The Blame for 'Enron' Debacle: Congress Tore Down FDR's Legacy of Regulation

by John Hoefle

In hearings on Enron's collapse, Congress has hauled various executives, Government officials, auditors, and bankers before the various committees to demand an explanation of how Enron's "abuses" could have happened. Who was asleep at the switch, and why?

The simple answer is that Congress itself deliberately removed the switch—sound economic regulations dating to FDR's New Deal—during the 1980s and 1990s. Congressional leaders will neither admit that, nor address the terrible damage Enron et al. have done to the U.S. economy as a result, and the financial crash still rumbling out of the Enron crater. The switch was systematically dismantled through a long series of policy decisions, Congressional acts, regulatory interpretations, and market shifts. These changes were intentionally designed to shift the United States from a production-based economy into a consumption-based economy dominated by speculation and the manipulation of money.

Let us review the steps by which these posturing political leaders, over 20 years, acted to dismantle the protective legacy of the Roosevelt New Deal, and thus to help Wall Street and London *turn the U.S. economy into an "Enron."*

'Controlled Disintegration'

The transformation of the U.S. banking system from a sector dominated by community banks which lent money to finance local production, into a handful of bankrupt giants which have overdosed on derivatives speculation, began in the 1970s. The New York Council on Foreign Relations set it out in its "Project 1980s" plan, published in 1976, for what the CFR itself termed the "controlled disintegration" of the economy. The main work, by economist Fred Hirsch, predicted a series of shocks to the economy—huge interest rate and energy price increases, credit cutoffs—which would "disintegrate" it. Hirsch's document was not a prediction, but a plan for the administration of Trilateral Commission member Jimmy Carter and his Trilateral Commission-dominated Cabinet.

Passed into law amid the energy hoaxes and credit shutdowns of Carter's four years, was the Steiger Act of 1978, which cut the capital gains tax rate to 28% from 49%. It was the first of many measures designed to promote speculative investment, against the real economy.

The following year, in October 1979, the new Federal Reserve Chairman and CFR leader, Paul Volcker—who is today, again, in the middle of the Enron-Arthur Andersen games being played by Congress—began hiking interest rates, reaching an incredible 21.5% prime interest rate in 1980. These rates were *intentionally* deadly to industries and productive project investments. While industry collapsed, Wall Street thrived.

This shift to favor speculation over productive activity was accelerated further with the Kemp-Roth Economic Recovery Tax Act of 1981, which handed out huge tax breaks for real estate speculators, thereby triggering a boom in metropolitan real estate markets. By running up the value of real estate, the speculators were able to "create wealth" for speculation. Further, Kemp-Roth again lowered the capital gains tax rate, this time to 20%, and implemented a range of other parasite-friendly measures.

The transformation of the economy into a giant casino took another step forward in 1982, with the passage of the Garn-St Germain Depository Institutions Act, which significantly deregulated commercial banking and the savings-and-loans. Among other provisions, it lifted the restrictions on the S&Ls' abilities to make commercial real estate loans, boosting the real estate bubble then, while famously bankrupting the S&Ls a few years later.

The next nail in the real economy's coffin came with the passage of the Gramm-Rudman-Hollings Balanced Budget and Emergency Deficit Control Act of 1985. This Act mandated dramatic Federal spending cuts, many of which fell on those infrastructure and social projects that had managed to survive Jimmy Carter's austerity measures. The implementation of the Gramm-Rudman-Hollings cuts was devastating to the Federal government and the economy, while—ironically—the budget deficit hit record highs, because capital gains and other business and financial tax revenues had been lost.

In 1987, Congress passed the Competitive Equality Banking Act, which expanded the power of the Federal Deposit Insurance Corp. to provide open-bank assistance to commercial banks (that is, to bail them out without having to close them). This Act also recapitalized the FDIC's S&L counterpart, the Federal Savings & Loan Insurance Co. (FSLIC),

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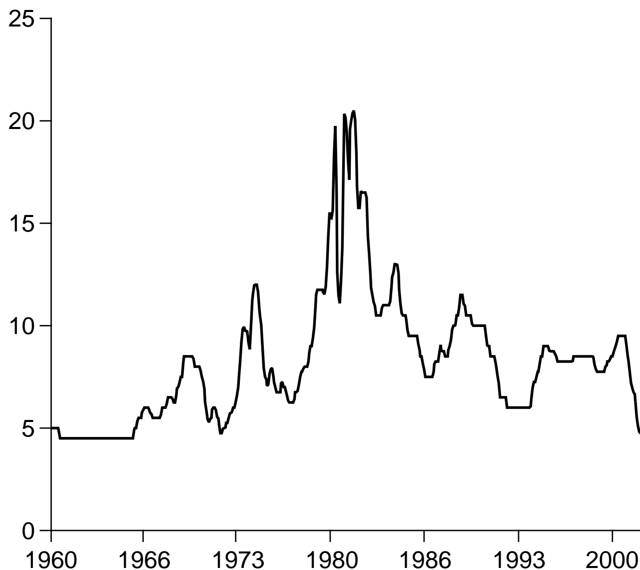
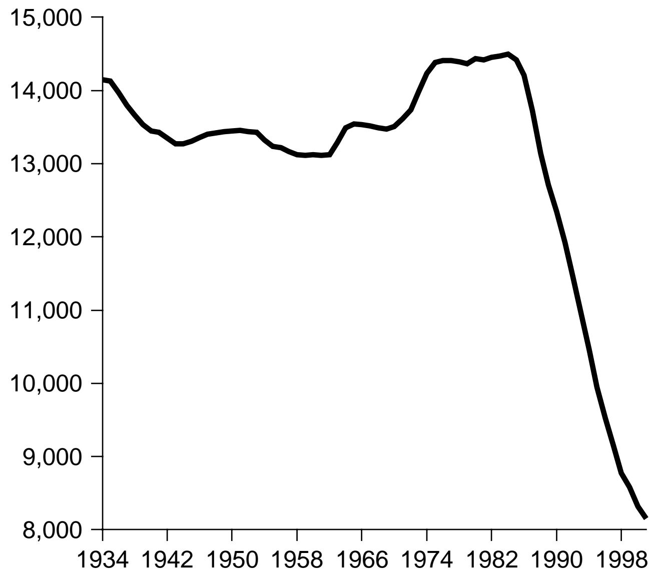
FIGURE 1
Prime Interest Rate Average Monthly Rate, 1960-2002
(Percent)



Source: EIRNS.

FIGURE 2
Number of U.S. Banks



Sources: FDIC Historical Banking Statistics.

which had run out of funds due to the record failures among S&Ls.

1987 also saw the 508-point crash of the Dow Jones Industrial Average on "Black Monday," Oct. 17, an event which showed that the "controlled disintegration" was becoming uncontrollable. The junk bond frenzy came to a crashing halt with the 98-count indictment against Drexel Burnham Lambert's Michael Milken in 1989, and Drexel's 1990 bankruptcy filing and subsequent liquidation.

Bailouts Begin

With the collapse of the related junk bond and real estate bubbles at the end of the 1980s, the U.S. banking system—not just the S&Ls, but the commercial banks, too—was bankrupt. Rather than address the policies which were causing the destruction, policymakers adopted a strategy of financial bailouts. They also made a headlong rush into the insane world of financial derivatives—the trillions of timebombs going off since the Enron debacle, under the shaky foundations of such huge hulks as J.P. Morgan Chase Bank.

The rush into derivatives, accompanied by rapid Federal Reserve cuts in interest rates, began in August 1989, with yet another bank-bailout law, the Financial Institutions Reform, Recovery and Enforcement Act of 1989. FIRREA abolished the FSLIC, and set up the Resolution Trust Corp. to manage and dispose of the assets of failed S&Ls held by the government.

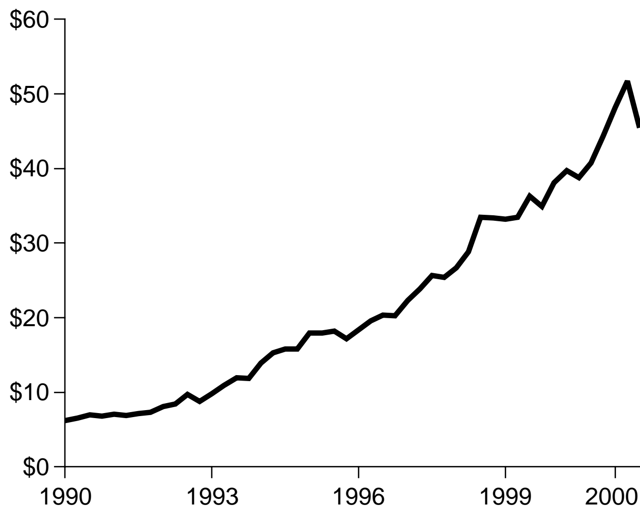
Despite the bailout measures, the banks continued to sink. In November 1990, the New York Fed secretly seized control of giant Citicorp, while the Boston Fed was pumping billions into the brain-dead Bank of New England to give time for its $36 billion derivatives portfolio to be "unwound." In December, Federal regulators held a secret emergency meeting on how to handle the banking crisis, in particular the basket cases: Citicorp, Chase Manhattan, Chemical, Manufacturers Hanover, Security Pacific, and the Bank of New England. On Jan. 6, 1991, Federal regulators closed the Bank of New England.

In June 1991, House Banking Committee Chairman Henry B. Gonzalez (D-Tex.), accused the Fed of running a systematic "backdoor bailout" of the big banks, "keeping brain-dead institutions open for extended periods."

In July and August, the Feds orchestrated mergers involving six of the top 12 banks in the nation, with Chemical taking over Manufacturers Hanover, Bank of America taking over Security Pacific, and NCNB taking over C&S/Sovran, forming NationsBank. Also in August, Warren Buffett bailed out both Salomon Brothers and Wells Fargo banks.

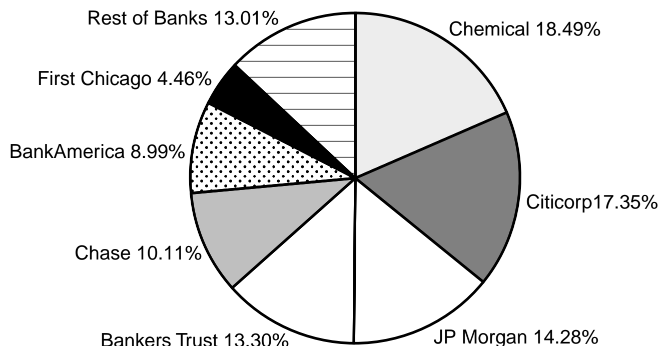
In December, the George H.W. Bush Administration called all Federal bank examiners to a meeting in Baltimore, where they were told bluntly to give banks the benefit of the doubt on bad loans as a matter of policy. "If America's banks are the engines for growth in this country, then you are at once the throttle and the governor," Treasury Secretary Nicholas Brady informed the examiners. "On the one hand, your decisions can choke expansion. On the other, you can foster the

FIGURE 3
U.S.Bank Derivatives Exposure Notional Principal Value, (Quarterly)
($ Trillions)



Source: FDIC.

FIGURE 4
Percentage of Total Bank Derivatives at Major Players, 1992
(Percent)



Source: Comptroller of the Currency, FDIC, *EIR*

injection of fuel that will lead to solid economic growth." "You are encouraged to give the benefit of the doubt, even if it might ultimately turn out to be a misjudgment," ordered Deputy Treasury Secretary John Robson. "Do not assume a doomsday scenario. Our economy will turn around, and so will troubled credit." This, of course, is the sin constantly preached against Japanese officials, by American bankers and officials, ever since.

In January 1993, the Commodities Futures Trading Commission, under the direction of outgoing Chairman Wendy Gramm, wife of Conservative Revolutionary Sen. Phil Gramm (R-Tex.), took the next step to tear down 60-year-old sound protections and regulations. The CFTC decreed that it would abandon the regulation of certain over-the-counter futures contracts, despite the fact that by law, such transactions were valid only if conducted on regulated exchanges. Gramm's decision opened the door for a wave of illegal derivatives speculation. One of the companies which lobbied the CFTC to issue the exemption was Enron; a week later, when Bill Clinton was sworn in as President, Gramm resigned her post. A few weeks later, Gramm joined the board of Enron, where she sat on its now-infamous audit committee. Among the other companies lobbying the CFTC for the exemption were J.P. Morgan, Chase Manhattan, Exxon, Mobil, and British Petroleum.

In the Spring of 1993, Lyndon LaRouche warned that the use of these derivatives instruments would dramatically increase the magnitude of the financial crisis, and called for a tax on derivatives transactions, aimed at drying out that volatile market. *EIR* published several articles on the derivatives activities of the major banks, some of which were entered into the *Congressional Record* by Representative Gonzalez. In the Fall, Gonzalez held the first Congressional hearings on derivatives—at which this author was invited to testify—forcing the Comptroller of the Currency to publicly reveal the size of the derivatives portfolios at major U.S. banks.

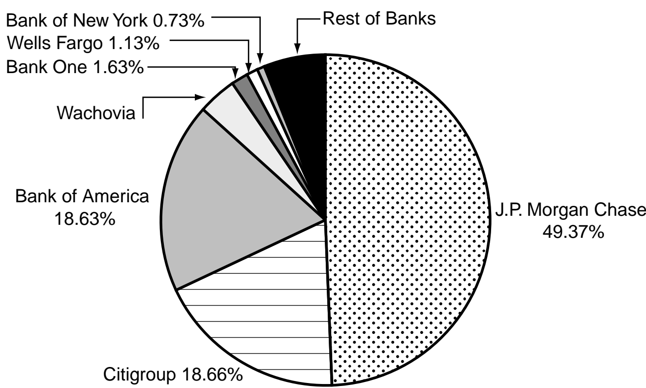
Also in 1993, the Group of Thirty expressed concern over the legality of the booming derivatives market, admitting that in many countries derivatives could be considered gambling, and as such not enforceable by law. Naturally, rather than give up gambling, the G-30 demanded that nations change their laws to accommodate the derivatives markets. Such arrogant criminality, pervasive in the political and regulatory apparatus, allowed the derivatives crisis now exploding, to develop.

Disaster Strikes

In Febuary 1994, Federal Reserve increases in interest rates immediately caused big losses at the giant hedge funds and rumors that Bankers Trust was insolvent. In September, when a suit was filed by Gibson Greeting Cards alleging fraud by Bankers Trust, the Federal government used this pretext to assume de facto control of the bank. Its $2 trillion derivatives portfolio was worked out, and the hulk sold to Deutsche Bank. 1994 also saw the bankruptcy of Orange County, California, due to a billion dollars of derivatives losses.

To aid further bailouts and consolidations among the banks, Congress then passed the Riegel-Neal Interstate Banking and Branching Efficiency Act of 1994, which allows banks considerably more freedom to branch across state lines—something they had been barred from since the 1930s. In August 1995, after big bankruptcies of Canadian real estate giant Cadillac Fairview and of Barings, the 300-year-old bank

FIGURE 5
Percentage of Total Bank Derivatives at Major Players, 2001
(Percent)



Source: Comptroller of the Currency, FDIC, *EIR*

of the British Empire, Chemical Bank announced it would take over Chase Manhattan, and adopt the more widely known Chase name.

1995 also saw the passage of the Private Securities Litigation Reform Act, which helped protect securities dealers and their accountants from suits, when they were caught abusing their customers.

At the end of 1995, Lyndon LaRouche introduced his now-famous "triple curve," or Typical Collapse Function concept, explaining both what had happened to the economy and showing what would happen were the prevailing policies to continue. Rather than heed the warning, Congress passed the Economic Growth and Regulatory Paperwork Reduction Act of 1996, further loosening restrictions on rolling over loans to troubled institutions and consumers, and streamlining the mortgage lending process, to help rebuild the real estate bubble which had fallen by 1994. 1996 also saw the beginnings of electricity deregulation in the United States, as several states either passed laws or issued regulatory decrees ordering the process to begin.

In March 1997, LaRouche pointed to the London *Sunday Telegraph* warning of the dangers posed by the "$55 trillion horror" global derivatives market, as a signal that another derivatives crisis, like that of 1994-95, was breaking out.

Above the Law

1997's hedge-fund raids against all the Asian currencies triggered the so-called "Asia crisis," actually the start of the rolling financial collapse afflicting the global financial system since that time.

How far the big banks, by then, saw themselves above the law, became clear in April 1998, with the announcement that Travelers Group, the giant insurance company which owned the Salomon Smith Barney investment bank, was buying Citicorp, the nation's largest bank holding company. Such a combination was *flatly illegal* under the Glass-Steagall Act of 1933 and the Bank Holding Company Act of 1956. In fact, the act by Travelers' Sandy Weill and Citicorp's John Reed in holding a press conference to announce the illegal merger, was itself a violation of Federal conspiracy statutes. Rather than enforce the law, however, regulators *immediately promised to rewrite the law to legalize the deal.* The merger, forming Citigroup, went through.

The deregulation of the electricity market began in California in April 1998, opening up a new venue for derivatives speculation and price manipulation in the energy markets. Enron expanded its trading operations and its fellow energy pirates began buying up power plants in California and other states.

In May 1998, the CFTC, now under Chairman Brooksley Born, issued a "concept release" which raised the prospect of reversing the disastrous exemption granted by Wendy Gramm in 1992. The response to this reasonable proposal was dramatic. On June 5, Federal Reserve Chairman Alan Greenspan, Securities and Exchange Commissioner Arthur Levitt, and Treasury Secretary Robert Rubin wrote jointly to the House and Senate, demanding legislation seeking "to protect this market from unnecessary, and potentially damaging, legal uncertainty." Attached to the letter was proposed legislation which recommended the CFTC's proposal be tabled, while the President's Working Group on Financial Markets (a.k.a. the "Plunge Protection Team") studied the matter. Born was run out of office and the threat—to enforce regulations—neutralized. By the time the Plunge Team released its study telling the CFTC to keep its nose out of the matter, the issue was already settled.

But the derivatives in question were still illegal. In a July 17, 1998, House Banking Committee hearing on the matter, Chase Manhattan Managing Director Dennis Oakley stated that "the Commodity Exchange Act requires that all commodity futures contracts be traded on a board of trade, and that since 1974, financial products have been considered commodity futures, unless they fall within the exception of the Treasury Amendment. If a product is deemed to be a future, and is not traded on a board of trade, it is null and void." The problem, he continued, "is that some of our fastest-growing products, such as equity and credit derivatives, are not covered by the exemption."

After much debate and large amounts of campaign contributions, Congress acted, putting a provision in the Commodity Futures Modernization Act of 2000 that exempted the derivatives from CFTC oversight.

Derivatives Crisis

The derivatives crisis of which LaRouche had warned nearly brought down the global financial system in late 1998,

when Russia defaulted on some of its debt and devalued the ruble. In the crunch that followed, investors fled speculative investments such as junk bonds and ran to the relative safety of U.S. Treasuries, sending the derivatives market into October gridlock. The most public casualty was the Long-Term Capital Management (LTCM) hedge fund, but many other banks and funds were similarly stricken. To stop a systemic collapse, the Fed orchestrated a bailout of LTCM by the big banks, and, in conjunction with the major European central banks, lowered interest rates and flooded the markets with a "wall of money." This policy, which has accelerated ever since, appeared to "work," but made the system even more unstable, and increased the level of market manipulation needed to keep it going.

Thus in 1999, the unholy grail of the destroyers of regulation was reached. The Gramm-Leach Bliley Act of 1999 repealed the last vestiges of FDR's Glass-Steagall Act. With it, went the last vestiges of the separation between commercial and investment banking, and the barriers between banking and insurance.

On the last day of 2000, the merger between Chase Manhattan and J.P. Morgan took effect, creating the world's largest derivatives bank. The bank, now known as J.P. Morgan Chase & Co., is actually the former Chemical Bank. Chemical, which took over Manufacturers Hanover in 1991, was a major derivatives player with a $3.4 trillion notional derivatives portfolio at the end of 1995; in 1996, it bought Chase Manhattan, which had $1.4 trillion in derivatives, making Chemical—renamed Chase—the top derivatives bank in the United States.

By the third quarter of 2000, Chase's derivatives portfolio had jumped to $14.4 trillion, topping J.P. Morgan's $8.9 trillion and Citigroup's $7.9 trillion. The subsequent combination of Chase and Morgan yielded a bank with a whopping $24.5 trillion in derivatives at the end of 2000, or 56% of the total reported derivatives held by U.S. banks. Citigroup held 18% and Bank of America (which was actually NationsBank, which acquired Bank of America in 1998 and kept the name) held 17%, giving just three banks 91% of all reported derivatives bets at U.S. banks.

The Federal Power Act

In November and December of 2000, the "California" energy crisis blew wide open, with prices soaring nationally in direct defiance of the 1935 Federal Power Act and Public Utilities Holding Company Act, which regulators would not enforce as the energy pirates manipulated the supply and gamed the market. LaRouche mobilized against Enron as the ringleader in this rip-off, and urged California officials to go on the attack. Gov. Gray Davis did just that, attacking Enron and its cohorts by name, publicly calling them "pirates." The combination of LaRouche's intervention and California's decision to fight, marked the beginning of the end for the energy pirates, and for electricity deregulation.

As details began to emerge about Enron's financial activities, the focus began to shift to the banks, which had both helped Enron set up, and been partners in, a number of its off-balance-sheet entities. One bank, in particular, seemed to be intimately and multiply connected to Enron, and that was J.P. Morgan Chase & Co.

Enron was basically a giant shell game, set up to build a market in energy derivatives as a way of expanding the global derivatives pyramid scheme, and J.P. Morgan Chase appears to have played a key role in Enron's scam. In one example, J.P. Morgan Chase, through an affiliate in the British Channel Islands known as Mahonia Ltd., made loans to Enron, which Enron treated as trades, allowing Enron to book the loans as income and hide the extent of its debt. To protect itself, J.P. Morgan Chase obtained—and Enron paid for—insurance against a default by Enron on the deals. When Enron collapsed, J.P. Morgan Chase turned to its insurers to collect, only to be denied. The deals, the insurance companies said, were scams, not legitimate transactions.

Enron used accounting tricks to hide billions of dollars of debt and losses in off-balance-sheet partnerships and affiliates. Enron did not do this alone—setting up such deals required a small army of bankers, lawyers, accountants, and consultants who were specialists in the field. That is to say, there exists among the world's leading banks, law firms, accountancies and consultants, a sector devoted to hiding losses, derivatives exposures, and dirty money flows. Enron was simply a prominent creature of this criminal element—whose activities Congress and administrations had "decriminalized."

Enron is now bankrupt. There are indications that J.P. Morgan Chase is either bankrupt, or nearly so, having used the merging of its two lead banks, Chase Manhattan Bank and Morgan Guaranty Trust, to *reduce its assets by $106 billion* in the fourth quarter. Even more telling is the $7 trillion reduction in combined derivatives exposure at those two banks in the quarter, an amount greater than the asset base of the entire U.S. banking system. Some of that reduction is undoubtedly due to the dissolution of derivatives deals between the two banks, but a lot of damage can be papered over with $7 trillion in adjustments. The economic story in 2002 will be major derivatives losses, as the process defined by LaRouche's Triple Curve plays out.

Today, the real physical economy—tariff regulation, energy re-regulation, and the infrastructure of the physical economy are suddenly back on the agenda; but President George W. Bush's steel tariff announcement is the only action that has yet been taken. Had Congress and the higher level of policy-makers listened to LaRouche, the story of 2002 would not have been a blowout, but of solid economic growth. Instead, at every step of the way, productive activity has been dismantled and speculation aided. Moves to reverse this should use as a model, the bold actions taken by FDR in the 1930s.