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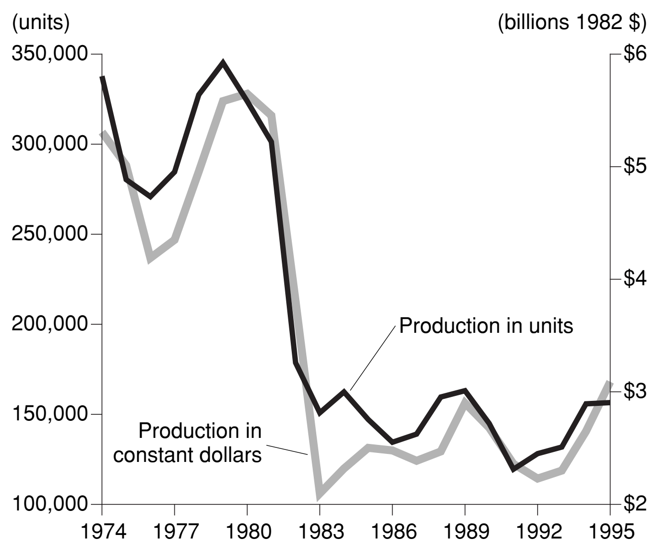
FIGURE 1
U.S. machine tool production, in units and 1982 constant dollars



Source: "Economic Handbook of Machine Tool Builders," various years.

Similarly, neo-liberal IMF "reforms" collapsed output for Poland, Hungary, and other former Communist nations.

Second, the actual functioning of the economies of western Europe—though the financial media would say it is robust—is revealed by the rates of unemployment. Officially, unemployment in western Europe is above 10%. Spain has an unemployment rate above 15%; France's rate is above 11%; Italy and Belgium have double-digit unemployment, and Germany is nearly there, at 9.8%. But Germany's true unemployment is paradigmatic for all of Europe. While the government reports that there are 4.4 million unemployed, the Institute for Labor Market and Professional Research reports that 6.3 million Germans are without regular work and regular income: Added to the 4.4 million officially registered jobless, there are another 1.9 million who are not registered as seeking a job, because they fail to meet the statistical criteria for being listed under any of the standard categories of "jobless." This brings Germany's actual jobless level above 14%.

Third, the United States is supposed to be experiencing the greatest economic growth of the major industrial nations. Certainly, any nation whose economy is growing would have an expanding machine-tool sector. Machine tools are the machines that make other machines. **Figure 1** shows the level of machine-tool production, as measured by close tracking of the number of units produced, and the value of shipments in constant 1982 dollars, for the period 1982 through 1996 (the last year for which figures are available). For 1996, compared to the high point of 1979, units produced and the value of shipments are down 48% and 45%, respectively. Other sections of U.S. manufacturing and industry follow a similar trend.

Deteriorating conditions in the physical economy extend from eastern Europe to western Europe to the United States, and to large sections of Ibero-America and Africa, as well. The next phase of financial disintegration will overwhelm a physical economy that is barely standing.

Derivatives bubble is set to explode

by Richard Freeman

The revelation by the May 26 *Wall Street Journal* that the now-defunct Peregrine Fixed Income Ltd. of Hong Kong had $9 billion in off-balance-sheet derivatives exposure to Indonesia—as much as its balance-sheet exposure to Indonesia—should not come as a shock to anyone who has been reading *EIR,* and who is familiar with Lyndon LaRouche's warnings about the derivatives bubble, dating back to 1993 (see article, p. 8).

Derivatives trading growth in Asia had been in the forefront of world derivatives market growth. Even a peek into the Asian derivatives holdings of leading banks is frightening. Derivatives are bets, gambles on underlying financial instruments and commodities. The size of the world derivatives' market is estimated at $130 to $140 trillion.

The May 4 *Swap Monitor* reported that four U.S. banks—Bankers Trust, Chase, Citicorp (soon to be Citigroup), and J.P. Morgan—had more than $1 billion in non-performing Asian derivatives (excluding Japan) as of March 31 this year, and had written off more than $150 million on them at the end of the first quarter. This figure of non-performing derivatives is a vast understatement, likely by at least one order of magnitude. Late last year, J.P. Morgan was still trying to collect on $489 million of the derivatives losses that the Korean company SK Securities had suffered in trades with J.P. Morgan, which SK Securities said it would not pay on, leaving Morgan holding the bag. According to the same issue of *Swap Monitor,* these four U.S. banks had $5 billion in total, non-Japan, Asian derivatives exposure. However, that figure, too, is a huge understatement.

The growth of derivatives leaves little doubt that U.S. as well as European banks have racked up sizeable derivatives holdings all around the globe. For example, in 1997, the seven largest U.S. derivatives holding banks (now six, since NationsBank and BankAmerica have merged) held $23.79 trillion in derivatives—led by Chase Manhattan's $7.7 tril-

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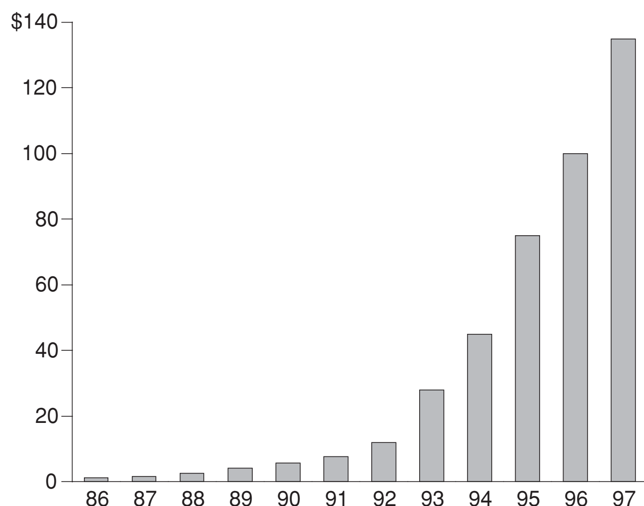
FIGURE 1
World derivatives growth: The cancer takes over
(trillions $)



lion—an increase of 27.2% in derivatives holdings over the year before, of $18.71 trillion. When the significant derivatives holdings of U.S. investment banks like Goldman Sachs and Salomon Brothers, as well as U.S. insurance companies and other U.S. companies, is added in, total U.S. holdings of derivatives swelled to $40 trillion. U.S. derivatives are five times the size of the Gross Domestic Product (GDP).

On March 24, the German Bundesbank revealed that the derivatives holdings of German banks had reached 25.9 trillion deutschemarks in 1997, compared to DM 16.8 trillion the year before, and DM 10.4 trillion in 1995. The German volume had grown two and a half times in two years. The German derivatives bubble is now seven times the size of its GDP.

Figure 1 shows the world derivatives cancer. These bets are future obligations that have to be met, out of the flesh and blood of the world's economies.

It is not possible to believe that the top four U.S. derivatives-holding banks hold only $5 billion in derivatives in Asia, when these four alone hold $20.2 trillion internationally. But the $489 million loss of J.P. Morgan in South Korea, stemming from its dealing with SK Securities, and the potential of $8 billion failed derivatives contracts by the defunct Peregrine investment firm of Hong Kong, in Indonesia, indicate that a swell of derivatives losses in Asia is to be expected, as the "Asia phase" of the world crisis deepens.

Derivatives failures travel electronically, at the speed of light. Derivatives are connected across markets and across countries. The "Asian" derivatives disasters of the morning, are American and European disasters by lunchtime.

International Commentary

Some reality pierces veil of virtual reality

The first two statements quoted below belong in the category of "out to lunch."

IMF Managing Director Michel Camdessus, press conference in Bishkek, Kyrgyzstan, May 27:

With reference to Russia's troubled markets, Camdessus said, "Contrary to what markets and commentators are imagining, this is not a crisis. I believe that with these measures, with the very strong reactions of the monetary authorities to the latest turbulence in the market, the turbulence could normalize soon. I believe and I hope."

U.S. Federal Reserve Chairman Alan Greenspan, testifying before the House Agriculture Committee, May 21:

"There was, and is, a small but not negligible probability that the upset in East Asia could have unexpectedly large negative effects on Japan, Latin America, and eastern and central Europe, that, in turn, could have repercussions elsewhere, including the United States." Greenspan went on to press for Congress to approve the $18 billion funding package for the IMF.

Erik Guyot and G. Pierre Goad, "Off-Balance-Sheet Items Threaten to Balloon Massive Liabilities of Indonesian Companies," *Wall Street Journal,* May 26:

"If you thought the foreign debt Indonesian companies was big at an estimated $80 billion, think again.

"There's another hefty pile of Indonesian liabilities that aren't included in official statistics: so-called off-balance-sheet items such as foreign-exchange contracts and other derivative contracts between Indonesian and foreign firms."

The authors take the case of the now-bankrupt Peregrine Fixed Income Ltd., which had, for every $1 it lent, $10 in foreign exchange contracts or other derivatives. "The total size of Indonesian companies' derivative contracts is almost impossible to calculate," the authors state, "given the wild swings in the value of the rupiah and the hidden nature of many of those transactions."

José Neme Salum, "Russia, in the 'Eye of the Hurricane' of the World Financial System; a Situation like Indonesia's Is Possible," *Excélsior,* Mexico, May 25:

José Neme Salum interviews *EIR*'s Ibero-American editor Dennis Small; the interview was also reproduced in the