EIR Economics

Derivatives: The Fed is no impartial observer

by Chris White

On Jan. 27, 1993, the Federal Reserve Board issued a report, "Derivative Product Activities of Commercial Banks," published jointly with the Federal Deposit Insurance Corp. and the Office of Comptroller of the Currency. The document is subtitled, "Joint Study Conducted in Response to Questions Posed by Senator Riegle on Derivative Products." Sen. Don Riegle (D-Mich.) is the chairman of the Senate Banking Committee.

The report highlights the absolute insanity that has developed along with the multitrillion-dollar bubble in speculation in financial derivatives.

There is a point to the senator's questions, to be sure; for example, the four sub-sections of Question 5: "What is the best way to measure the risk derivative products pose to the financial system? How serious is that risk? Can a failure at one institution be transmitted through derivative products to other institutions? How likely is such systemic risk?"

The Fed's replies do indeed concede the dangers, now given the bureaucratic name "aggregation" or "interconnection risk." "Interconnection risk can also be seen as one basic element in systemic risk: the risk that a disruption by any participant or group of participants causes widespread difficulties throughout financial markets."

But the whole thing is crazy. The assumption, both on the part of the questioner and of the respondent, is that so-called derivative products are an exotic and even exogenous feature of the financial system as a whole, which may or may not have effects outside its own autonomous sphere.

Suppose instead what is more truthful: that since the stock market crash of 1987, derivative products have *become* the financial system (see *EIR*'s cover story in last week's issue). What then would be the best way to measure the risk derivative products pose to the financial system?

Then we would have to come up with an answer to the question, "Well, just what is a financial system for?" Is it simply a means for converting society's accumulated wealth into so-called money, in the pockets of the few? The Founding Fathers who allocated Congress the function of money and credit creation, in Article 1, Section 8 of the Constitution, and who made the regulation of interstate commerce a federal responsibility, evidently did not think so, nor did they think the matter unimportant enough to be left to the elaboration of courts through positive law. Inclusion in the Constitution established that credit generation is a matter of public principle, not private privilege.

Without the efficient exercise of that power, there is no continuing basis for the existence of the state, nor for the protection and improvement of the individuals who populate that state. Instead, there is the arbitrary intervention of the market, the monied interest protecting itself.

The Fed's usurpation of power

Congress illegally abdicated its credit and money creation powers to the Federal Reserve, which it brought into existence in 1913, a privately owned special kind of bank, which oversees the process by which money and credit are generated, by coordinating the terms on which funds will be loaned to and borrowed from the federal government, which, under the Constitution, is the sole source of money and credit.

That's roughly what the Federal Reserve does with its Fed Funds rate, its discount rate, and its repurchase agreements on government securities. No one denies it.

All the more ridiculous, then, that the Federal Reserve should leave itself out of its own report on derivatives. Just

© 1993 EIR News Service Inc. All Rights Reserved. Reproduction in whole or in part without permission strictly prohibited.

as derivatives are treated as an intervention into the system from the outside, so also is the Federal Reserve itself. The organization of credit flows is omitted, in favor of a passing mention of the Federal Reserve as "examiner" and "regulator." What a farce!

If you say that the Federal Reserve has been pumping up the banks with government debt, at a rate of about $100 billion per year, there are people who will quibble, "What's your proof? How do they do it? There's no evidence on their balance sheets that it is going on!" Maybe they don't use a credit card, or pay down a mortgage, or pay off a car loan. How does the Federal Reserve do it? By using its control over interest rates to direct credit in the manner desired. It doesn't have to give the banks, for example, money—though it can do that, too.

The Federal Reserve's version of the story is that it does not conduct its foreign exchange and open market operations in such a way as to safeguard the workings of the commercial banks' financial derivatives trading. As befits the intervenor from the outside, the story goes that "the Fed does have contingency plans if something goes wrong. But the Fed does not want to get into a position in which it is back-stopping the trading in derivatives. If we started subsidizing the trading, we would be obligated and linked into the market, and that we don't want."

Compare the rates paid to the banks, with, for example, the Fed Funds overnight rate, the rate the Fed charges bank borrowers; on credit card debt it is 15% plus, up to more than 24%, against less than 3%. Credit card debt is the most egregious case; mortgage debt and auto loans—"low APR"—are lower, but the spread is a sizeable one in the banks' favor. Compare the under 3% rate on Fed Funds with the around 7% rate on the Treasury's 30-year bond. Banks, for example, can borrow at less than 3% from the Fed, and lend the same funds, or funds that come from loan payers, to the Treasury at 7%. The 4% difference is a free handout from the taxpayers, organized by the Federal Reserve.

That is roughly $4 billion on the $100 billion new debt taken on last year, out of total holdings of federal government debt of more than $700 billion. Over the year, it was more than George Soros, Citibank, and others made in their speculative killing of the European Monetary System last September. They no longer have to set aside reserves against holdings of Treasury debt. They make money without tying up other assets. This is all done without linking the Federal Reserve into the market. But never mind "subsidizing trading"; the 4% margin, before anyone does anything at all, is what makes the whole arrangement work.

The market in U.S. government debt, $300 billion per day globally, is the second largest after the currency markets. At that rate of turnover, all the publicly held debt outstanding of the U.S. government could change hands around every 10 trading days. Anyone who disputes the idea that the 4% spread the Fed organized in favor of bank holdings of Treasury debt has not functioned to put a floor under that market, is crazy.

And since U.S. government fixed interest paper is used to hedge other speculations, including between fixed and floating rate instruments, involving switches between currencies, in spot and forward transactions, it is not much more of a leap to the conclusion that the interest rate spread which the Federal Reserve has organized over the last three years has been the key component of the last three years' growth of derivative instruments.

Better then than having the Fed report on derivatives to the Senate, and their associated "risks," would be to commission a report on the Federal Reserve.

But the Federal Reserve is privately owned. Apart from the Federal Reserve Bank in Washington D.C., the Fed is organized on the basis of regional Federal Reserve banks. Federal Reserve Bank of New York, Chicago, Kansas, etc. The regional Federal Reserves are owned by the banking interests, and, according to some, other prominent individuals from the region.

More questions

Another tricky question. The U.S. Constitution is the constitution of a federal republic. Its organizing unit is the state. There is no place for "regions" in the Constitution. There is a place for the three branches of government, and for the states, but not for "regions" which escape federal law, but are not covered by state law either. Typical skullduggery. Don't like a law, eh? Then find a "gray area," move into it, exploit it, and pretty soon the gray area becomes the law. So it was with "regions," corporate existences which are neither federal nor state entities, and not accountable at either level.

According to the Fed's reply to Senator Riegle, Bank Holding Companies with assets of greater than $10 billion dominate almost 99% of all the derivatives trading conducted by banks. For example, banks with over $10 billion in assets, trade 98.21% of the interest rate swaps; 98.78% of the interest rate futures/forwards; 98.95% of the interest rate options; 99.95% of the foreign exchange swaps; and 99.93% of the foreign exchange options. These five markets represent the lion's share of derivatives trading by the commercial banks. The total notional values volume of these respective markets, as of June 1992, was $5,133.2 billion. Outside these five markets, the banks trade only $102.4 billion in all other kinds of financial derivatives markets.

There are seven commercial banks that are really big players in the financial derivatives markets: Citicorp, Chemical, J.P. Morgan, Bankers Trust, Bank America, Chase Manhattan, and First Chicago. These seven banks alone control 90% of the market.

And these, it must be presumed, include the banks which own the New York Federal Reserve, which runs the Fed's open market operations. No wonder that the Fed tries to keep its distance from what it has unleashed.