EU plots imperial response to financial crisis

By Elisa Barwick

As warnings of a new global financial crisis intensify, the financial elite centred in the City of London and Wall Street continue to fortify the global order, preparing to entrench their power with dictatorial rule and police-state laws—justified by financial collapse and the threat of terrorism or foreign interference.

Following the 2008 financial crisis, City of London insiders revealed the City's financial elite were prepared for the implementation of martial law had banks closed and ATMs shut down. The latest anti-terror bill before the UK parliament, the Counter-Terrorism and Border Security Bill 2017-19, along with unprecedented spying powers would allow London police to completely shut down London's "Square Mile", supposedly to prevent a terrorist attack or protect the City in a financial breakdown. ("UK Establishment plans martial law?", *AAS* 3 January 2016; "'Techno-Stasi' police state laws before UK parliament", *AAS* 27 June 2018.)

Anglo-American policy enforcer JPMorgan Chase, in a May 2013 report "The Euro area adjustment: about halfway there", openly discussed plans to transform the European Union into a fully-fledged dictatorial authority. The biggest obstacle to the creation of a seamless banking and economic policy superstructure, the report said, was the constitutional and political legacies of the fight against 1930s fascism in southern European rim states such as Italy, Spain, Portugal, Ireland and Greece. The political systems of many European nations were formed "in the aftermath of dictatorship", read the JPMorgan report, and therefore boast features such as a weak executive and the protection of labour rights and the population's right to protest unwelcome changes, "reflecting the political strength that left wing parties gained after the defeat of fascism". Wall Street's biggest bank complained that, constrained by such constitutions, these nations have been hamstrung from producing adequate fiscal and economic reform agendas—namely that of crushing austerity and more liberalisation, deregulation and privatisation.

The same sentiment was expressed by French Finance Minister Bruno Le Maire who has warned that Europe will not survive a financial crisis unless it rapidly finalises its banking union, so that policy can be effectively dictated top-down to all nations. According to City of London scribe Ambrose Evans-Pritchard, writing in the *Telegraph* on 12 November, Le Maire declared that "If there was a new financial and economic crisis tomorrow, the eurozone could not respond. It is really urgent that we build-up the eurozone's defences. We have been talking for too long."

In his remarks to German newspaper *Handelsblatt*, Le Maire demanded the EU banking union and capital markets union be urgently finalised, including an EU treasury and budget, a social security system and a tax authority, or the euro would not survive the next crisis. Observing that "we are going into a world where power matters", Le Maire insisted that Europe must become a "form of empire".

A summit on the future of the euro is scheduled for December. Evans-Pritchard noted: "It is the first time that a top EU politician has admitted openly that the logic of European integration is imperial, rather than a hybrid treaty club of nation states.

"Eurosceptics have long made this case", he continued, "arguing that an imperial EU will necessarily become authoritarian. Their critique is that there is no unified people or 'demos' that can plausibly form the foundation of an authentic pan-European democracy, and that the locus of accountable government must remain the nation state."

In fact the EU had its roots in the 1930s fascist movement, with Benito Mussolini and Adolf Hitler supporters of the Pan-European Union vision for a "single Europe" launched by Count Richard von Coudenhove-Kalergi. City financier Sir Siegmund Warburg was a prominent supporter of the Count's movement. In the 1950s he and his co-thinkers launched the financial globalisation project which led to the creation of the euro and the global dominance of the City of London. "Warburg's ultimate business objective was always to establish an optimal transatlantic triangle that would link together London, New York and a continental European financial centre", wrote his biographer Niall Ferguson in *High Financier: The Lives and Time of Siegmund Warburg*. (*The British Empire's European Union*, CEC pamphlet, May 2016; "How London's Euromarket killed Bretton Woods", *AAS* 19 September.)

From the crash front

The Italian crisis is at the forefront of the minds of leaders like Le Maire. The exposure of French banks is huge, the equivalent of 12 per cent of French GDP, which is six times as much as its exposure to Greece in 2010, according to Evans-Pritchard. BNP Paribas holds the equivalent of nearly 50 per cent of its core capital in Italian sovereign and private debt. The European Central Bank (ECB), which has bought up almost all Italian treasury bonds in the last two years, is set to end its quantitative easing purchases next month, leaving Italy and its creditors in the lurch.

With extremely low interest rates for a decade, speculation has dangerously spiked, warned the IMF in a 15 November blog post, following other institutions like the Bank of England in ringing alarm bells over the growth of leveraged debt—loans to weak or heavily indebted companies.

"We warned in the most recent Global Financial Stability Report that speculative excesses in some financial markets may be approaching a threatening level", read the report. "For evidence, look no further than the US$1.3 trillion global market for so-called leverage loans, which has some analysts and academics sounding the alarm on a dangerous deterioration in lending standards. They have a point."

Leveraged loan issuance has surpassed pre-global financial crisis highs, the IMF points out, asking if a breakdown of this market could "threaten financial stability" given all the "signs reminiscent of past episodes of excess".

US billionaire and hedge fund operator Paul Tudor Jones, who warned of the 1987 crash, has called the US corporate debt bubble unsustainable, saying it "could be systemically threatening if we don't have ... appropriate responses". In 15 November hearings with Federal Reserve representatives, US Democratic Senator Elizabeth Warren warned of leveraged debt being akin to subprime loans, saying, "I'm not sure that I see much distinction between what you're doing now and what the Fed was doing in pre-2008, and I think that's deeply worrisome. I'm very concerned that the Fed dropped the ball before and they may be dropping it one more time."

Dan Berger, President and CEO of the National Association of Federally-Insured Credit Unions, brought the solution to the table with a statement issued prior to a 13 November Senate Judiciary Committee hearing on "Big Bank Bankruptcy—10 years after Lehman Brothers". People are still recovering from the 2008 crisis, he said, and Too-Big-To-Fail banks again threaten the US economy: "That is why we believe Congress should consider a modernised *Glass-Steagall Act*."

Just how big is the global derivatives bomb?

By Robert Barwick

Newham in London is one of the poorest boroughs in the UK. In 2017-18, Newham Council collected £68 million in council taxes, but spent £75 million servicing debt in the form of LOBO loans to banks including Barclays. LOBO (Lender Option Borrower Option) loans have an initial, low "teaser" interest rate, but every five years the lender has the option to raise the rate which the borrower has the option to accept, or repay the entire loan.

LOBO loans contain complex financial derivatives that can involve substantial dangers for the borrower. Some have inverse floater terms, such that if general interest rates fall, the interest rate on the LOBO loans actually goes up. If a council tried to repay its loan early it would need to pay a "break penalty" to exit the loan, which given the pricing of derivatives in the contracts can cost multiples of the original loan principal. In 2014 ex-Barclays Capital employee Rob Carver made the following observation of the complexity of LOBO loans: "You just need a Bermudan swaption pricer to know the relevant volatility surface, some kind of interest rate model calibrated to the appropriate processes and the full forward and spot curve."

These are not instruments that British council financial managers are equipped to understand. So from the early 2000s banks including Barclays and RBS issued them to councils *en masse*, £15 billion worth to 240 councils, on the recommendation of specialist financial advisers who, unbeknownst to the councils, were being paid commissions from the banks. At least 12 councils have the most expensive LOBO loans, containing the inverse floating interest rates. While the banks pocketed up-front profits alone of £1 billion, the councils have been forced to slash social services to repay debt at interest rates that are more than double what they would be paying to the government entity that is their traditional lending source. Councils are now suing Barclays and other LOBO lenders over the legitimacy of these loans, and the banks are finally making moves to end the practice, but the damage has been done.

LOBO loans to British councils are just one example of the harm derivatives cause in the community. Local councils all over the world have been sucked into buying these dangerous products, which have subsequently blown up in their faces. Charities, hospital boards, and schools have all fallen prey to derivatives salesmen, as have conservative financial institutions such as pension funds and insurance funds which are required to invest in safe products, only to be defrauded by complex derivatives and get badly burnt.

Banks trade in derivatives because they are immensely profitable, and the scale of the global derivatives trade indicates that enormous profits are being made. But those profits are drawn from somewhere, and ultimately that is from the communities which are burdened with debt and high living costs, including from inadequate services, unaffordable housing, high fuel and energy prices, high food prices, and many other aspects of life that are affected by derivatives in one way or another. It was derivatives traders who rigged the LIBOR (London Inter-Bank Offered Rate) benchmark interest rate, which is the basis for most of the world's financial contracts, affecting prices of virtually everything. And derivatives were used to rig the foreign exchange market, driving up costs and driving down profits for exporters all over the world, costs ultimately borne by consumers. Derivatives are a cancer that has taken over the financial system. The ongoing damage they are causing, however, is nothing compared with the destruction they will wreak when the global derivatives bomb finally explodes.

Little Boy and Fat Man

The justified horror of nuclear weapons is based on their display of destructive power when the USA dropped two nuclear bombs codenamed Little Boy and Fat Man on the Japanese cities of Hiroshima and Nagasaki. The two devices, with yields of 15 kilotonnes (thousand tonnes TNT equivalent) and 21 kilotonnes respectively, were tiny compared with modern thermonuclear weapons, which have yields in the tens of Megatonnes (million tonnes TNT equivalent)—one thousand times the size of the bombs that killed between 130,000 and 220,000 people in the two Japanese cities. Between the USA and Russia, there are more than 10,000 of these awesome, planet-destroying weapons. The derivatives crises that the world has experienced to date, even the 2008 financial crisis, are only Little Boys and Fat Mans when measured against the explosive potential of the total pool of global derivatives.

The danger of derivatives first became evident starting in 1994, when there was a series of major losses from the instruments:

• Gibson Greeting Cards, a minor Ohio-based company, announced in April 1994 a US$20 million loss on derivatives sold by Bankers Trust;

• Manufacturing giant Proctor & Gamble reported a US$157 million loss on derivatives also sold by Bankers Trust;

• Orange County California, one of the richest municipalities in the United States, declared bankruptcy in 1994 after suffering losses of US$2 billion on derivatives sold by Merrill Lynch—3,000 public employees lost their jobs;

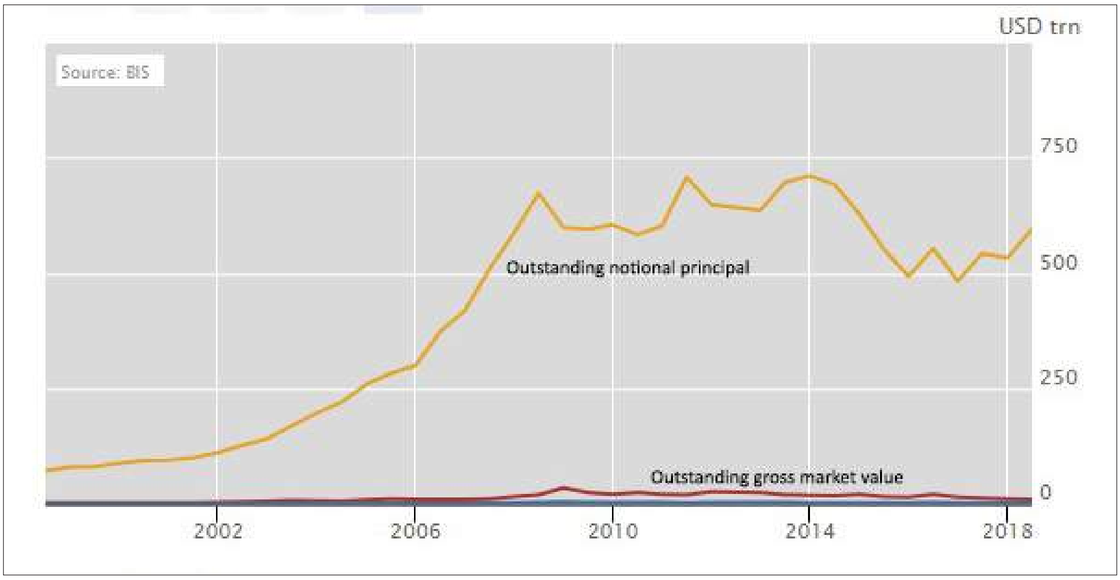
• Barings Bank, Britain's oldest merchant bank, collapsed in 1995 after suffering US$1.3 billion in losses on derivatives traded out of its Singapore office;

• The first really big derivatives disaster occurred in 1998, when a hedge fund called Long-Term Capital Management (LTCM), which boasted Nobel Prize-winning economists Myron Scholes and Robert Merton on its board, who had shared the 1997 prize for their theory on how to determine the value of derivatives, used derivatives to leverage US$5 billion into more than US$1 trillion, but lost US$4.6 billion in less than four months following the 1997 Asian financial crisis and 1998 Russian bond default; in response to the LTCM crisis, which IMF director Michel Camdessus later admitted threatened a global financial meltdown, 16 major banks put up US$3.6 billion to bail out LTCM under the supervision of US Federal Reserve.

These experiences proved that the reality of derivatives did not match the theory; that the risk assumptions that banks and companies made when dealing in derivatives ignored real-world possibilities which could lead to inconceivable losses. However, the speculators chose to ignore those lessons, and resisted any attempt to change their assumptions, which can be seen in the way derivatives are reported.

There are three terms used to report derivatives: notional principal, which is the very large figure in the trillions of dollars that ordinary people find shocking; market value, a much smaller figure that reflects what derivatives can be traded for; and credit exposure, also a much smaller figure, which derivatives traders claim represents the net risk of the derivatives. The figure for credit exposure, however, is based on the assumptions of the traders relating to risk and the solvency of the counterparties, assumptions which every derivatives crisis has proved to be false.

By 1999, the notional principal amount of global over-the-counter (OTC) derivatives had grown to around US$100 trillion. Instead of taking stock of the risks as evidenced in the LTCM disaster, and the warnings of Brooksley Born, the chair of the US Commodities Futures Trading Commission, who in 1998 tried and failed to have OTC derivatives regulated, the US government set off the equivalent of a derivatives arms race. Under heavy lobbying from Wall Street, in 1999 the government repealed the *Glass-Steagall Act*, which allowed investment banks to merge with commercial banks and hijack customer deposits to collateralise their derivatives trading. And in 2000 Congress passed the *Commodity Futures Modernisation Act*, which exempted derivatives from regulation. This led to a massive expansion of derivatives gambling. Whereas it had taken 13 years, from 1986 to 1999, for derivatives to grow to US$100 trillion, in the next seven years derivatives expanded to almost US$700 trillion. Standalone investment banks like Morgan Stanley, Goldman Sachs and Lehman Brothers complained that the megabanks like JP Morgan had an unfair advantage because they were able to gamble with deposits, so they received permission from the US Treasury to increase their leverage in their derivatives gambling from 16:1 to 33:1. This mania was the direct cause of the 2008 crash.



The BIS figures for global OTC derivatives show the rapid increase following the 1999 repeal of Glass-Steagall, but since the 2008 crisis banks have taken to hiding their true position. The real figure is US$1.2 quadrillion!

The 2008 meltdown

In the afterword to the 2009 edition of his 1997 book *FIASCO: Blood in the Water on Wall Street*, whistleblowing former Morgan Stanley derivatives salesman Frank Partnoy wrote: "Without derivatives, leveraged bets on subprime mortgage loans could not have spread so far or so fast. Without derivatives, the complex risks that destroyed Bear Stearns, Lehman Brothers, and Merrill Lynch, and decimated dozens of banks and insurance companies, including AIG, could not have been hidden from view. Without derivatives, a handful of financial wizards could not have gunned down major mutual and pension funds, and then pulled the trigger on their own institutions. Derivatives were the key; they enabled Wall Street to maintain its destructive run until it was too late."

We know what happened in 2008: the bankruptcy of Lehman Brothers, from its exposure to subprime mortgages, triggered defaults on US$150 billion worth of derivatives obligations which would have triggered the collapse of AIG, and then the entire global financial system and the US$700 trillion global derivatives bubble, had not governments intervened with massive bailouts. The total size of the US bailout alone has been measured at US$29 trillion.

But what has been done to address the derivatives danger at the centre of the system? Effectively nothing. Regulators made a big deal about requiring banks to conduit their OTC derivatives through so-called clearing houses called central counterparties (CCPs), but this does not reduce the risk, it merely concentrates the risks in the CCPs, as even former Goldman Sachs boss and Trump adviser Gary Cohn has warned. Otherwise, nothing has been done to make the banks reduce their derivatives gambling.

Instead, there is reason to believe that the banks have taken to hiding the true scale of their activities. In Australia for instance, three of the Big Four banks, CBA in 2012, NAB in 2016, and ANZ in 2017, stopped disclosing the full notional principal amount of their derivatives in their annual reports, arguing that the figure wasn't relevant, and that only market value and credit exposure mattered. The regulator APRA for sure isn't going to make them disclose their position. As the 4 November 2008 *Sydney Morning Herald* reported at the height of the global financial crisis: "The banks do not provide counterparty details in their reporting to APRA and the regulator says there is no direct scrutiny of bank 'off-balance sheet activities' [OTC derivatives]. An APRA spokesman said: 'We are not in the business of running banks, we are in the business of supervising them', adding that the role of APRA was to set standards that the banks agreed to abide by."

Global OTC derivatives figures are recorded by the Bank for International Settlements (BIS), based on voluntary disclosure from the banks. Curiously, the BIS figures show that following the 2008 crisis, derivatives oscillated around the US$700 trillion mark, and since 2014 have actually fallen to around US$500 trillion. These official figures make no sense, not least for the reason that in that time global debt has skyrocketed from US$170 trillion to US$245 trillion, and much of the global derivatives trade relates to hedging on debt.

The Citizens Electoral Council, and US magazine *Executive Intelligence Review*, which have led the warnings on derivatives since 1993, have consistently estimated that the true scale of the derivatives bubble since the GFC is US$1.2-1.4 quadrillion (thousand trillion)! British mathematician and renegade "quant", or financial quantitative analyst, Dr Paul Wilmott, also estimates the global derivatives trade at US$1.2 quadrillion. This puts 2008 and prior derivatives crises in perspective, and underscores the urgent need to disarm this megabomb through restoring the Glass-Steagall separation of the financial system that can cut derivatives speculation off from deposits and force most of them to be unwound and cancelled.