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Derivatives disintegration, not stocks, fuels the panic

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The month of August saw the breakout in certain U.S. media, of a message that has been in the headlines for months in Europe: Watch out for the coming stock market crash. So far, two prominent publications, *Time* magazine and the *New York Post,* following the lead of earlier fictionalized predictions in Europe, have run elaborate scenarios of minute-by-minute accounts of what the "day of the crash" would supposedly look like.

What stands out about these kinds of prognostications, is that there is no truth, even in the sense of truth as fiction, in them. They present an expected crash as a phenomenon of a cyclical crisis of the type, "what goes up, must come down." But, the reality is that we are faced not with some crisis limited to the stock markets, nor a containable currency crisis, nor some other isolated event. We are dealing with a *systemic* crisis of the *entire* financial system.

As of mid-August, the financial crises under way in almost every time zone around the world underscore the point. In Southeast Asia, currency devaluations and banking and financial crises are rippling throughout all five major nations in the region, and are causing chain-reaction impacts in Japan, South Korea, and so on. The International Monetary Fund-engineered emergency action for Thailand, announced on Aug. 12, is a disaster for that nation, and only raises the prospect of "other Thailands" in the making, as the IMF era draws to a close.

To address what is required, Lyndon LaRouche plans a presentation at the end of August, on "Toward a New Bretton Woods System," at a conference near Washington, D.C. In a radio interview with "EIR Talks" on Aug. 12, he said, "As I speak, unless something happened in the last several hours that I don't know about, I can say that no government, no central banking system, no International Monetary Fund, or any combination of institutions on this planet presently has *any plan which would be adequate for what is hitting the world now*.

"In other words, on the basis of the present program of all governments, including the United States, the IMF, and so forth, that if the crisis hits tomorrow, or October, or at the end of the year, which are the dates most often discussed, there's no government, or combination of governments, on this planet which is presently, as of this moment, prepared to do anything to prevent the *entire financial system from disintegrating,* that is, the financial system, and the banking system."

Derivatives hide and seek

In the United States, there is a little side drama taking place in Washington, related to the issue of accounting practices and derivatives, which reflects the bursting-point condition of the financial bubble.

The Financial Standards Accounting Board (FASB), which sets accounting standards for U.S. corporations, has proposed new rules that would require U.S. corporations, including banks, to report derivatives holdings on their balance sheets, and to value their holdings at current market value. The FASB first proposed these rules in 1996, and plans to put them into effect on Jan. 1, 1999.

The response to this rather mild directive, reveals volumes about the real fear of the bankers and their regulators: that the global derivatives bubble will burst, triggering a chain-reaction disintegration of the international financial and monetary systems.

Federal Reserve Chairman Alan Greenspan, for example, has sent three letters to FASB Chairman Edmund Jenkins, in an attempt to block the imposition of the rule. "The proposal may discourage prudent risk management activities and in

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some cases could present misleading financial information," Greenspan claimed, in a July 31 letter to Jenkins.

Greenspan's contention is absurd, on all levels. The idea that derivatives are "prudent risk management activities," a view widely touted by the financiers, is false. Derivatives are "risk management" only in the sense that betting both on the red and the black in a game of roulette, is risk management. Derivatives are bets, and the derivatives market is the biggest casino in the world. To discuss risk management in such a context, is an exercise in virtual reality. Greenspan's claim that reporting derivatives exposures on the balance sheet "could present misleading financial information," is also ridiculous. Who in their right mind would believe that forcing companies to reveal millions, billions, and even trillions of dollars in off-balance-sheet side bets would be more misleading to investors, than would keeping those bets hidden? The only way Greenspan's statement would be true, is to turn it on its head, and argue that for companies to attach any value to derivatives, on or off the balance sheet, is misleading.

To add weight to his position, Greenspan's letter stated that "major companies in a number of industries that use derivatives have expressed serious concerns" about the proposed accounting rules. Greenspan was referring to the heads of 22 corporations, who also sent a letter to FASB Chairman Jenkins on July 31, in what was clearly a coordinated attempt to put political pressure on the FASB to back down.

Pandora's box

Which are these companies, that are fighting to keep their derivatives exposures hidden? The signers of the letter include the heads of Bankers Trust, Chase Manhattan, J.P. Morgan, NationsBank, Wells Fargo, BankAmerica, First Chicago NBD, Goldman Sachs, and American International Group, to name a few, plus Senate Banking Committee Chairman Alfonse D'Amato (R-Wall Street), kook economist Sen. Phil Gramm (R-Tex.), and U.S. Reps. Tom Bliley (R-Va.) and Michael Oxley (R-Ohio). In short, the major derivatives players and their pet politicians. What are these guys trying to hide?

Take Chase Manhattan, for example. As of March 31, Chase Manhattan Corp. had $20.7 billion in stockholders' equity, $340 billion in assets, and $6.6 trillion in derivatives. or $19 in derivatives for every $1 in assets, and $316 in derivatives, for every $1 in equity. How about J.P. Morgan, the so-called conservative bank? As of March 31, Morgan had $11.2 billion in equity, $225 billion in assets, and $5.3 trillion in derivatives, or $23 in derivatives for every $1 in assets, and $473 in derivatives for every $1 in equity. Among the other signers, Bankers Trust had $16 in derivatives for every $1 in assets and $386 in derivatives for every $1 in equity, compared to $10 and $124 for First Chicago NBD, $7 and $84 for BankAmerica, and $6 and $69 for NationsBank, respectively. Overall, the U.S. commercial banking system had $22.4 trillion in derivatives as of March 31—of which 94% was held by eight banks—versus $390 billion in equity and $4.6 trillion in assets, with another $8-10 trillion in derivatives held by investment banks. That's about $4 in derivatives for every $1 in Gross Domestic Product, a ratio which is rising.

The banks have consistently fought tooth-and-nail against all attempts to shed light on their derivatives exposures, and the exposures of their clients, because exposure almost always brings them trouble. What little light has been shed, is due primarily to the efforts of former House Banking Committee Chairman Henry B. Gonzalez (D-Tex.), who, after reading reports of derivatives exposures in *EIR,* held hearings in 1993 on the banks' derivatives activities, and forced the Comptroller of the Currency to release the figures. With the cat out of the bag, the Federal Deposit Insurance Corp., which had been tracking derivatives since 1990, suddenly added a new line to its Quarterly Banking Profile, "off-balance-sheet derivatives," which then stood at $12 trillion. Once those numbers came out, the banks launched a major propaganda campaign to portray derivatives as "risk management" tools, a campaign which backfired spectacularly when billions of dollars of derivatives losses surfaced, putting a spotlight on the weakest link in the financial system. Since then, they have attempted to put derivatives back in their Pandora's box.

Disintegration

The sudden outpouring of stock market hysteria in the United States, is due to the fear that the derivatives market will collapse. With some $100 trillion in derivatives outstanding, and some $1 quadrillion in derivatives and related turnover annually, the failure of even one major derivatives player could send shock waves of defaults through the system, triggering a chain-reaction collapse of bank after bank, until nothing was left standing. The terms "crash" and "collapse," which are often used to describe 10% or 20% drops in the stock markets, do not begin to describe what is coming, the disintegration of the global financial system, virtually overnight, when the derivatives bubble goes. This is what the bankers are trying to hide.

"What you're seeing in this crisis here, is an eruption, a decay, in the *weakest* part, the most *rotten* part of the system, which is the financial and banking system—it's about to collapse because there is *very little underneath it,* that is, there's very little economy," LaRouche said on Aug. 12. "So, this is like the fall of Sodom and Gomorrah. This is not like the '29 Wall Street Crash, as the *New York Post* might have you believe with its fictional story—and others, too. It's nothing like that. It means we've got to recognize we have made a fundamental mistake in the basic assumptions of economic and related policy-making over the course of 30 years. This means, we have to junk—except for civil rights—about every change we have made in policy, or in way of thinking, during the past 30 years. If we are not willing to do that, then, 'Look, Ma, no country!' This country will disintegrate, along with many others, somewhere toward bridging the end of this century, unless we can make that change."