearings on S. 257, she ridiculed the notion that it is safe to allow so-called "sophisticated" traders to operate in a deregulated way. Born expressed fears that the Senate proposal "would result in pervasive deregulation of the U.S. futures and options markets," and would mean that "many recent problems, such as Barings PLC's tradings on the Singapore Exchange, and Sumitomo Corp.'s trading on the London Metal Exchange, could be replicated in the United States."

In Greenspan's prepared testimony to the Senate Banking Committee for Feb. 26, in which he warned of the "bubble," he gave, as an explanation, the standard, economics textbook myth of business cycles—what goes up, must come down. His text stated, "There is no evidence, however, that the business cycle has been repealed." He added, "Another recession will doubtless occur someday."

"History demonstrates that participants in financial markets are susceptible to waves of optimism, which in turn foster a general process of asset price inflation that can feed through into markets for goods and services. Excessive optimism sows the seeds of its own reversal, in the form of imbalances that tend to grow over time. When unwarranted expectations ultimately are not realized, the unwinding of these financial excesses can act to amplify a downturn in economic activity, much as they can amplify the upswing," Greenspan said.