After the Ball

by Roy C. Smith

The event will be long remembered in the history of financial delirium. On the weekend of March 16, 1985, some 2,000 well-heeled "players" began descending on the Beverly Hills Hilton for the sixth annual Predators' Ball, sponsored by 38-year-old junk-bond impresario Michael Milken of Drexel Burnham Lambert. The assembled guests included oilman T. Boone Pickens and a growing list of other corporate "raiders," individual investors such as Saul Steinberg, and money managers who bought junk bonds for insurance companies, pension funds, savings and loans (S&Ls), and other institutions. All had come together for a frenetic week of meetings, presentations, networking, and dealmaking beginning every day at six A.M. The dinners and parties were lavish Hollywood affairs. No expense was spared to keep these rising financial stars happy. At the gala conclusion, Diana Ross sang for the crowd. Nothing like it would ever have been seen on drab, straitlaced Wall Street.

Milken and his Drexel associates at the firm's Beverly Hills office had made their name by pioneering a market that mainline Wall Street had disdained. In the 1970s, Milken had discovered that there was money to be made trading in "fallen angels," corporate bonds that bore exceptionally high yields because their prices were so low. These were bonds issued by companies that had since run into trouble or bankruptcy but still had prospects for recovery. A scornful marketplace had pushed the prices so low that money could be made, despite the risks. From this, it was a logical next step to begin underwriting new high-yield bonds for highly leveraged, risky companies with growth potential. One of the secrets of Milken's success was putting together—by hook or, as it was later revealed, by crook—a "new boy network" of investors who would buy the bonds he touted. Milken sponsored the Predators' Ball to allow the borrowing companies to make their pitches to the assembled investors. In the beginning, most junk-bond issuers had used the borrowed money to expand their own businesses. Now, however, the junk-bond revolution was about to enter a new phase.

Early in 1985, Drexel had financed two attempted takeovers of well-known corporations by small, comparatively unknown companies. Coastal Corporation, headed by a brave new "financial entrepreneur" named Oscar Wyatt, had acquired American Natural Resources for $2.5 billion ($600 million of it to be raised through the sale of junk bonds), and a company controlled by another obscure predator, Nelson Peltz, had taken over National Can Company for $456 million, all of it financed by Drexel. The size of the two takeover-related financings surprised traditional Wall Street, which wondered where Milken's

"placing power" was coming from. Where was he finding buyers for so much of what the Street saw as "junk"? Within weeks of the 1985 ball, five more companies would launch giant takeover bids financed by Milken's machine. Lorimar, a film production company with a net worth of $100 million, bid over $1 billion for Multimedia, and Steve Wynn's Golden Nugget hotel group offered $1.8 billion for Hilton Hotels. During the next few years, Milken would develop the ability to distribute junk bonds to more and more institutional investors to finance even larger and more numerous deals, culminating in the junk-financed "leveraged buyouts" (LBOs) of Beatrice Foods in 1986 ($6.7 billion) and RJR-Nabisco in 1988 ($25 billion).

Even without the rise of the junk bond, the 1980s would have been remembered as one of the more financially momentous periods in American history. Interest rates tumbled, stock prices tripled, and countless new financial inventions—including various financial futures and options products, interest-rate and currency swaps, mortgage-backed securities, and program trading—spawned in the fertile decade, rich in the economic nutrients of easy money, loosening regulation, and new computer-based technologies. Access to credit—even for the individual consumer, besieged by offers of credit cards and home-equity loans—expanded beyond all previous limits. The decade's financial innovations, many of which arose to fill the credit void left by failing banks and S&Ls, increased the liquidity of financial markets and their importance as a source of funds for American industry. More transactions than ever before were completed in the marketplace, rather than on the books of banks and insurance companies.

The lure of easy riches was powerful and disorienting. In *Bonfire of the Vanities* (1989), Tom Wolfe describes a Wall Street trading room as a place where young men assembled "to bay for money," imagining themselves to be "Masters of the Universe" as they swore and bellowed into telephones, trading securities worth millions in the space of a few seconds, believing that "by age 40 you were either making a million a year or you were timid and incompetent." The high volume of transactions, loose regulation, and enforcement deficiencies led to market-rigging and insider-trading scandals that caught up a shocking number of the Street's best and brightest. Several, including Milken, went to prison. Many Americans were appalled by these scandals and by the outbreak of junk-backed (and other more conventional but equally hostile) takeover attacks. They saw fine old American companies with thousands of loyal employees suddenly boarded by financial pirates with no interest in anything but slashing costs and stripping assets for short-run profits, often leaving the company burdened with enough debt to send it to the bottom. Treasury Secretary Nicholas F. Brady, formerly an old-fashioned investment banker, lamented in 1989: "I have a growing feeling that we are headed in the wrong direction, when so much of our young talent and the nation's financial resources are aimed at financial engineering while the rest of the world is laying the foundation for the future." Just safeguarding against potential attacks by buccaneers, some critics maintained, was crippling American business at a time of growing global competition. "There is little evi-

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dence to suggest that mergers have on the average enhanced the profitability or productivity of merging enterprises," Harvard's Robert Reich (today a top Clinton adviser) declared in 1989. "America has had enough. Even by the cynical standards of the 1980s, Wall Street is giving greed a bad name."

The financial prince of the 1980s, Michael Milken made $715 million in a single year and more profoundly influenced the shape of the U.S. economy than any single financier since J. P. Morgan.

Was Wall Street's greed the cause of all the decade's upheavals? Though it is often thought to be the root of all financial misfortunes, Wall Street greed is no different from any other variety. People who made a living strictly as Wall Street operators accounted for only about 10 percent of the new names added to the "*Forbes* 400" list between 1982, when the list first appeared, and 1988. Most of the great fortunes of the '80s were made by corporate founders and entrepreneurs such as Sam Walton of Wal-Mart, controversial real-estate developers such as Donald Trump, and obscure venture capitalists. Some of these fortunes have since been diminished as market conditions have reversed. Greed itself, however unattractive, is not illegal. But it is a natural, indispensable element in the functioning of capitalism.

When credit is plentiful, there never seems to be a shortage of fledgling entrepreneurs, people whom Walter Bagehot, editor of the *Economist* magazine in the late 19th century, called the "New Men" of capital. Bagehot coined the phrase in 1873 to explain how English capitalism worked. Ambitious newcomers willing to borrow heavily to trade in the markets against risk-averse "old capitalists" would ultimately drive the latter into retirement. The New Men are the risk-takers, the agents of change, the unruly (and often unsuccessful) *enfants terribles* of all periods of intense financial activity. Henry Ford was a New Man. So were Andrew Carnegie, Bernard Baruch, James Ling, and Michael Milken. In "a country dependent mainly on great 'merchant princes,'" Bagehot observed, "commerce perpetually slips more and more into routine. A man of large wealth, however intelligent, always thinks, 'I have a great income, and I want to keep it. If things go on as they are, I shall keep it, but if they change I *may* not keep it.'... But a

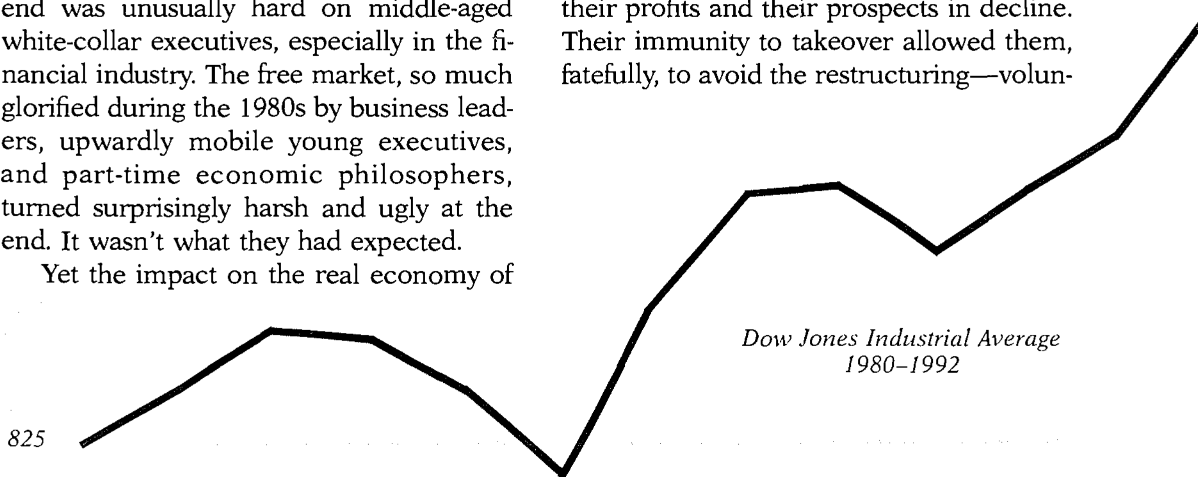
new man, who has his way to make in the world, knows that such changes are his opportunities.... The rough and vulgar structure of [such] commerce," Bagehot said, "is the secret of its life."

During the 1980s, free-market purists in the Reagan administration and the business world hailed the rise of the latest New Men and fought off most attempts to regulate the takeover wave. The takeovers, they believed, were no more than the free market's adjustments to changing competitive, regulatory, and financial conditions. The premiums paid for takeover targets showed that these companies were undervalued. Whole industries, such as autos and semiconductors, were losing out to foreign competition or failing to keep up with technological change. A shake-up, or simply the fear of one, would help reinvigorate and restructure American industry.

While takeover critics grew obsessed with the costs and excesses of the merger wave, proponents argued that the benefits of restructuring were worth the costs and would be lost if regulation were to protect entrenched managers. Restructuring enthusiasts such as Michael Jensen of Harvard Business School preferred not to acknowledge the problems at all. When the decade ended with a bang and a slump, there were unpleasant consequences. The end was unusually hard on middle-aged white-collar executives, especially in the financial industry. The free market, so much glorified during the 1980s by business leaders, upwardly mobile young executives, and part-time economic philosophers, turned surprisingly harsh and ugly at the end. It wasn't what they had expected.

Yet the impact on the real economy of all the distress in the financial sector has not been as great as is generally perceived. In the first half of 1992, unemployment averaged 7.4 percent; in 1982, during the last recession, it was 9.5 percent. By the middle of this year, as the excesses and rough spots of the boom years faded, it was possible to see benefits. A *Wall Street Journal* report showed that, despite a slow economic recovery, corporate profits increased by more than 20 percent during the first half of 1992, as compared to a year earlier, "partly reflecting the fact that corporate restructuring has been improving profit margins." Exports, too, were rising. U.S. corporate debt had been reduced significantly. It was still somewhat high, but not especially so. The fact is that the vast majority of mergers during the 1980s were not financed with junk bonds—LBOs accounted for only about 15 percent of all completed mergers, 25 percent during the peak year of 1988. (Only a deal financed almost entirely with borrowed money is known as a LBO.) The rest of the deals were financed either with surplus cash and moderate levels of borrowing or with stock.

Ironically, the companies that were considered fortunate during the 1980s because they were too big to be takeover targets—IBM, General Motors, Sears Roebuck, and AT&T—have lumbered into the '90s with their profits and their prospects in decline. Their immunity to takeover allowed them, fatefully, to avoid the restructuring—volun-



Dow Jones Industrial Average 1980–1992

tary or involuntary—that swept the rest of corporate America.

The merger boom of the 1980s was nothing new in American history. It was, in fact, only the most recent of four the country has experienced. The three others came in 1898–1902, the 1920s, and the 1960s. Each produced obvious excesses and abuses, but each wrought necessary and beneficial economic changes that were not generally appreciated at the time.

The first, biggest, and most significant merger wave in American history was the one that capped the late-19th-century era of unrestricted capitalism. This was the Gilded Age, as a scornful Mark Twain called it, the time of the "Robber Barons." This period of restructuring involved a significantly bigger share of American manufacturing than did the boom of the 1980s. According to economist Ralph Nelson, more than 2,600 transactions took place and more than $90 billion (in 1990 dollars) changed hands. This era gave birth to the grandaddy of all megadeals, the creation of U.S. Steel in 1901 through the combination of Andrew Carnegie's steel company with nine others. Masterminded by J. P. Morgan, the deal was worth some $20 billion in 1990 dollars—the largest in history until the 1988 RJR-Nabisco transaction—and earned the famous investment banker a fee equivalent to more than $100 million in today's dollars. The press reacted to the transaction much as it did to the RJR-Nabisco LBO 87 years later. In New York and London, the merger was denounced as a "menace to commerce" and a "triumph of the millionaire." But the steel industry, with U.S. Steel in the lead, became one of the dynamos of the American economy, the power behind American triumphs in autos and other industries and the foundation of the "arsenal of democracy" in World War II. By the 1980s, when corporate raider Carl Icahn threatened to dismember U.S. Steel (by then renamed USX), editorialists reacted as if he were attacking one of the pillars of the republic. Icahn thought that shareholders would be better off if USX got out of the oil business, which it had entered in the early 1980s with the acquisition of Marathon Oil. USX chairman David Roderick warned of "massive abuses by a small group of raiders, arbitrageurs, promoters and investment bankers, who reap enormous profits serving only their own self-interest at the expense of... employees, creditors, communities, and the nation at large."

The turn-of-the-century boom, like that of the 1980s, required plentiful capital to get started, but American industry was also ripe for change. Alfred Chandler, a Harvard business historian, views the mergers as "a response to the growth of a national and

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increasingly urban market." Dozens of capital-hungry industries, from steel to tobacco to paint, had grown up helter-skelter and by the late 19th century were experiencing suicidal levels of competition. Around 1870, prices of manufactured goods began a 30-year skid. To fix prices and otherwise restrain competition, business created cartels, but these were outlawed by the 1890 Sherman Anti-Trust Act. Mergers were the only logical solution left. The mergers "set in place the structure of the new capital-intensive industries and define[d] their major players for much of the rest of the 20th century," Chandler writes. Many smaller family-owned firms disappeared as America entered the age of "managerial capitalism."

Ready money and the rise and consolidation of new industries—autos and especially electric power—also figured in the next giddy spell on Wall Street. The 1920s saw one of the first junk-bond issues, for General Motors, and Henry Ford's somewhat ruthless leveraged buyout of his early partners. Samuel Insull was the decade's deal-making star. Starting as a 22-year-old employee in Thomas Edison's London office, he got himself installed as the great inventor's personal secretary and came to America. Rising to head Commonwealth Edison of Chicago in the 1890s, Insull recognized that because they required heavy capital investment, the many small electric utilities in Chicago and other cities would have to be consolidated into cartel-like entities if they were to survive and prosper. His great insight was that this could be accomplished by conceding that utilities should become regulated public monopolies.

In 1912, the 53-year-old Insull's career took a new turn when he became a financier and promoter. He formed a holding company to buy up stock in small utilities and then invited the public to invest. Other budding tycoons did the same, but none had quite the overarching ambition of Insull, who erected a huge and highly leveraged pyramid, paying ever higher prices for the companies he wanted in the speculative markets of the '20s. "By 1926 or thereabouts," historian Frederick Lewis Allen writes, "... Samuel Insull's head appears to have been pretty thoroughly turned." This boom ended with an even greater catastrophe than usual, the great stock-market crash of 1929, and Insull's investors eventually lost between $500 million and $2 billion. Millions more were lost by those who poured money into the highly leveraged investment trusts formed by banks and Wall Street brokerages to speculate in utilities and other stocks. Insull, charged with fraud, embezzlement, and other crimes, fled to Europe. Extradited in 1934, he was tried and acquitted three times in Chicago.

The banks had participated heavily in the speculative markets of the 1920s—they were found to have rigged markets, distributed worthless securities, and recklessly endangered their own safety (and thus their depositors' money). The banks were blamed for the Great Depression that followed the market crash, and their penalty was the Glass-Steagall Act of 1933, which subjected them to New Deal government regulations and barred them from participation in the securities business.

When the next boom came, the individual investor was no longer in the lead. The surge of the 1960s was led by growth-oriented "institutional investors": public and private pension funds, insurance companies, and mutual funds. As a group, institutional investors owned 12.5 percent of all U.S. financial assets in 1960, up from 5.2 percent in 1950. (Today they own one-quarter of such assets.) The men—there were precious few women—who managed the money at the institutions were smart, well-

educated, and aggressive. They were also young (having displaced the gray and cautious, Depression-era generation on Wall Street), cocky, and ambitious, known in the financial world as "gunslingers." Unlike their predecessors, who favored "safe" companies with solid dividends, they were interested in companies with strong growth in earnings per share derived from new technologies and savvy management. They made companies such as IBM, Litton Industries, Polaroid, Texas Instruments, ITT, and Xerox the glamor stocks of the era.

Glamorous double-digit growth was difficult to obtain from regular business operations, however. So many companies tried to grow through acquisitions instead. Blocked by federal antitrust enforcers from acquiring firms in similar lines of business—firms, in other words, whose business they understood—they proceeded to create "conglomerates" of unrelated businesses, along with a persuasive jargon about "synergy" and other benefits of their new corporate combinations. One of the great wizards of conglomeration was James J. Ling, a high-school dropout from Oklahoma who took a modest electrical-supply company and, beginning in 1955, created high-flying LTV Industries, which eventually included, among other things, an airframe manufacturer, a meat packer, a sporting-goods company, an insurance company, and finally, in 1968, a large, underachieving steel manufacturer.

Ling and his fellow conglomerators, such as ITT's Harold Geneen and Litton Industries' Charles ("Tex") Thornton, initially boosted earnings through acquisitions; they then created more growth through spin-offs and recapitalizations and other exotic financial transactions. (One of the 1960s conglomerates, Gulf & Western, was known on Wall Street as "Engulf & Devour.") Applied "financial engineering" as we know it today was born in the '60s. LBOs began then; so did large-scale issuance of "subordinated debentures" (whose owners are paid off after banks and others in the event of liquidation) and other high-yield securities. There were also exchange offers (a public offer to exchange a new security for an outstanding security), and hostile tender offers.

By the end of the decade, however, the conglomerates were beginning to suffer severe gastrointestinal complications. They had acquired more than they could manage. Their many operating units suffered from neglect, which hurt profits and forced the curtailment of new acquisitions. The conglomerates fell from the financial firmament, and the stock market dropped with them, the Dow Jones Industrial Average plummeting from 1,000 to just over 750 in 1969 alone. The party was over. Again.

Almost immediately, however, the foundations were being laid for the next boom. In the markets, the double-digit interest rates of the 1970s set in motion the process of "disintermediation," as individuals and corporations shifted their money from S&Ls and banks directly into the financial marketplace. Individuals withdrew their bank deposits to buy shares in money-market funds; corporations issued short-term debt in the commercial paper market to capture lower rates. In 1980 federal banking and S&L regulators, worried about the outflow, repealed rate ceilings on deposits to allow these institutions to attract more money. But that merely put the institutions in a different kind of squeeze: Now they had to find investments that earned enough to allow them to pay depositors the higher rates. The pressure on S&Ls, stuck with portfolios of long-term mortgages at fixed interest rates far below current levels, was especially intense. In 1982, responding to many appeals for help, Congress permitted the

ANATOMY OF A SCANDAL

Some critical turns in the long development of the savings and loan (S&L) crisis, which may ultimately cost taxpayers $500 billion, are recounted by writer L. J. Davis in Harper's *(Sept. 1990):*

By 1982—that is, two years into the deregulatory "reforms" advanced by Washington—the S&L industry, representing some 3,300 thrifts, was effectively broke. In 1980 these institutions had a collective net worth of $32.2 billion; by December 1982 the figure was $3.7 billion. Paying 12 and 13 percent for their deposits while receiving a pittance in income from their mortgage portfolios, the thrifts had managed to virtually wipe themselves out.

Yet salvation of a sort was at hand; it only required a little patience together with a willingness on the part of the thrifts to swallow a little bad-tasting medicine. The draconian policies of Paul Volcker's Federal Reserve had finally broken the back of the inflationary spiral. Free-market interest rates were falling; S&L depositors' interest rates would inevitably follow. The industry could expect to be making money again soon. Of course, a number of thrifts would fall by the wayside. But closing them was a simple matter that would cost the Federal Savings and Loan Insurance Corporation a few billion dollars. This would strain the fund—a fund, remember, built of moneys drawn from the *thrifts themselves*—but not destroy it. Were the industry to take its losses now, it would cost the taxpayers *nothing*.

There was only one problem with this scenario. The U.S. League of Savings Institutions, the industry's principal lobbying group, refused to buy it. And it was common knowledge in Washington that Freddy St. Germain, chairman of the House Banking Committee, did anything the U.S. League wanted him to. So did the Federal Home Loan Bank Board. Instead of a mild purge followed by renewed profitability on the economy's upswing, it was decided that much of the thrift industry would be permitted to *pretend* that it was making a great deal of money....

With the blessing of Congress, and flying in the face of everything that had been known about banking for hundreds of years, the Bank Board, under the leadership of Jimmy Carter appointee Jay Janis and then of Reagan appointee Richard Pratt, did what it could to destroy every vestige of capital discipline at the thrifts. Before the Bank Board began this tinkering, a thrift, like a commercial bank, was required to maintain reserves—real money, cash on hand—equal to five percent of its assets.... It has long been a truism in Washington, however, that when economic reality collides with an official agenda, the official agenda survives. Unremarked by virtually anybody outside the financial community, the board proceeded to lower the reserve requirement to three percent, meaning that a thrift needed to keep only half as much real money in its vaults. With the proverbial stroke of the pen, sick thrifts were returned to a state of ruddy health, while thrifts that... had been among the dead who walk were now classified as merely enfeebled.

The Bank Board also made esoteric changes in the industry's accounting practices. The changes were hard to understand; they were almost impenetrable by laymen and by much of the financial press, who consequently ignored them. But by abandoning Generally Accepted Accounting Principles, which were themselves notoriously subject to a certain amount of creative manipulation, the board allowed a rapidly expanding S&L to show a handsome profit even if it was disastrously run, and the S&L could continue to show handsome profits until it was utterly looted by its owner.

Looted by its owner? Weren't most thrifts owned by you and me and the guy down the block, little guys like in *It's A Wonderful Life*? Well, yes, they were, and no, they were no longer to be.

At the time the Reaganauts landed in Washington, most federally chartered thrifts were still mutual associations, owned by their depositors. But, thanks to a little-noticed reform of the 1970s, a few of them were joint-stock companies operating under severe restrictions designed to protect the small depositors while keeping out the real-estate developers, whose hunger for money—to finance development schemes—could be expected to empty the coffers in short order.... Now, in 1982—its thinking addled by the crisis and also by the deregulation Zeitgeist of the 1980s—the Bank Board decided that anyone who had the money could buy or start a thrift.... And to make it easier for [an "entrepreneur"] to purchase an S&L, regulators, in the fullness of their wisdom, would allow him to start his thrift not only with money—with cash—but also with non-cash assets, such as the 1,000 acres of dry, useless scrubland he could arrange to have a friend appraise in the millions.

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S&Ls to invest in new higher-yielding but riskier areas, such as business loans, commercial real estate, and junk bonds. This did not do much to halt disintermediation; but it did give yet another push to the snowballing S&L crisis. [See box, p. 38.]

The economic policies of the Reagan administration further increased the importance of financial markets. The sale of Treasury securities ballooned by $3 trillion as a result of growing federal deficits, which sparked a burst of growth within the economy in the early years. The dollar, too, rose rapidly until 1985, as foreign investors, seeing the American economy and financial markets rebound, poured capital into the country. Also, antitrust enforcers in the Reagan Justice Department made it plain that the stringent policies of the 1960s and '70s would be relaxed.*

As in cases past, however, the merger boom was more than a matter of money and opportunity rubbing together. Corporate America was overdue for change. In 1980 the market valued the shares of American companies at about the same prices that it had in 1970, despite the high levels of inflation during the 1970s and the fact that many companies had increased their earnings and cash flow and substantially reduced debt. After the conglomerate era and the difficult '70s, many companies had become large, cash-rich, and conservative. They had grown into rigid and bureaucratic institutions managed by executives who did not feel especially accountable to their boards of directors or their shareholders. "Corporate capitalism failed," management specialist Peter Drucker wrote in 1986, "primarily because under it management was accountable to no one and for nothing. In this the corporate raiders are absolutely right." While these corporations provided comfortable berths for managers and workers alike, they underperformed their competitors, particularly overseas rivals, clinging to old ways despite ample evidence that change was needed. In the stock market, the shares of conglomerates and other companies traded significantly below the net asset value of their various divisions. In other words, these corporations appeared to be worth considerably less than the sum of their parts.

The New Men sought out undervalued companies that could be restructured profitably. By borrowing money to make the acquisition, the entrepreneur would increase his financial leverage and earn a higher return on investment than the old shareholders he had replaced. By using super-leverage, as in a LBO, even higher returns could be expected. Invigorating the company with new management would increase efficiency, while selling off selected parts of the business would produce some early returns of capital.

Some of the early LBO specialists, such as Kohlberg, Kravis & Roberts (KKR), capitalized on their success by creating large LBO funds for institutional investors. When the institutional money came in, however, it came in torrents and flooded the market. In the relatively short three-year period from 1986 to '88, 232 large LBOs (each over $100 million) were completed, totalling $150 billion in value; in addition, 84 large deals totalling $120 billion were offered but not completed. This compares with 92 deals totalling $47 billion completed during the six-year period 1980-85. Many of the later deals were financed by LBO funds and the issuance of junk bonds.

*It could be argued that antitrust policy became so lax that many companies not especially interested in acquiring others had to do so anyway in order to protect themselves from a takeover by a competitor. The oil, paper, and publishing industries underwent just this kind of industry consolidation. Other companies, such as Philip Morris, felt the need to take advantage of opportunities to acquire large companies (Kraft and General Foods) whose acquisition might not be approved by future antitrust enforcers.

FOR WHOM THE BILL COMES

In Money of the Mind *(1992), financial analyst James Grant, editor of* Grant's Interest Rate Observer, *offers an informed skeptic's perspective on the credit explosion of the 1980s:*

Animal spirits [in John M. Keynes's famous phrase] are an American staple, and the tendencies of the 1980s do not constitute some alien strain in the national character. Real-estate speculation must be as old as the land—in the United States, it is certainly as old as the frontier—and the first bad bank loan was no doubt made around the time of the opening of the first bank. It would be hard to find a more corrupt, reckless, and incompetent lending institution today than the Second Bank of the United States, which closed in 1836.

Still, the boom of the 1980s was unique. Not only did creditors lend more freely than they had in the past, but the government intervened more actively than it had ever done before to absorb the inevitable losses. Two important trends converged in the boom: the democratization of lending and the socialization of risk; more and more people were able to borrow, and more and more debt was federally subsidized. The combination stimulated lending and borrowing and thus the nation's financial markets (and, for that matter, the world's). One of the signal features of the 1980s was the absence of a coast-to-coast bank run. Unafraid for their insured deposits, people did not queue up to demand cash from all the banks that had overlent against the dubious collateral of commercial real estate. The passing of the system-wide bank run has gone unmourned, and understandably so, but it cannot be denied that the resulting public complacency has brought its own costs, most visibly the unpaid invoice for the banking and S&L debacles. By standing behind good banks and bad banks alike, the government in effect removed the oldest franchise in banking—that is, safekeeping.

The reinvention of unsecured paper money similarly played an expansive role in the boom of the 1980s. Up until 1971, the dollar had been convertible into gold on demand, at a fixed and certain price (even if the right of convertibility had been steadily narrowed; it was vested at last only with foreign governments or their central banks). As the last remnant of the interna-

By the end of 1988, the high point of the LBO market, institutions and other investors had contributed $30–$40 billion to LBO funds, which through leveraging could potentially yield "takeover power" of $300–$400 billion, amounts vastly in excess of the supply of good deals. Prices for companies were driven sky high, and only the incurably acquisitive and those playing risklessly with large piles of other people's money stayed in the game. Unfortunately, there were plenty of such buyers around.

The best defense against a predatory attack was a high stock price, but this could be achieved only through superior quarter-to-quarter earnings improvement. Critics, including many liberals as well as conservatives such as Treasury Secretary Brady, charged that the pressure to produce the right numbers forced managers to focus on short-term results at the expense of long-term investment and research, to the detriment of America's international competitiveness. But these critics neglected to note that this pressure also produced sharply focused efforts to improve management and productivity, as has occurred at RJR-Nabisco and many other firms that went through successful LBOs.

The ever-present takeover threat also encouraged self-restructuring throughout corporate America. Many companies decided that if they could not be sure of beating the raider, they would emulate him by initiating the restructuring that he would carry out. In some companies (Levi Strauss, Macys) executives decided to "go private" by organizing as a group to buy all of their company's stock. Other corporations (Kroger, Polaroid) increased leverage, cut costs and expenses, sold off divisions, increased dividends, and took other steps to capture value for their own shareholders. The net effect, after a decade, is that

tional gold standard was abolished by President Richard Nixon, the great inflation of the 1970s was accelerated. Interest rates rose for a decade, conditioning a generation of investors to expect the high yields that the junk-bond salesmen of the 1980s subsequently promised them.

Risk-taking is inseparable from lending. Every loan, even if fully secured, is a kind of speculation. The degree of risk varies according to the character and strength of the borrower and the quality of the collateral. "If A lends $1,000 to B, A is speculating upon B's honesty, industry, skill, and promptness," Freeman Tilden wrote. "That is precisely what debt is, and precisely what credit is; and it is basically nothing else—a speculation."

With the partial socialization of the banking business, a process materially and ironically advanced in the Reagan years, the element of speculation was not removed, but its costs were shifted. The public sector's credit increasingly supplanted the private sector's. Government guarantees—of bank deposits, residential mortgages, farm loans, student loans—became widespread, and thereby expanded the volume of borrowing. As the marginal debtor received the marginal loan, the extra car (or house or boat or corporation) was sold. All this worked to enlarge the national income. In the 1920s and 1930s, an abundance of lending was succeeded by a drought and an inflation of prices was duly followed by a deflation. The riddle of the years to come is whether the government has succeeded in breaking this cycle: not the upswing, which in fact it has enthusiastically subsidized, but the downswing. It is whether the sheer bulk of the federal guarantees will forestall the kind of contraction that paralyzed business activity in the Depression and demoralized speculative activity for a generation after that. The fundamental investment question is whether even the government is big enough to underwrite, with good money, the losses born of the lending practices of the 1980s. If the answer to that question is "yes" (and I happen to doubt it), one would want to know why the government does not guarantee everyone. If every debtor had a call on the Treasury, and if the Treasury were none the worse for that commitment, interest rates would be lower and the nation more prosperous. The stock market would never have another bad day.

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some form of restructuring has occurred in almost all publicly owned U.S. companies—restructuring that has made them more efficient, more dynamic, and more competitive.

The mergers, restructurings, and other developments encouraged stock-market investors, who continued to push the market higher. By the end of the 1980s, few distinctions were made between friendly and unfriendly deals, or between those with good or bad economic prospects. What the critics had been saying all along was finally coming true: It was restructuring itself, which would generate generous fees and capital gains, that counted.

The market began to adjust, first on October 19, 1987, when the Dow Jones Industrial Average dropped an astonishing 508 points, terrifying everyone before recovering somewhat the next day. Two years later, the Dow fell 200 points after it was announced that the latest in a series of efforts to finance an employee-backed LBO of United Airlines had failed. The junk-bond market then collapsed, killing off all hopes for further LBOs in the near future and, more dramatically, for the repayment of several large "bridging loans" provided by aggressive investment banks to previous LBOs. By early 1990, the markets for acquisition finance were in shambles. It was to be the worst year for Wall Street since the 1930s. One major firm, Drexel Burnham, failed, and First Boston, Shearson Lehman Hutton, Kidder Peabody, and Prudential Securities might have gone under but for the rescue efforts of their well-capitalized parent companies.

The 1980s merger boom had run to excess, as all booms tend to do. The big losers were the investors, chiefly large financial institutions, that had put money into junk bonds and LBO funds and sold out at the

bottom of the market in 1990. Other losers, of course, include the struggling LBO managers themselves and their employees, most of whom, however, had signed on for the ride voluntarily. Today, large amounts of corporate debt remain outstanding, concentrated in the LBOs completed toward the end of the boom, in 1986–88. Perhaps two-thirds of these LBOs are in trouble. Among the ailing companies are Revco, Fruehauf, Southland, and several airlines and big department-store chains, such as Federated, Allied, and Macys.

Yet the main body of corporate America is not especially burdened by debt. In 1980, total corporate debt as a percentage of capital was 33 percent; by 1989 it had increased to 57 percent. That was high but not unmanageable, especially considering that the 1989 average was inflated by the big LBOs in which debt ratios of 90 percent were not uncommon. By 1990 and '91, the junk-bond default rate had topped 10 percent, a record for the '80s (it was 12 percent in 1970), but again not intolerable when one considers, among other things, the distorting impact of some of the terrible deals that were done toward the end of the decade. In any event, the default rate declined sharply to an annualized rate of about six percent during the first quarter of 1992.

Despite Wall Street's turmoil during the early 1990s, stock market prices are much higher now than at the beginning of the '80s because they are much closer to the real value of companies. There are few conglomerates left and many companies have restructured themselves, which has reduced the incentive to take them over. (LTV, the high-flying conglomerate of the '60s, was too sickly to interest even the takeover artists and survives today only as a bankrupt shell.) Indeed, higher stock prices have encouraged many companies to sell new stock and reduce debt.* Overall, corporate America is better off today than it was in 1980.

Americans have a tendency to exaggerate both their own weaknesses and the strengths of their rivals. For years Americans were encouraged to believe that the Soviet Union was the equal of the United States as a superpower. We now know better. Likewise, the Japanese colossus looks less formidable now that the Tokyo stock market has crashed and the nation's political and financial leaders have been caught up in scandals reminiscent of the Third World. Now American anxieties are focusing on Europe, where the European Community is moving toward a post-1992 single market that will overshadow that of the United States.

The move toward a single market is propelled by the fear of many Europeans that if they remain a collection of small, economically independent, and protected states, they will be overwhelmed by increasing American and Japanese competition and their relative standards of living will decline. What these Europeans want now is a larger and more effective economic system

*For the past decade, in every year but two, corporate acquisitions and stock-repurchase plans have taken more shares off the market than corporations have issued. Before 1991, public equity capital for American industry declined by an alarming $552 billion in seven years. In 1991, a record $75-billion surge of new equity issues reversed the downward trend, yielding a net addition to equity capital of about $50 billion, the first positive number in eight years. The trend has continued in 1992. In general, more equity means less debt for U.S. corporations.

that can be globally competitive. To achieve this, they are attempting what they think of as an American experiment, a turn toward freer and more competitive market economies. Broad deregulation has already begun, especially in banking, insurance, and other financial services.

Europe's new direction has already encouraged a surge of European mergers, acquisitions, and corporate restructurings. Since the beginning of 1991, about three-fourths by volume of all the world's mergers and acquisitions (and LBOs) have involved non-U.S. corporations, most of them European. Yet vast portions of European industry remain to be restructured or privatized—and that is not to mention what needs to be done in the former communist states. During the 1990s it appears that Europe will experience its first merger boom—a financial restructuring that may outdo the one experienced by the United States during the '80s. And Japan, which has so far eschewed most forms of domestic mergers and acquisitions, but which also needs to address corporate restructuring, cannot be far behind.

The American financial market will be a model, and periodically a source of capital, for the rest of the world. Compared to all others, it is deep, honest, well-regulated, and hard to fool. And because the American marketplace has been open, allowing deals to happen as long as buyers and sellers agree, the financial know-how needed for restructuring is today essentially an American, and to some extent British, possession. America's leading investment and commercial banks suddenly find themselves with unique competitive advantages in the international marketplace. When the Mexican government recently decided to privatize the national banking system, for example, it turned to Wall Street's J. P. Morgan to handle the complicated deal, not to seemingly more powerful Japanese or German banks. Likewise, in Europe, Goldman Sachs, CS First Boston, and Shearson Lehman Brothers are among the most sought-after acquisition advisers.

In the next decade, the American banking firms that survived and learned from the 1980s and can project their business onto the global stage will almost certainly climb back to the top of the world's financial power structure. If so, it will be an ironic and unexpected outcome of a much-decried decade of takeovers, junk bonds, and greed.