# 'Bailouts' won't work: The whole financial system is disintegrating

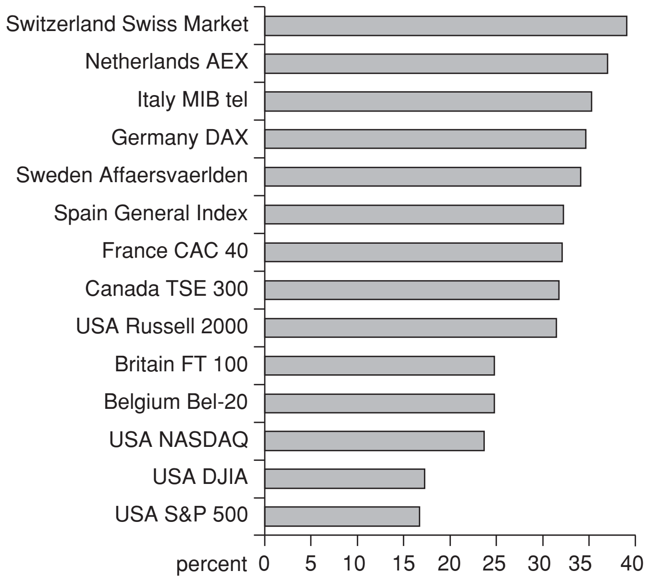
by John Hoefle

The spectacle of world financial leaders scrambling to find tens of billions of dollars in a vain attempt to prevent the global financial firestorm from spreading to Ibero-America, dominated the annual meeting of the International Monetary Fund and the World Bank in Washington in the first week of October. In their assembled wisdom, the finance ministers are openly working on a plan for the IMF to provide $30 billion or so to Brazil, and are more covertly working on a plan for Argentina. That the IMF "bailouts" have only helped spread what used to be called the "Asian contagion" to over half the world, does not seem to deter these witch-doctors from cooking up more of the same medicine.

Nobody is actually proposing to save Brazil or Argentina, of course; after all, in the rarefied world of high finance, nations are just cash cows to be milked dry, then slaughtered for their meat. The IMF doesn't bail out nations, it bails out the big Western banks, whose successes at looting the so-called emerging market countries, invariably leave those nations unable to pay their debts. But politically, it's a lot easier to pretend that the IMF is helping nations, rather than admit that the IMF plays the nasty role of bill collector for the loan-sharking financiers.

The problem facing the banks, is one familiar to any clan of cannibals: When your survival depends upon eating your fellow man, how do you protect your food supply? The present financial system exists by cannibalizing the nations and peoples of the world, and were it to stop doing so, it would immediately collapse. It cannot save Brazil, because it must destroy Brazil in order to save itself.

FIGURE 1
**Drop in major Western stock indices from mid-1998 peak**




## The hole truth

While the bankers are searching for billions to plug the holes, trillions are evaporating from the collapse of financial markets worldwide. Since mid-July, when the U.S. and European stock markets went into near free-fall, and especially since Aug. 17, when Russia declared a debt moratorium, tens of trillions of dollars of notional value of financial assets have simply evaporated. From record highs earlier this year, most of the major European stock market indices have declined between 30% and 40%, and the major U.S. indices have dropped some 15-25% (**Figure 1**).

Most of the major players in the financial markets place their bets on margin, or with borrowed money, greatly increasing their potential profits through leverage. As long as the markets are rising, tremendous amounts of money can be earned through leverage. But the reverse is also true: When the markets drop, the leverage goes into reverse, and losses grow even faster than did the profits. When markets are dropping, participants are often forced to sell assets at a loss to meet margin calls, and the more participants are forced to sell, the faster prices drop, which in turn forces more selling.

The effects of this reverse leverage is even greater in the derivatives markets. Take the case of Russia, where many Western financial institutions bought ruble-denominated Russian government-backed GKO bonds. To protect themselves against the possibility that the ruble would collapse in value, the institutions also bought derivatives from Russia, which would pay off if the ruble dropped. When Russia declared a debt moratorium and allowed the ruble to float, the value of the GKOs dropped sharply; meanwhile, the institutions were unable to collect on their derivatives bets. The

FIGURE 2
**Drop in stock price since mid-1998 peak**

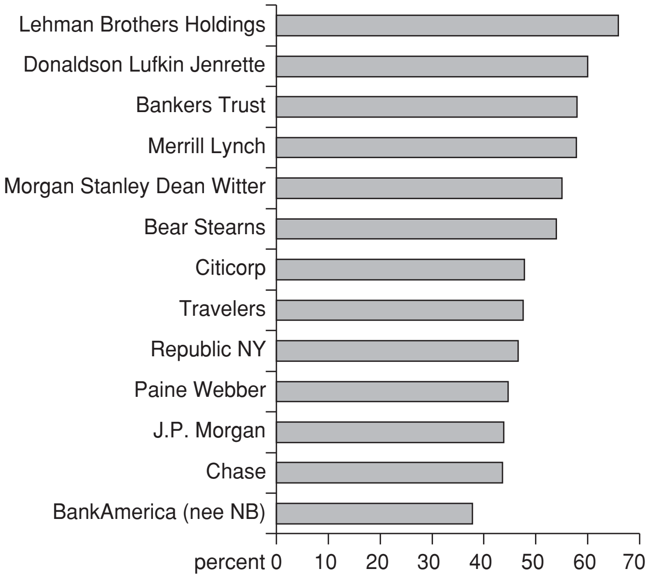
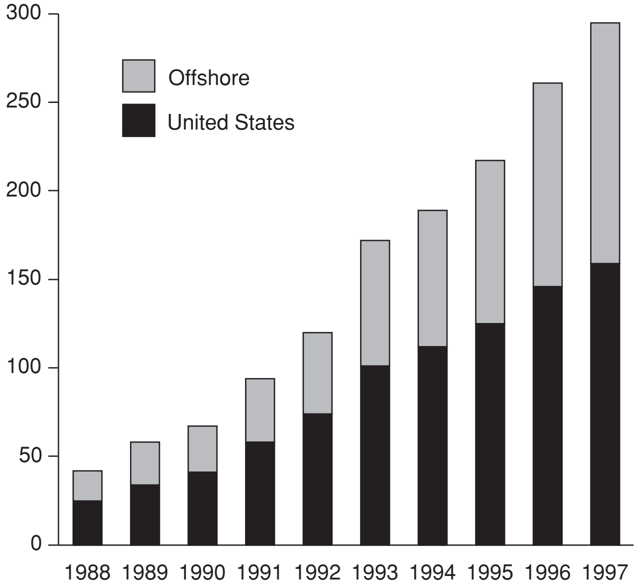



FIGURE 3
**Money under management by hedge funds**
(billions $)




result was huge losses to Western banks, some of which are said to be fatal. At least one major European bank is on the verge of failure, according to European banking sources.

## In defense of chaos

The banks have historically insisted, that volatility in the financial markets was good for business. In 1993, Michael G.J. Davis, the deputy head of risk management at Chase Manhattan Bank, made the revealing statement that "the bank's biggest fear would be a long period of calm and stability in the markets, which would lull companies and investors into slowing their trading activities. The worst thing for us is a marketplace where nothing happens."

The whole derivatives market, in fact, is based upon chaos. The derivatives market can be fairly compared to the protection racket favored by organized crime: You throw a brick through someone's window, then sell him glass insurance. The 1971 introduction of floating exchange rates was the brick, and currency derivatives the insurance. The interest rate derivatives perform a similar function for the bond markets.

Risk has become the buzzword of the 1990s, with "risk management" presented as if it were the high point of human economic activity, rather than a clinical insanity. It has become almost obligatory, in financial, regulatory, and journalistic circles, to sing the praises of "risk management," and of those modern financial instruments known as derivatives.

The commitment of the bankers and their supposed regulators toward defending speculation at all costs, was obvious at the hearing held on Oct. 1 by the House Banking Committee, to examine the failure of Long-Term Capital Management, a Connecticut-based hedge fund. Federal Reserve Chairman Alan Greenspan, who has not only explicitly endorsed the derivatives market, but has actively fought all attempts to regulate them, testified.

"If, somehow, hedge funds were barred worldwide," Greenspan told the committee, "the American financial system would lose the benefits conveyed by their efforts, including arbitraging price differentials away. The resulting loss in efficiency and contribution to value added and the nation's standard of living would be a high price to pay—to my mind, too high a price." Greenspan added that our current economy, with its "highly leveraged financial institutions, has been a conscious choice of the American people since the 1930s."

## Hedge against disintegration?

The Banking Committee hearing on Long-Term Capital Management (LTC) was mostly a sideshow, focussing mainly on whether the Federal Reserve should have gotten involved in arranging for a group of banks to take it over, and whether there should be increased regulatory oversight of hedge funds.

As of the end of 1997, there were some 5,500 hedge funds worldwide, with some $295 billion in funds under management, Van Hedge Fund Advisors President Steven Londsdorf told the committee (**Figures 2** and **3**). These figures do not include the trillions of dollars of derivatives holdings of the hedge funds.

While most of these hedge funds are relatively small, some are huge, like the $20 billion Quantum funds of George Soros, and the $20 billion Tiger Management Funds of Julian Robertson. It was Soros, a financial warfare specialist for the British Empire, who launched the so-called Asian crisis in mid-1997, with assaults on the currencies of Southeast Asia. British agents Soros and Robertson are heavy users of derivatives, and have made both multibillion-dollar gains and multi-billion-dollar losses in recent years.

What the committee and the speakers danced around, was the systemic nature of LTC's failure. While LTC was dangerously overleveraged, with derivatives holdings more than 500 times its equity capital, what triggered LTC's failure was the disintegration of the financial system, from underneath its bets. Had the Fed and the banks not intervened to protect LTC's derivatives exposures, LTC would have defaulted on its debt the next day, blowing a trillion-dollar hole in the derivatives markets, and likely setting off a chain reaction of defaults which could have brought down the entire financial system.

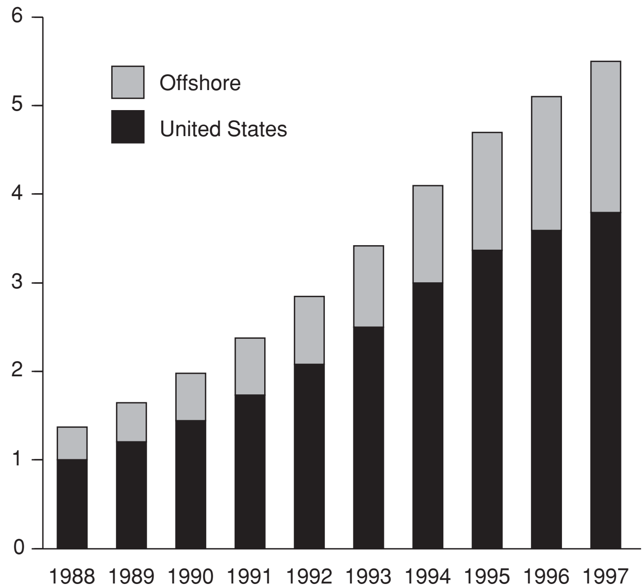
Federal Reserve Bank of New York President William McDonough hinted at this danger at the Oct. 1 hearings, telling the Banking Committee: "Had Long-Term Capital been suddenly put into default, its counterparties would have immediately 'closed-out' their positions. If counterparties would have been able to close out their positions at existing market prices, losses, if any, would have been minimal. However, if many firms rush to close out hundreds of billions of dollars in transactions simultaneously, they would be unable to liquidate collateral or establish offsetting positions at the previously existing prices. Markets would move sharply and losses would be exaggerated. Several billion dollars of losses might have been experienced by some of Long-Term Capital's more than 75 counterparties." In addition, McDonough said, "as losses spread to other market participants and Long-Term Capital's counterparties, this would lead to tremendous uncertainty about how far prices would move. Under these circumstances, there was a likelihood that a number of credit and interest rate markets would experience extreme price moves and possibly cease to function for a period of one or more days and maybe longer. This would have caused a vicious cycle: a loss of investor confidence, leading to a rush out of private credits, leading to a further widening of credit spreads, leading to further liquidations of positions, and so on."

In short, a reverse-leverage chain reaction.

## On the edge

While the immediate LTC crisis has been temporarily contained, the problems which triggered it have not. Worldwide, there is a flight out of anything perceived as a "risky" investment, and into relatively safer major-nation sovereign debt, such as U.S. government Treasury securities. Risk, the darling of financial markets just a few short months ago, has suddenly become a pariah. Greed has given way to panic.

FIGURE 4
**Number of hedge funds**
(thousands)




This sudden reluctance to take risks has put a damper on the mergers and acquisitions (M&A) and initial public offering (IPO) markets, as well as the junk-bond markets. M&A activity slowed dramatically in the third quarter, to about half the level of the second quarter, and a number of IPOs have been put on hold. One of the IPOs which has been postponed, is that of Goldman Sachs, the private partnership which announced in early September that it planned to go public to raise money. For a company which prides itself on knowing what is happening on world markets, Goldman's sudden decision to cancel its IPO was undoubtedly embarrassing. But that embarrassment was more than offset by the thought of losing billions of dollars, due to the general decline in commercial and investment bank stocks.

Among the first stocks skittish investors unload, are those of the big derivatives-holding commercial and investment banks, the stocks of which have plummetted since mid-year (**Figure 4**). Lehman Brothers, whose stock has declined some 60% in value in the last few months, took the unusual step of publicly denying that it was insolvent. Bankers Trust, whose stock has dropped nearly as much, is also the subject of much rumor.

The rapid drops in the bank stocks indicate that the institutional investors are unloading their holdings, because they know that the banks face losses much larger than anything they have admitted publicly. The losses due to LTC are still being calculated, and they are just the tip of the iceberg of the losses in the global derivatives markets. The system itself, is disintegrating.