

The 'New Economy,' Frankenstein's Monster

by Stuart Rosenblatt

When Genius Failed: The Rise and Fall of Long Term Capital Management

by Roger Lowenstein

New York: Random House, 2000

264 pages, paperbound, \$14.95

A battle broke out among financial policy-making circles in the United States and Europe in February and March 2003, centering on what to do about the out-of-control, completely unregulated financial bubble in the market for so-called financial derivatives contracts. *EIR* has estimated that as much as \$400 trillion is at issue, and nothing less than the liquidity of the hopelessly bankrupt financial system is called into question.

On the side of insanity, Federal Reserve Chairman Alan Greenspan and Fed Board member Ben Bernanke both have declared—within a couple of days in November 2002—the Fed ready to crank up the printing presses to an unlimited excess, to save the derivatives bubble. In February, when the head of the Office of Federal Housing Enterprise Oversight issued a report saying that Fannie Mae and Freddie Mac could experience wide-ranging crises due to their massive derivatives exposure, he was immediately fired by the Bush Administration, and replaced with a former leading derivatives specialists from J.P. Morgan Chase.

But in early March, Berkshire Hathaway chair Warren Buffett sent a letter to shareholders warning, that “Derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal. . . . We view them as time bombs, both for the parties that deal in them and the economic system.” *EIR* on March 14 and March 21 covered these developments in depth.

One good study on the origin of the derivatives bubble and the shape of new derivatives disasters, is a scathing exposé of Long Term Capital Management, a gigantic Greenwich, Connecticut-based derivatives gambling house whose meltdown nearly blew out the entire world financial system in August 1998. Author Roger Lowenstein was a *Wall Street Journal* reporter and author of a previous book on Warren Buffett. Contrary to the myth that derivatives are merely a

smart hedge against risk, Lowenstein shows that derivatives trading is a massive and lethal assault against the very substance of the economy.

Economist and Presidential pre-candidate Lyndon LaRouche, most recently in his State of the Union address of Jan. 28, has said the world financial crisis in the Fall of 1998 marked the turning point in the disintegration of the post-war financial system and the bursting of the “New Economy” bubble. At the center of this near-total meltdown of the system was the spectacular bankruptcy of Long Term Capital Management (LTCM).

Poster Boy for the New Economy

Lowenstein’s book makes clear that without the intervention of the major merchant banks, especially Merrill Lynch and its vice president, Herbert Allison, there never would have been an LTCM. It was cobbled together in the Fall of 1993 and opened for business the following February. From the stock market crash of 1987 to the banking crises of 1991-92, in which Citibank, among others, was placed on Federal Reserve life support, several leading commercial banks were hovering on the brink of insolvency. Beginning in the early ’90s, they launched, with ample help from the Fed, the New Economy bubble and its associated buildup of the derivatives cancer. LTCM, like Enron, MCI-WorldCom, and others, was a poster firm for the ensuing madness. The Frankenstein-like creation of hedge funds or arbitrage bond-trading units in the major banks, became one of the major Wall Street-sponsored operations to get the banks “back on their feet” during the “great prosperity” of the 1990s.

LTCM was an agglomeration of the core group of high-flying bond traders, headed by John Meriwether, at Salomon Brothers, which was shut down and its remnants bought up by Smith Barney, due to the exposure of criminal operations involving junk bonds and the U.S. Treasury-bond market. The entire Salomon arbitrage group moved as a bloc into LTCM. Several big-name academics, who would be awarded the Nobel Prize in economics at the very moment LTCM began to come apart four years later, Myron Scholes and Robert Merton, came on board. They were topped off by the addition of Federal Reserve vice chairman David Mullins, heir apparent to Alan Greenspan.

LTCM entered into business with the largest equity pool in history, \$1.25 billion, garnered from around the world. Major firms in at the outset included Paine-Webber, Sumitomo Bank, Dresdner Bank, Bank Julius Baer of Switzerland, the Liechtenstein Global Trust, and others. More interesting were Michael Ovitz, the Hollywood agent; Phil Knight, the CEO of slave labor-supporting Nike shoes; and Republic National Bank New York Corp., headed up by Edmond Safra.

Hedge funds deliberately eluded all Federal regulation. They are private investment funds limited to small numbers of the wealthy people, who put in a substantial amount of

money (each investor must be worth at least \$1 million), which is then managed for them by so-called professionals. They do not have to register with the Securities and Exchange Commission, their portfolios are hidden, and they have unlimited borrowing power. They are the modern-day dream come true of Meyer Lansky, and are home to the most notorious “legitimate” gangster types, including George Soros, Julian Robertson, and Michael Steinhardt.

Justifying their actions as merely “hedging risks” by mirroring one bet with an opposite transaction, hedge funds like LTCM made only the riskiest of bets. In contrast to its name, LTCM was a day-to-day cutthroat money machine. It became the foremost trader in the most exotic forms of speculation, known as derivatives. The various forms included swaps, options, futures, equity volatility, merger arbitrage, and wilder creations.

Derivatives are unregulated financial instruments whose value is “derived” from an underlying asset whose value is being speculated upon—a stock, commodity, bond, etc. They were brought into being in the early 1970s by the deregulation of the financial markets. The first currency futures were traded at the Chicago Mercantile Exchange (CME), and interest rate futures were traded at the Chicago Board of Trade and the CME in this period. The financial wizards who promoted the theory of these markets were Fisher Black and Myron Scholes, for whom the Black-Scholes model, now synonymous with the demise of LTCM, is named.

The ‘Theory’ Behind the Practice

LTCM also propounded a set of principles, which it held as axiomatic. Lowenstein does an excellent job in presenting and later debunking this so-called theory. LTCM was the major practioner of the Black-Scholes model as developed by Fisher Black and taught by LTCM’s Myron Scholes and Robert Merton. It was part of the “sex-appeal” of the firm.

Black-Scholes’ variety of John von Neumann-ite lunacy held that all prices, including stock market prices, were accurate reflections of reality, and their past fluctuations could be relied upon to predict future fluctuations; further, that all “markets” were “efficient” and would tend to converge on historic, previously established numerical levels. Past performance of markets, prices, volatility, etc. was an accurate barometer to gauge the future. According to these radical empiricist charlatans, markets mimicked the behavior of various physical processes, such as heat transfer, where seemingly large numbers of random events would eventually find a calculable pattern, imitating the “normal” distribution of a bell curve. Hence, risk was quantifiable, precisely as rolling dice was quantifiable and predictable. With a large enough sampling and with computer calculations, one could assess risk and predict outcomes—stock and bond prices, spreads, interest rate fluctuations—even to the smallest degree.

Into this witches’ brew of Newtonian financial physics,

LTCM added one further ingredient: leverage. Their investments, especially in financial derivatives, relied on minute divergences in historic patterns, and the exploitation of the expected movements (always back toward convergence on historic valuations). They poured in enormous amounts of borrowed money—leverage, “other people’s money”—to play the differentials. They bet the house. The professors figured out the spreads, much like a bookie, and the bankers poured in the lines of credit to execute the trades. The banks were paid substantial fees by LTCM, and other hedge funds, reaped large rates of return, and extended more lines of credit, usually with no collateral, to the star investors. It was a marriage made in Hell.

Creative Accounting for All

LTCM was in no way acting on its own, not a “lone assassin,” an aberration among otherwise respectable, conservative bankers. Everyone was in on it. From the outset in 1994, LTCM was reporting handsome profits: a 27% rate of return in 1994, 59% in 1995, 57% in 1996, and so on until it crashed. However, as Lowenstein writes, they also subscribed to the Arthur Andersen accounting school, and regularly failed to subtract the leverage from their balance sheets. The real earnings were more in the range of 3-6%!

Betting options on future prices of stocks, called equity volatility, became LTCM’s mainstay; it bet “equity vol” to fall. Its fallacious long-term models told its managers to short equity volatility globally, and so they had “a staggering \$40 million riding on each percentage point change in the United States, and an equal amount in Europe” on this trade alone.

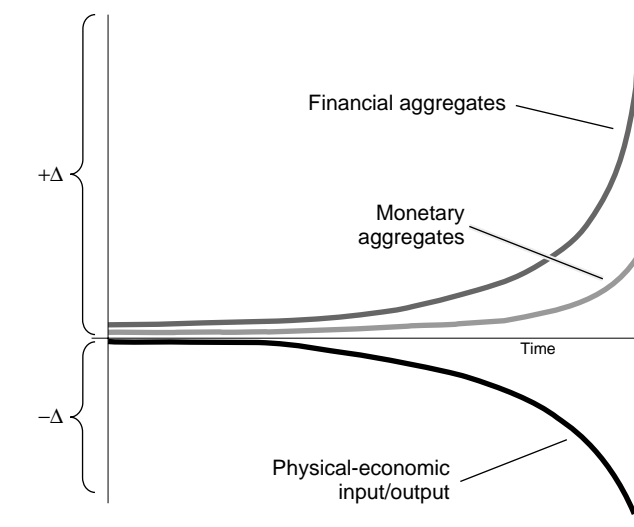
The geniuses at LTCM also moved heavily into Brazilian and Russian state debt in 1997, into directional unhedged bets on bonds, various other options, merger arbitrage, including the financing of the brilliant MCI-WorldCom merger, and other madness. All of this was funded and egged on by J.P. Morgan, Merrill Lynch, United Bank of Switzerland, and the others. By the end of 1997 every major financial institution was awash in bad derivatives and related debts, the markets were saturated, and any tiny tremor would bring down the entire house of cards.

In January 1998, LTCM looked good on paper. It had \$4.6 billion in equity, compared to the \$1.25 billion it had opened with in 1994. But it also owed \$140 billion in loans, and had an astounding \$1.4 trillion in outstanding derivatives contracts! There were, conservatively, 50 counterparties (banks, insurance companies, brokerage firms, etc.) to LTCM’S derivatives trades, and at least 7,000 separate derivatives contracts. In the Fall of 1997, during the so-called Asia crisis—in reality the initial phase of the bursting of the global bubble—Scholes and Merton of LTCM won the Nobel Prize for Economics.

As the markets around the world tumbled from that Fall of 1997, the geniuses at LTCM and elsewhere were caught. Since then, the underlying laws of the universe have been asserting themselves in a greater and greater crisis. As

FIGURE 1

LaRouche's Typical Collapse Function



LaRouche had forecast three years earlier, with his now famous Triple Curve collapse-function analysis of May 1995 (**Figure 1**), the biggest financial bubble in history—of which LTCM was one star manipulator—was hopelessly out of proportion with the underlying physical reality that was being cannibalized to meet the requirements of the financial aggregates of that bubble. It was guaranteed to burst, and disintegrate the entire system. At no point could the linear-extrapolation models of Nobel Prize winners Merton and Scholes predict this occurrence. In fact, it was their model that caused the debacle, which appropriately devoured the authors!

Systemic Crisis

As the markets roiled throughout 1998, LTCM and other such funds began to fall apart. The demise of the Russian GKO state bond scheme triggered the shocking Russian state default. This in turn set off chain reaction, reverse-leverage collapses across the globe of stock markets, currencies, and other national indebtedness. LTCM, worth \$4.6 billion in equity in January 1998, lost \$1 billion in the Spring and early Summer, another \$1.4 billion in August alone, and every remaining penny by Oct. 1!

Lowenstein’s portrayal of the final months of LTCM and the near meltdown of the whole system allows a peek through a keyhole rarely made public. In mid-September, sensing the crash was out of control, LTCM-partner and former Federal Reserve Vice President David Mullins, and Goldman Sachs CEO and LTCM controller Jon Corzine, summoned William McDonough, the New York Fed chief, to survey the damage. McDonough, who had been monitoring the situation himself, sent in Peter Fisher, the official in charge of monetary manipulations for the Fed. Looking

through the books at LTCM, Fisher was shocked. LTCM's trades, massive in volume, and heavily leveraged, were linked to similar trades around the world. Were they to fail, and they were hemorrhaging badly, they immediately threatened the integrity of the whole system. Should LTCM's counterparties sell everything in unison and overwhelm the markets, it would cost the 17 leading counterparties, such as Merrill Lynch, Goldman Sachs, J.P. Morgan, and Salomon Brothers, as much as \$2.8 billion.

"Fisher eyeballed the number and thought, 'That might be plausible in a normal market.' But markets were already sorely frayed; now they could go totally haywire. Mentally, Fisher adjusted the potential losses to \$3 billion, to \$5 billion, and even that was a guess. It wasn't just Long Term that was on the hook—it was all of Wall Street. . . . 'I'm not worried about markets trading down,' he confided. 'I'm worried that they won't trade at all.' As others he spoke with remarked, 'This is a new paradigm.' "

Fisher concluded that everything was in jeopardy, and Lowenstein captures this sense of panic. "Fisher's concern was the broader notion of 'systemic risk': if Long Term failed, and if its creditors forced a hasty and disorderly liquidation, he feared that it would harm the entire financial system, not just some of its big participants. Greenspan later used the phrase 'a seizing up of the markets,' conjuring up the image of markets in such disarray that they might cease to function—meaning that traders would cease to trade. McDonough evoked a parallel fear—that losses in so many markets and to so many players would spark a vicious circle of liquidations, extreme fluctuations in interest rates, and then still further losses: 'Markets would . . . possibly cease to function for a period of one or more days and maybe longer.' "

The elected U.S. government should have moved, during 1998, to place LTCM, its counterparties, and other similarly bankrupt entities into an orderly Chapter 11 bankruptcy reorganization, much as Franklin Roosevelt did in 1933 upon taking office. However, the Federal Reserve functions as a central bank on behalf of the private banks, and operates strictly on their behalf to maintain their system, even by the looting and destruction of the U.S. economy itself.

Upon hearing the results of the Fed investigation, the major banks, including Merrill, Morgan, and Goldman, asked the Fed to pull together the necessary venue where this enormous problem could be solved, at least to their liking. The Fed served merely as referee among the competing, vulture-like banks, whose thuggery against one another threatened the integrity of the system itself. Two items were on the agenda: an immediate, short term, massive financial bailout of LTCM, that must be done literally overnight or the whole shebang would blow out; and second, a longer-term bailout of the system itself, using government power and money. The first item could not wait for government action. The second item came to be known as the "wall of money" policy, limitless government printing of cash to save the system.

Two back-to-back meetings took place in a 24-hour period on Sept. 22-23, 1998. Both meetings were convened by the Fed and held in the boardroom. "Fisher opened the massive wooden doors and invited them in. It was an awesome gathering, the cream of Wall Street. . . . Twelve banks had sent twenty-five bankers—all men, all middle aged. Even these thick-necked bankers, though familiar to one another, were unaccustomed to seeing so many of their brethren on such short notice and in such a place, squeezed into soft, leather-backed chairs under the quiet gaze of the gold-framed oil portraits that rimmed the boardroom. Morgan's Sandy Warner broke the ice, jovially declaring, 'Boys, we're going to a picnic, and the tickets cost \$250 million.' "

The meeting dragged out all night, with no resolution. They reconvened the next morning with nearly double the numbers, swelled by the likes of Sandy Weill of Citibank and Richard Grasso, the president of the New York Stock Exchange. Finally, a deal was hashed out. \$3.6 billion was raised on the spot, primarily from 14 banks, to take over and salvage LTCM.

Bankruptcy Reorganization

The next morning, Fed Chairman Greenspan lowered the prime rate, and the system was saved, for the moment. Greenspan had reluctantly initiated a policy, dubbed "the wall of money," which has been implemented ever since, to hyperinflate the financial markets. In cranking up the printing presses, Greenspan borrowed a page from the German government actions of 1923 that set into motion the financial bubble that bankrupted the German mark and eventually brought in the Hitler government.

Lowenstein concludes his book with stinging attacks on Greenspan's opposition to any regulation of hedge funds or derivatives, despite the obvious mayhem they have caused. To rectify the crisis, Lowenstein recommends a return to regulation, especially regarding derivatives, calling for increased reporting and total control over the market. He castigates Congress and the White House for their collective failure to take the necessary actions. While acknowledging the curious timing of the Monica Lewinsky affair, Lowenstein missed the true import of the event. At the same moment (September 1998) that President Clinton and Treasury Secretary Robert Rubin were calling for a "new financial architecture," under the influence of Lyndon LaRouche's mobilization for a New Bretton Woods system, the Monica scandal was unleashed to prevent precisely such action by the President.

Lowenstein is also blunt in his attack on Scholes, Merton, and the idea of computer modelling of the financial markets. "If Wall Street is to learn just one lesson from the Long Term debacle, it should be that. The next time a Merton proposes an elegant model to manage risks and foretell odds, the next time a computer with a perfect memory of the past is said to quantify risks in the future, investors should run, and quickly, the other way."