

Drying out the hedge funds

The point was conveyed to the major institutional investors, whose combined assets far exceeded those of the hedge funds, that the “victim” of this dramatic interest rate tightening was to be the unregulated hedge funds. “The hedge funds will be the ones to pay the price,” reported a senior European banker who had just returned from extensive client talks with a broad grouping of U.S. bankers, pension fund managers, and Wall Street firms. “There is a clear consensus among U.S. financial and central bank circles, that the huge, unregulated power of the hedge funds will not be allowed to continue. It had simply become a systemic danger to all. They have closed ranks to defend their existence,” he said.

Indeed, there is evidence that the “Chinese water torture” of rising Fed interest rates has begun to take a huge toll on hedge funds. “Since August, hedge funds have been almost absent from the major markets,” noted one Luxembourg banker who tracks these developments for his bank. Two weeks ago, reports circulated that Soros, the largest hedge fund operator who reportedly counts the Queen of England among his investors, had incurred added trading losses of \$400-600 million on guessing the dollar trend wrongly. On Nov. 21, Soros announced he was liquidating a major real estate venture he had entered two years ago in Britain.

The informed expectation among central bankers and major financial market participants with whom this writer has spoken in recent days, is that the latest rise by the Fed has all but finished the threat from hedge funds to the financial system for the present. With the exception of Soros’s Quantum Fund, most hedge funds allow investors to take funds out only at the end of the calendar year, Dec. 31. Unless the hedge funds are able to recoup their huge losses for the first 11 months of this year, the expectation is that some of the larger hedge funds will find themselves in bankruptcy courts early in 1995.

To this extent, Fed Chairman Greenspan’s “correction,” which he set in motion last February with the first rate rise in five years, has apparently lessened the threat from highly leveraged hedge funds as well as, perhaps for the moment, derivatives.

The problem, however, is one inherent in the very mandate of the Federal Reserve, embedded in the original congressional act of 1913 which made the Fed a private body, whose mandate was to maintain the solvency and stability of the U.S. private banking system. It is purely secondary to the Fed whether this also enhances the general health and welfare of the population, or the growth of the real economy.

This is the inherent flaw of the mandated monetarism of the Federal Reserve. The impact of the interest rate increases has indeed smashed the most speculative elements such as the hedge funds. But at a price which has so raised interest rates in the United States and Europe and elsewhere that economic investment in real infrastructure and technology is even more remote.

Debt has swamped the real physical economy

by Anthony K. Wikrent

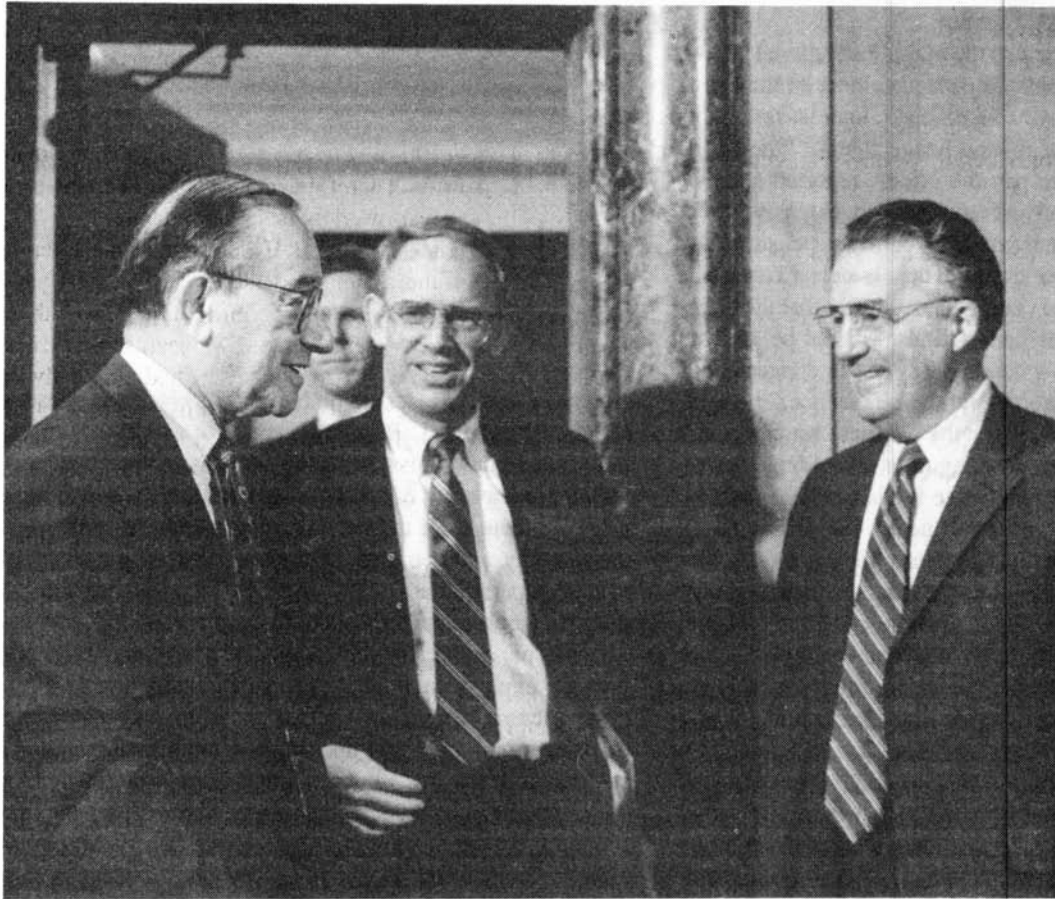
In a memo to his associates on Nov. 17, 1994, U.S. physical economist Lyndon LaRouche warned, “It would be a potentially dangerous omission in the analysis of the [financial] bubble, to leave out of account the relationship among three principal features of the structural interrelationship between the real *physical* economy, and the leveraged monetary-financial superstructure. Only when we take into account the physical parameters of consumption and production in physical terms per capita, per household, and per square kilometer, does the explosiveness of the global monetary and financial systems come into view.

“Greenspan et al. are operating essentially in the monetary-financial domain, with virtually no competent regard for the relationship of leveraged income-streams from the real economy, to the magnitude, and rates of change of magnitude, of financial and monetary aggregates,” LaRouche continued. “Thus, the very mechanisms by means of which Greenspan may be seeking to deflate most of the hedge funds, as an ameliorative measure, can trigger the very explosion which he deludes himself he is working to bring under control.

“The problem here is properly reduced to its axiomatic terms,” LaRouche explained. “The use of the axiomatic assumptions of monetary theory—any variety of monetary theory—to shape economic, monetary, and financial policies now, will tend to accelerate the crash of the system as a whole. That is the tragedy of the system—in Schiller’s definition of tragedy.”

It was precisely the failure to identify these axiomatic assumptions of policy outlook among the U.S. Federal Reserve and other government institutions, that led U.S. President Bill Clinton and the Democratic Party into the electoral disaster on Nov. 8. “Silly talk about the ‘recovery’ . . . was Clinton’s great folly,” LaRouche observed on Nov. 8. “There obviously *is no recovery*, there never was one.” What we shall attempt to do here, is to provide for the reader some of the evidence that there is no economic recovery.

In **Figure 1**, we use data series from the U.S. Department of Commerce’s Bureau of Economic Analysis and Bureau of the Census, to provide an approximation of the rate of profit of the U.S. economy as a whole. By “rate of profit,” we do not mean the rate at which a financial investment generates a



The mechanisms which Federal Reserve Chairman Alan Greenspan (left) may be seeking to deflate the hedge funds, can trigger the very explosion which he deludes himself he is working to bring under control. To Greenspan's right: Richard Breeden, chairman of the Securities and Exchange Commission, and Sen. Paul Sarbanes (D-Md.), at a hearing of the Senate Committee on Banking, Housing, and Urban Affairs in 1992.

paper profit; we mean the rate at which the economy is producing *surplus economic activity* over and above that level of economic activity required to meet the needs of a living and reproducing human population—the food it eats; the housing it uses; the clothes it wears; the infrastructure that provides it drinkable water, electricity, and transportation capabilities; the medical care and education services it requires.

For an approximation of profit we take manufacturers' shipments and subtract the costs of producing the goods shipped. We approximate the costs of producing the goods shipped by adding together cost of materials; wages of manufacturing workers; investment/depreciation of the machinery and equipment used up in the production process (machinery wears out, just like the family car, and must be replaced); and the cost of money, i.e., an effective, not nominal interest rate, which we approximate as total interest payments divided by total debt.

These calculations give us an approximation for the profit of the economy; we next need to approximate the rate of profit. To do this, we subtract debt service from profit, and divide the resulting figure by the costs of producing the goods shipped. The equation thus is:

FIGURE 1
Rate of profit of U.S. economy
(1967=\$1.00)



$$\frac{\text{shipments} - (\text{cost of production} + \text{debt service})}{(\text{cost of production} + \text{interest})}$$

where

the cost of production =

the cost of materials + wages + depreciation.

In a healthy economy, the cost of production is reduced by introducing technological advances into the economy, increasing the productive power of labor. This increase in productivity can be measured by the amount of land area per operative, which should decline over time as labor power increases, providing that the production of goods and services to support human population is not only the same, but is increasing in both quantity and quality. Another measure is energy use per capita, as technological progress involves greater mastery by mankind over the forces of nature, most specifically over the spectrum of different “types” of energy. A healthy economy, therefore, will always show a secular increase of per capita energy use over a number of years.

What we find for the U.S. economy is exactly the opposite.

Figure 1 shows that the rate of profit of the U.S. economy peaked during the Kennedy administration, and has fallen since. If a ratio of 1.00 represents economic breakeven—meaning the (nonexistent state of equilibrium) point at which the economy is producing just enough goods and services to support its human population—then it is clear that the U.S. Federal Reserve’s 1979 switch from controlling interest rates, to controlling the money supply while allowing interest rates to “float,” drove the U.S. economy below breakeven, into depression. Calculated using 1967 as the base year, \$2.50 is now lost for every dollar that is invested in the U.S. economy. Yet, \$3 in debt service is demanded for each dollar of profit!

Debt service per dollar of profit

The growth of per capita indebtedness reflects the spreading cancer of usury and speculation. In the United States, indebtedness per capita and per unit of land area has increased tenfold since the 1960s. The total volume of all credit market debt outstanding, owed by the three principal sectors of the economy—business, including farms; household; and government, including federal, state, and local—is exploding. In the past few years, it has grown at the rate of half a trillion dollars or more each year. By 1993, the total debt outstanding in the United States stood above \$15 trillion.

As this debt mountain builds up, the interest charges also escalate. The debt level considered here actually understates the size of the debt, because figures for certain categories of debt were not available. The debt used in our calculations is: a) credit market debt; and b) debt of one year or more in maturity. But there is additional debt of the business, household, and government sectors of the economy which is not traded in a market, i.e., it is not “credit market debt” (for

example, roughly one-third of the federal government’s debt is held by federal trust funds such as the Social Security fund, and is not tabulated in the Federal Reserve’s survey of credit market debt); and there is much debt, such as corporations’ commercial paper (90- to 270-day IOUs) which is less than one year in maturity. Therefore, none of that is counted in the debt or the interest-owed figures reported here.

EIR’s economic research staff determined the interest payment level on the mountain of debt. This interest payment, no matter how earned, must come out of the wealth of the physical economy. That is, anyone who earns interest has a dollar claim—and that claim can be satisfied ultimately as a claim against physical goods. These claims have multiplied far beyond the physical capacity of the U.S. economy to meet them.

In 1951, the interest on the debt was \$17 billion, the “value-added” by the manufacturing sector was \$102 billion, and the ratio of interest on the debt to value-added of manufacturing was 16¢. So, for every \$1 of manufacturing value added in 1951, interest on the debt made a claim of 16¢.

In 1967, the interest on the debt was \$91 billion, the value-added by manufacturing was \$262 billion. For every \$1 of manufacturing value added, interest on the debt made a claim of 34¢.

By 1991, the interest on the debt was \$1.725 trillion, the value-added was \$1.331 trillion, and the ratio of interest debt service to value-added level was \$1.29. For every \$1 of manufacturing value-added in 1991, interest on the debt made a claim of \$1.29. The financial claims on production, are now greater than production. It is a situation that cannot be sustained.

To measure this relative to 1967, *EIR* took the ratio of interest debt service to value-added in 1967—which was 34¢—and set it equal to an index number of 1. By 1991, the index is five times higher than its 1967 level (see **Figure 2**).

Debt is engine of destruction

The engine of destruction here is the rapid increase in debt, which the Federal Reserve, professional economists, bankers, and Wall Street traders, in their astonishing stupidity, count as part of the increasing “monetary aggregates” which they claim “proves” that the U.S. economy is in “recovery.” **Figure 3** shows how the debt per unit of land area has increased over one order of magnitude over the past three decades.

This increase in debt per unit of land area is especially significant in light of the requirement of a real, healthy economy, that the amount of land area required to produce what the society needs, must *decline* over time. **Figure 4** shows that this requirement was met until 1969. The sharp peaks since that period result not only from the technological stagnation imposed on the economy by environmentalism, consumerism, the “service economy,” and other hoaxes, but also from the vicious cycles of workforce reductions implemented

FIGURE 2
Debt service per dollar profit in U.S. economy
 (1967=\$1.00)

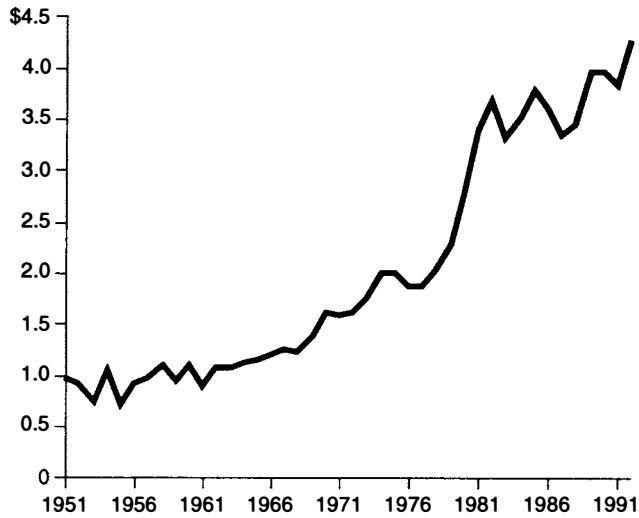


FIGURE 4
U.S. land area divided by manufacturing production workers

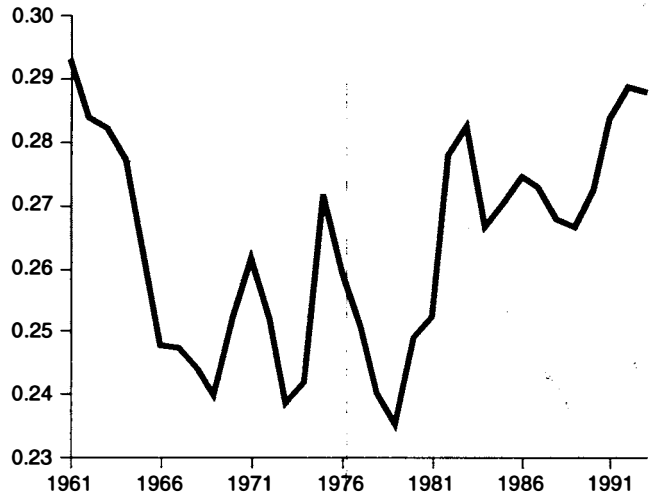


FIGURE 3
Total debt per square mile of U.S. land area
 (Thousands of dollars)

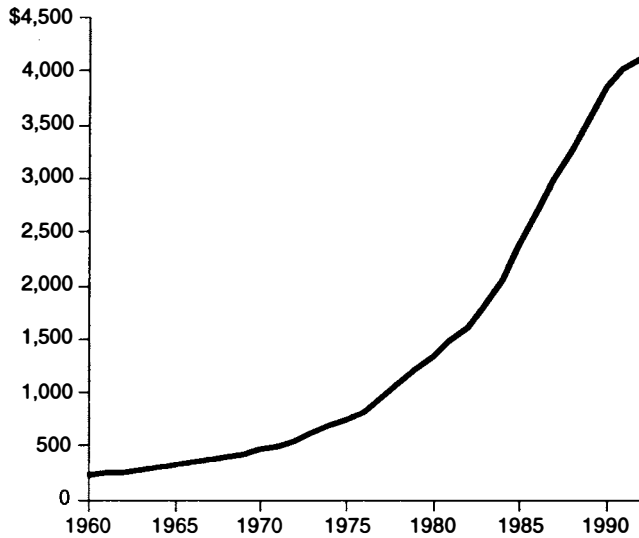
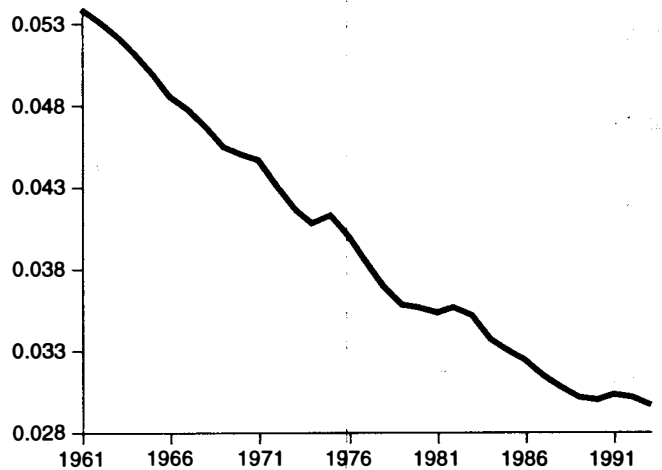


FIGURE 5
U.S. land area divided by total employed



by U.S. business managers who learned monetarism, not economics, in college.

What's the difference between Figure 4 and Figure 5? **Figure 5** shows the total number of employed people per unit of land area; **Figure 4** shows the number of manufacturing production workers—the people who actually produce some-

thing by transforming raw and intermediate materials into finished goods. The startling difference between the two figures highlights how so much of the U.S. labor force has been wastefully employed in the "service economy."

Figure 6 shows what has happened to U.S. total energy consumption per capita. The collapse of this key indicator of technological progress and economic growth is clear. Incredibly, a new axiomatic tenet has emerged among professional economists in the past few years, that the United States has "decoupled" energy use from economic growth.

FIGURE 6
Per capita energy consumption
 (Millions of BTUs)

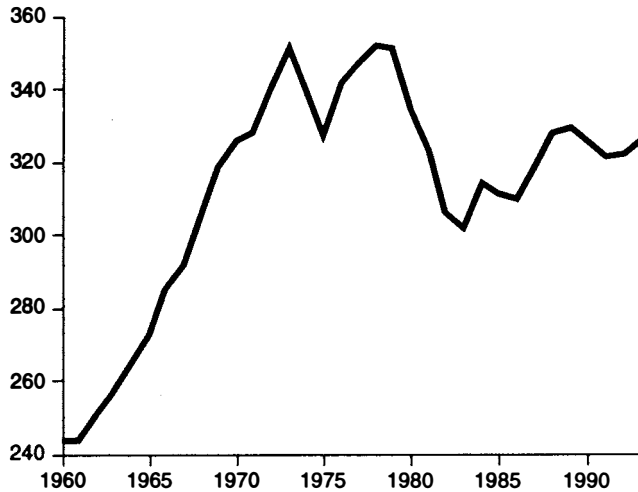


FIGURE 8
Derivatives compared to U.S. gross domestic product
 (Trillions of dollars)

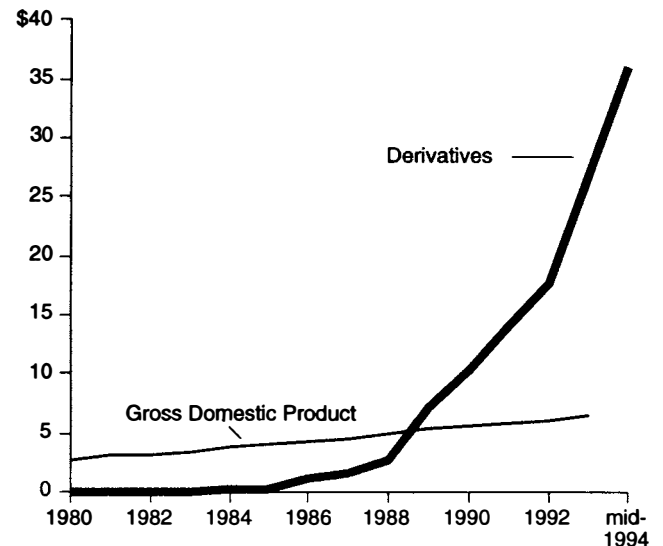
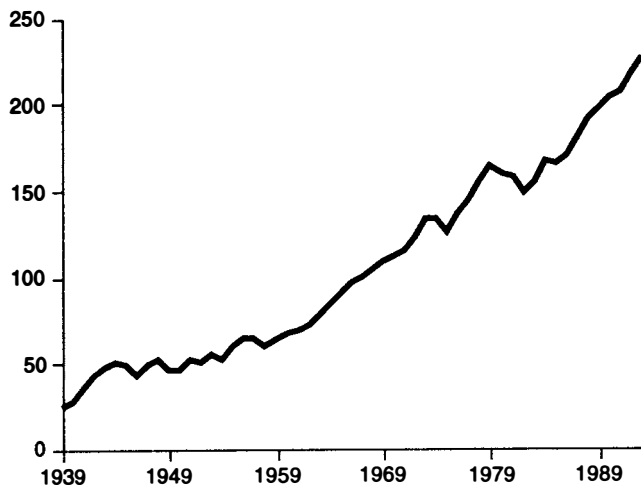


FIGURE 7
Ton miles/land area/population



The appearance of healthy growth in the ton-miles moved per unit of land area/population evident in **Figure 7** is deceiving, because there has been an approximate 20-25% increase in the length of haul over the past three decades. This increased length of haul resulted from the “rationalization” of production, which shut down 20-50% of productive capacity, depending on which industry you’re looking at. For example, when General Motors closed its assembly plant in Van Nuys, California a few years ago, the length of haul for a GM car

sold in the Los Angeles area increased from a maximum of 50 miles, to 500-1,000 miles or more.

A particularly large factor in the increase of the length of haul is the switch to “clean” coal mandated by various environmental laws. Massive coal deposits in Illinois, Kentucky, and other midwestern states are no longer being worked because the coal from these deposits has a high sulfur content that is “more polluting” when burned in a power plant. In many cases east of the Mississippi River, power plants were located immediately next to, or very close to, these now-abandoned coal deposits.

“Clean” coal is found mostly in the West, particularly the Powder River basin of Wyoming. Most coal is moved by railroad. Railroads account for over one-third of the total ton-miles hauled in the United States; coal accounts for over one-quarter of all carloads hauled by railroads, and probably a much higher percentage of tons, and ton-miles, hauled by railroads. According to the Association of American Railroads, the average length of haul of U.S. railroads increased from 461.3 miles in 1960, to 615.8 miles in 1980, and further increased to 762.5 miles in 1992.

Finally, just to rub their noses in it, we use the figures for Gross Domestic Product accepted by the professional economists and government officials who have led the United States into this disaster. These GDP figures, with all their fluff, when juxtaposed to the explosive growth of derivatives paper outstanding, clearly show how the financial system has become completely separated from economic reality (see **Figure 8**).