# LaRouche associates intervene in California financial crisis

LaRouche associates administered a healthy dose of reality to the Jan. 17 hearings held by the California Senate Special Committee on Local Government, on the $2 billion derivatives debacle in Orange County. Prior to the hearings, *EIR* Houston Bureau chief Harley Schlanger had circulated to members of several California state House and Senate committees, a memo written by *EIR* economics correspondent John Hoefle. That memo, reprinted below, stated that the massive losses incurred by Orange County were part of an ongoing collapse of the global derivatives bubble, and that any attempt to deal with the crisis in Orange County without dealing with that global economic collapse, would be futile.

That point was further emphasized during the hearing itself, by LaRouche associate Andrea Ingraham. "I represent *Executive Intelligence Review,* the newsweekly founded by Lyndon LaRouche, the only competent economist in the world today," she began. "The crisis in Orange County is not merely the result of bad judgment by county officials, but is a reflection of the disintegration of the entire world monetary system. Look at Mexico," she continued, and proceeded to elaborate on the crisis and what the alternative is.

After about two minutes the chairman cut her off with "Can you speed this up? We can read about it in this written testimony you've submitted," the chairman exclaimed, waving a copy of Hoefle's memo in the air. "Is there one final thing you'd like to add?"

"Only to say that you will not solve this problem by seeing it as a local problem; we have to nationalize the Federal Reserve System, and go back to national banking . . ."

"That's too big for us, we're a state government," the chairman responded.

"Well, that's the only way it can be solved," Ingraham replied. "A global depression can't be reversed on a local level."

Meanwhile, back in Orange County, the residents continue to suffer. The heavy rains which pounded southern California in early January, caused widespread flooding and several deaths, and exposed the deadly inadequacy of the county's infrastructure.

The storm "overtaxed the storm drains and flood control channels," admitted county flood control manager Herb Nakasone, who advised residents to stockpile sandbags and buy flood insurance, since no money was available to fix the drainage system.

## Text of the memo by John Hoefle to the California House and Senate

> The presently existing global financial and monetary system will disintegrate during the near term. The collapse might occur this spring, or summer, or next autumn; it could come next year; it will almost certainly occur during President William Clinton's first term in office; it will occur soon. That collapse into disintegration is inevitable, because it could not be stopped now by anything but the politically improbable decision by leading governments to put the relevant financial and monetary institutions into bankruptcy reorganization.
>
> —Lyndon H. LaRouche, April 1994

Ladies and Gentlemen:

The crisis which has unfolded in Orange County is not merely the result of bad judgment or other errors by county officials, but is rather a reflection of the ongoing disintegration of the entire global financial system. To view this as some sort of localized phenomenon which can be dealt with through ordinary legislative and judicial methods, is to miss the forest for the trees. The present currency and debt crisis unfolding in Mexico, for example, is part of this same process.

Whatever personal errors may have been committed by Orange County officials are largely irrelevant to the matter at hand. Punishing these officials will neither bring the money back, nor prevent other California counties from losing money. Changing the investment rules will neither bring the money back nor prevent future losses. Passing rules against the disintegration of the financial system is folly, as is dealing merely with the symptoms.

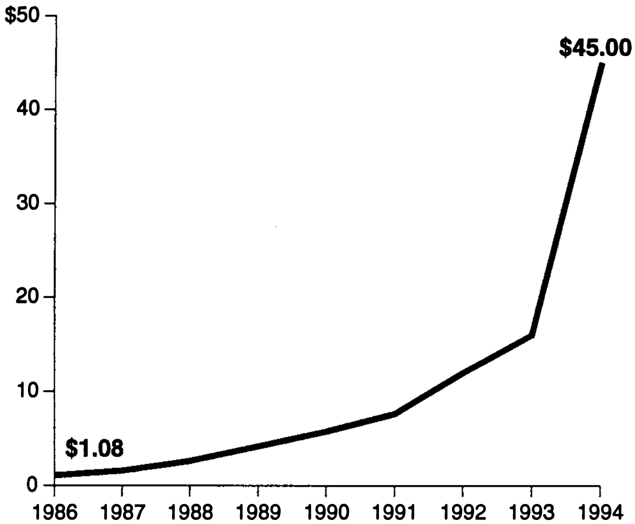
The question before this body is: How do we deal with the financial disintegration which is in progress, in such a way that we can minimize the destruction of the lives and welfare of the population?

### Only two choices

There are in reality only two choices.

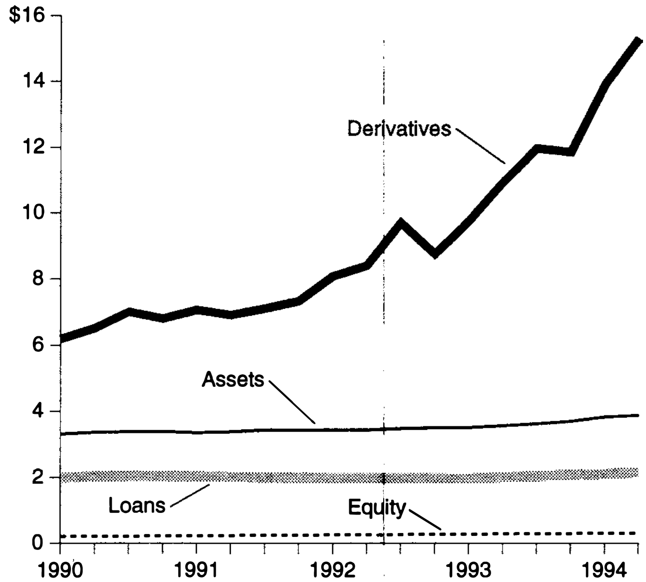
The first is to put the world's financial system through the equivalent of a Chapter 11 bankruptcy proceeding, in which the unpayable debts are written off, and attention

FIGURE 1
**World growth of derivatives**
(trillions $)




Sources: Bank for International Settlements, Swaps Monitor, EIR.

FIGURE 2
**Derivatives dominate U.S. banking system**
(trillions $)




Source: FDIC.

turned to rebuilding our tattered infrastructure to provide the basis for economic recovery.

The second is to fail to implement such essential changes, whereupon we watch the unfolding chain reaction collapse of the global financial bubble, which, once triggered, will occur with breathtaking speed, thanks to reverse leverage.

There is no middle ground. Either we reorganize the system to minimize the losses—and make no mistake: the losses are already of enormous proportions, and are growing geometrically—or we sit back and watch the whole system collapse into uncontrollable chaos and a depression far worse than the 1930s.

You will no doubt hear a lot from the so-called experts about "paper losses," losses which the experts insist become real only if people panic and pull out their funds. The truth, as Orange County has so painfully demonstrated, is that the losses are real, affecting schools, municipal services, transportation, and other aspects of the infrastructure upon which civilization depends. The losses are painfully real. It is the profits which exist only on paper, as claims to pieces of a speculative bubble which is in the process of disintegration.

## Paper profits

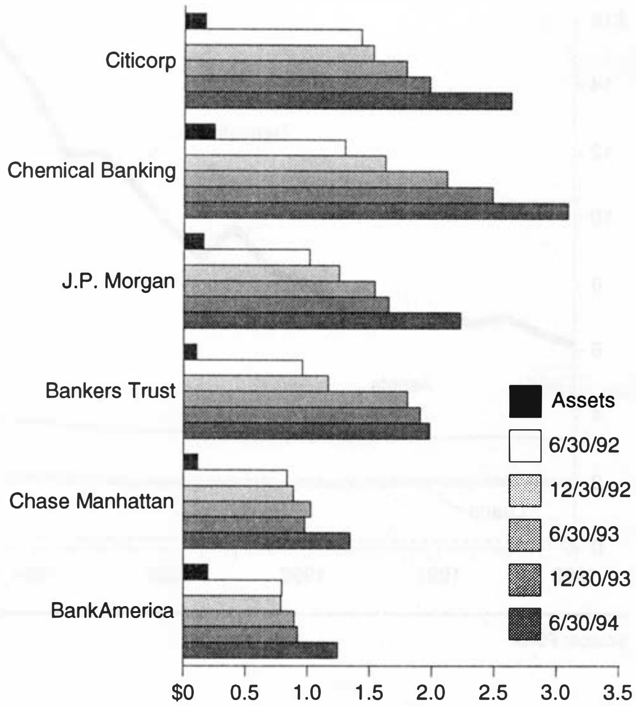
When the Orange County crisis first broke, Mr. Citron attempted to portray the losses as mere "paper losses," a temporary drop in the value of a portfolio, caused by the normal fluctuation of financial markets. Since then, officials of other governments in California and elsewhere have repeated that unfortunate phrase. "If everyone will just stay calm and leave their monies in these funds," the officials claim, "we can hold these securities until their maturities, and all will be well."

Nothing could be further from the truth.

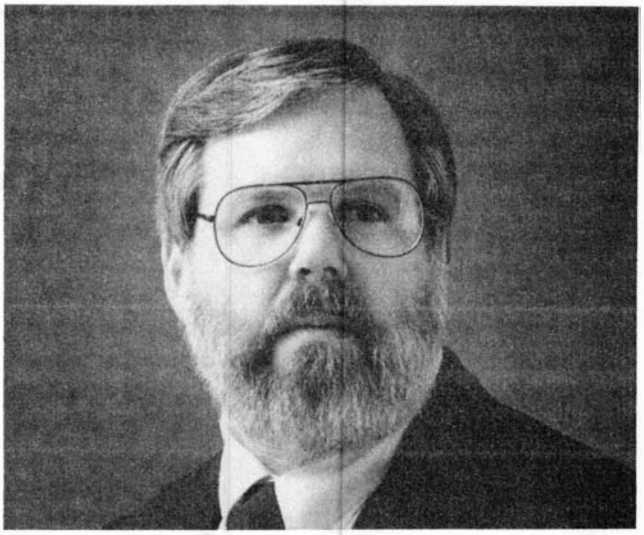
The U.S. financial system is dominated by an enormous speculative bubble, which grew rapidly in the 1980s and has grown even more rapidly since. This bubble has gone through several phases, including the collapse of the stock, real estate, junk bond, and Less Developed Country debt markets of the late 1980s, which bankrupted the U.S. banking system. To keep the banks afloat, the Federal Reserve rapidly lowered interest rates, which allowed the banks to feed off the increased differential between what they paid for money, and what they charged for money. The Fed also encouraged banks to rush into currency trading, interest-rate speculation, and other sorts of gambling, called derivatives in polite company. That is, the derivatives bubble was created to cover the collapse of the stock, real estate, junk bond, and LDC debt bubbles. Its growth was fueled by the deregulation of the commodities market, by former Commodities Futures Trading Commission Chairman Wendy Gramm, beginning in 1989.

This derivatives bubble has grown with breathtaking speed (it will collapse even faster). **Figure 1** shows the growth of derivatives worldwide over the last eight years, while **Figure 2** shows the growth of derivatives held by U.S. banks since 1990. The U.S. totals are held by a handful of banks, whose derivatives exposures dwarf the assets they declare on their balance sheets, as **Figure 3** shows. Note that these figures are snapshots, showing the notional principal

FIGURE 3
**Major U.S. banks and derivatives**
(trillions $)




Sources: U.S. Office of the Comptroller, Salomon Brothers, EIR.



*"Economics is not about money. Economics is about what people need to survive and grow," economist John Hoefle, shown here, told legislators in testimony submitted to the California House and Senate.*

values of derivatives at the ends of years or quarters. The turnover on these instruments during the year, is perhaps 200 times the notional values.

The alleged profits from this derivatives bubble are "paper profits," similar to the profits declared by the slumlord who pads his bank account by letting his building decay, and pocketing as profit the money which should go into maintaining and improving the building. Such profits are illusory, because they come from asset-stripping, the deterioration of the physical assets upon which the income is based. Sooner or later, that building will become unlivable.

The derivatives bubble works much the same way, substituting the physical economy for the slum building in the analogy. Money that should be reinvested in necessary infrastructure projects is instead pumped into the bubble, asset-stripping the economy as a whole. Thus the physical economy, which generates the income streams upon which the bubble subsists, is collapsing, making the collapse of the bubble itself inevitable.

## Real losses

The Orange County losses are but the latest in a string of huge losses which began in early 1994, when the Federal Reserve shifted from a policy of pumping up the bubble to bail out the banking system, to a policy of attempting to bring the bubble itself under some sort of control. The Fed instituted a series of interest rate hikes which caused massive losses among the hedge funds, mutual funds, institutional investors, investment banks, commercial banks, pension funds, municipal governments, and others, who had placed bets that interest rates would continue to drop, or at least fall no further. These gamblers—"investors" is not the appropriate term for this activity—bet their own money, and that of their clients, customers, and citizens, that interest rates would drop, and they lost their bets. Some of this was clearly illegal, as the Bankers Trust case shows, and some of this was technically legal, but it was, and is, stupid and immoral. It is bad enough when one takes one's own money to the casino, and inexcusable when one takes money entrusted to one by others to the casino.

Whatever else Mr. Citron and his colleagues in Orange County and elsewhere may have done, they should have stayed out of the casino. That they were not alone, that everybody else does it, is true, and is precisely the problem facing this body. This casino must be shut down, through forced bankruptcy.

Orange County has joined the growing list of gamblers who have lost over $1 billion through speculation. That list includes Bank Negara of Malaysia, Kidder Peabody, the World Bank, Ferruzzi, Kashima Oil, Metallgesellschaft, and now Orange County, with even more victims soon to appear. The list of those who have lost money in derivatives runs for pages, with some $28 billion in losses reported between 1987 and 1994.

## Pop goes the bubble

What has kept the bubble intact so far, is a combination of massive government aid, fraudulent bookkeeping, regulatory protection, and the political power of the financial markets to keep everyone in line. As long as everyone could count their paper profits, that protection racket worked—but with the losses piling up, the consensus is breaking down. When confined to the financial markets, these billion-dollar losses could be covered up or explained away, with soothing statements and technical babble from legions of so-called experts. The losses were real, but the spin-doctors were able to keep the magnitude of the crisis confined to insiders and those able to read between the lines of the financial pages.

Unfortunately for these speculators, reality has a way of intervening, and it is, with a vengeance. As the losses spread to municipalities and the pockets of their residents, citizens who were content to ignore the problem are now demanding answers, creating a political shock wave which will destroy the controlled "everything's okay" environment. At the same time, the losses are speading like wildfire, breaking out in U.S. investments in Mexico, Argentina, and other so-called emerging markets. The Ibero-American debt crisis, which the banks claimed to have solved years ago, is back, and worse than before, as shown by recent events in Mexico.

Even if the financial system manages to survive the current outbreak, it must ultimately collapse, and everything which is done to postpone that collapse, only serves to make the eventual collapse worse.

The rapid growth of debt, is the trick by which the collapse of the system is being postponed. Because this debt cannot be repaid, it is rolled over when due, creating the illusion of solvency while increasing the debt. These debts have grown far beyond the capacity of the economy to repay them. By the end of 1993, the total U.S. credit market debt outstanding stood at $15 trillion, and is growing at a rate of half a trillion dollars or more every year, while the ability of the economy to service that debt shrinks.

The debt has grown so large and the economy has fallen so far that, according to an *EIR* study published in August 1994, some $2.50 is now lost for every dollar that is invested in the economy, while $3 in debt service is demanded for every dollar of paper profits generated, relative to 1967 (**Figure 4**).

The faster the bubble grows, the more surely it, and we who must live in the economy which it is destroying, is doomed.

## Time for action

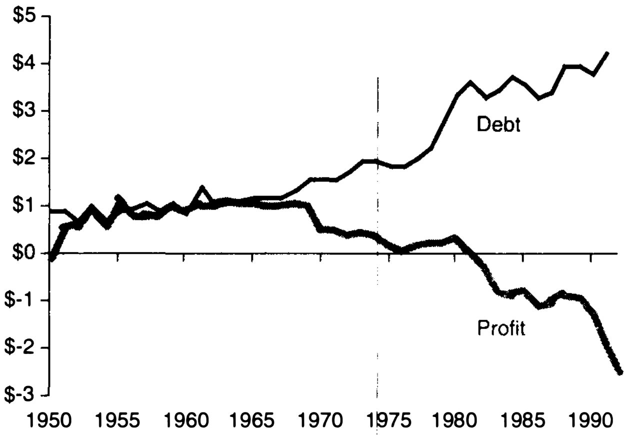
This crisis will not go away. Either we put an end to the speculative casino by putting it through the equivalent of Chapter 11 bankruptcy, or we will suffer not just a collapse, as we had in the 1930s, but a disintegration, where much of our institutional framework will simply disappear.

The financial experts will implore and cajole this body that you must let the experts handle this problem, and they will threaten you with dire consequences if you interfere. The future of the markets is at stake, they will insist, and the markets are the heart of the economy. It is the equivalent of

FIGURE 4

**Debt demand per dollar of profit and loss per dollar of investment in the economy**

Indexed to 1967 = $1.00




Sources: Federal Reserve Flow of Funds, Commerce Dept. Survey of Current Business

a cancer demanding that it must be allowed to thrive, in order to protect the health of the body.

Economics is not about money. Economics is about what people need to survive and grow, about what is needed to raise the standard of living over successive generations. People need jobs, education, health care, fresh water, electrical and other forms of energy, transportation, waste disposal, and such. That is what economics is all about, and the role of money and the financial system is to facilitate that process. Whenever someone insists that the financial markets are the heart of an economy, that person is confessing his incompetence, and should be dismissed as a fool.

What is required, to begin with, is the nationalization of the Federal Reserve, taking away its status as a quasi-independent corporation controlled by the bankers, and making it an institution of the U.S. government, similar to Alexander Hamilton's Bank of the United States under President George Washington. This bank could then, under constitutional powers, provide government credit to the productive sector of the economy for the rebuilding of our industrial capacity and the infrastructure necessary to support that growth.

What California needs, is economic growth. California needs infrastructure, to provide sufficient fresh water for its people, farms, and industry; to provide cheap and plentiful electrical power; and to improve its transportation grids to allow people and goods to move efficiently. California needs health care, to stop the waste of human life and potential that comes from diseases that could be eradicated. California needs to provide a Classical education to its children, to teach them *how* to think, so that they may meet the challenges of tomorrow.

This is what California needs, and the first step in meeting those needs, is to put an end to this speculative bubble, this parasite which is destroying us all.