Click here for Full Issue of EIR Volume 26, Number 14, April 2, 1999

Dr. Greenspan battles to save the derivatives cancer

by John Hoefle

Addressing the Futures Industry Association's annual International Futures Industry Conference in Boca Raton, Florida, on March 18, out-going Commodity Futures Trading Commission chairman Brooksley Born issued a strong warning on the dangers facing the global derivatives markets. The volume of trading in the over-the-counter (OTC) derivatives market "has exploded in the last five years," and "the number and type of derivatives products offered over the counter continues to mushroom even as the volume of transactions in that market increases exponentially," Born said. She added that "the size and nature of the OTC market create a potential for systemic risk to the nation's financial markets."

"The LTCM [Long-Term Capital Management] episode demonstrates the unknown risks that the OTC derivatives market may pose to the U.S. economy and to financial stability around the world," Born warned. "It also illustrates the lack of transparency, excessive leverage, and insufficient prudential controls in this market as well as the need for greater coordination and cooperation among domestic and international regulators. . . . We must urgently address whether there are unacceptable regulatory gaps relating to trading by hedge funds and other large OTC derivatives market participants."

The next day, addressing the conference by satellite, Federal Reserve Board chairman Alan Greenspan defended the derivatives markets and called for less, rather than more, regulation.

"By far, the most significant event in finance during the past decade has been the extraordinary development and expansion of financial derivatives," Greenspan said. He called derivatives "an increasingly important vehicle for unbundling risks. These instruments enhance the ability to differentiate risk and allocate it to those investors most able and willing to take it."

"I am quite confident that market participants will continue to increase their reliance on derivatives to unbundle risks and thereby enhance the process of wealth creation," Greenspan concluded.

Cancerous growth

Just figuring out the size of the global derivatives market is tricky, given the variations and gaps in reporting, but the market is unquestionably, to use Born's term, exploding.

In its March 1999, *International Banking and Financial Market Developments* quarterly review, the Basel, Switzerland-based Bank for International Settlements put the notional amount of OTC derivatives outstanding at the end of June 1998 at $70 trillion, with another $14 trillion in exchange-traded derivatives outstanding, for a combined total of $84 trillion worldwide. These figures are adjusted for double-counting of transactions between the derivatives dealers involved in the study, so that, for example, a $100 million derivatives contract between Chase Manhattan and Credit Suisse only adds $100 million to the world total, even though it shows up as a $100 million deal on each bank's books. The gross notional value of global derivatives is significantly higher. In its annual derivatives survey published in November 1998, the Bank for International Settlements (the central bankers' central bank) put the derivatives holdings of a select group of some 70 banks and securities firms in the major industrial nations, at $103.5 trillion at the end of 1997. That figure, representing only selected institutions and also adjusted for some double-counting between institutions, presumably reflects most, but certainly not all, derivatives activity worldwide.

© 1999 EIR News Service Inc. All Rights Reserved. Reproduction in whole or in part without permission strictly prohibited.

According to Greenspan, the $70 trillion in OTC derivatives reported by the Bank for International Settlements for June 1998, "doubtless is closer to $80 trillion today." "Once allowance is made for the double-counting of transactions between dealers," Greenspan continued, "U.S. commercial banks' share of this global market was about 25%, and U.S. investment banks accounted for another 15%," giving U.S. firms a 40% share of the global OTC market.

The U.S. commercial banks, according to the Federal Deposit Insurance Corp.'s *Quarterly Banking Profile* for the fourth quarter of 1998, had an aggregate of $33.4 trillion of "off-balance-sheet derivatives" at the end of 1998, representing an $8 trillion—31.5%—increase over the $25.4 trillion the banks reported at the end of 1997. Throw in another $20 trillion or so for the big U.S. investment banks (plus some non-bank derivatives dealers such as AIG and Enron), and the U.S. derivatives total rises to about $55 trillion.

Were the $103.5 trillion in derivatives outstanding at the end of 1997 to have grown at the same rate as the U.S. commercial banks' derivatives holdings, the total for the end of 1998 would be around $136 trillion. However, none of these figures should be considered a world total. *EIR* estimates that the gross notional principal value of derivatives contracts worldwide, is in the range of $165-200 trillion, and rising rapidly.

"Despite the world financial trauma of the past 18 months, there is as yet no evidence of an overall slowdown in the pre-crisis derivative growth rates, either on or off exchanges," Greenspan told the futures conference.

'Wealth creation'?

Listening to Greenspan and his fellow derivatives cheerleaders talk about the financial markets of the "new economy," makes it clear that they live in a world of virtual reality, where common words have strange meanings, and the laws of the universe have been turned on their heads.

"The value added of derivatives themselves derives from their ability to enhance the process of wealth creation," Greenspan exclaimed.

Other proponents of the "new economy" insist that rising stock markets also "create wealth," that derivatives products can be "manufactured," and that the Information Age is a natural evolution from, and improvement upon, the outmoded Industrial Age. Who needs factories, when we have the Internet?

In Greenspan's mind, it is humanity and the real world which threaten his beloved markets, rather than the other way around.

"History tells us that sharp reversals in confidence happen abruptly, most often with little advance notice. They are self-reinforcing processes that can compress into a very short time period," Greenspan said. "Panic market reactions are characterized by a dramatic shift to maximize short-term value, and are an extension of human behavior that manifests itself in all forms of human interaction—a set of responses that does not seem to have changed over the generations. I defy anyone to distinguish a speculative price pattern for 1999 from one from 1899 if the charts specify neither the dates nor the levels of the prices."

In the financial panic of last autumn, Greenspan insists, "derivative instruments were bystanders."

Deregulation

Having adopted the position that the financial markets "create wealth," Greenspan logically argues (demonstrating anew that logic is not a substitute for reason), that all impediments to the expansion of the financial markets must be eliminated. Rather than increase the regulation of the derivatives markets, Greenspan says, "It would be far better to provide incentives for banks to enhance their risk modelling procedures by taking into account the potential existence and implications of discontinuous episodes."

Just how linear market models that are based upon the growth of the largest financial bubble in all history could possibly accurately forecast the non-linear collapse of that bubble, Greenspan doesn't say. The recent "discontinuous episode," which began in Asia in mid-1997 and is rapidly spreading worldwide, caught all the modellers off guard, even the Nobel Prize winners at LTCM. The models don't work, and no amount of incentives will fix them.

Greenspan cited the faster growth of OTC derivatives relative to exchange-traded derivatives, as proof that further deregulation is necessary. "The largest banks, in particular, seem to regard the regulation of exchange-traded derivatives, especially in the United States, as creating more burdens than benefits," he said. "The fact that the OTC markets function quite effectively without the benefits of the Commodity Exchange Act [which created the Commodity Futures Trading Commission] provides a strong argument for development of a less-burdensome regime for exchange-traded financial derivatives."

That statement is music to the ears of the futures dealers, who have long complained that the derivatives exchanges were over-regulated, and have been heavily lobbying Congress to "level the playing field" by repealing burdensome "horse-and-buggy" restrictions.

One of the burdens they want removed, is the fact that many of the derivatives they sell are illegal under U.S. law. If, as the Commodity Futures Trading Commission suggests, swaps are futures under the law, then many of the OTC swaps contracts are illegal, because with a few clearly defined exceptions, off-exchange futures are illegal. As Senate Agriculture Committee Chairman Richard Lugar (R-Ind.) told a derivatives conference in October 1998, if swaps are futures, "many of these contracts could unravel and become unenforceable. Given that the notional value of these instruments run in the trillions of dollars, the legal risks of firms transacting swaps is significant."