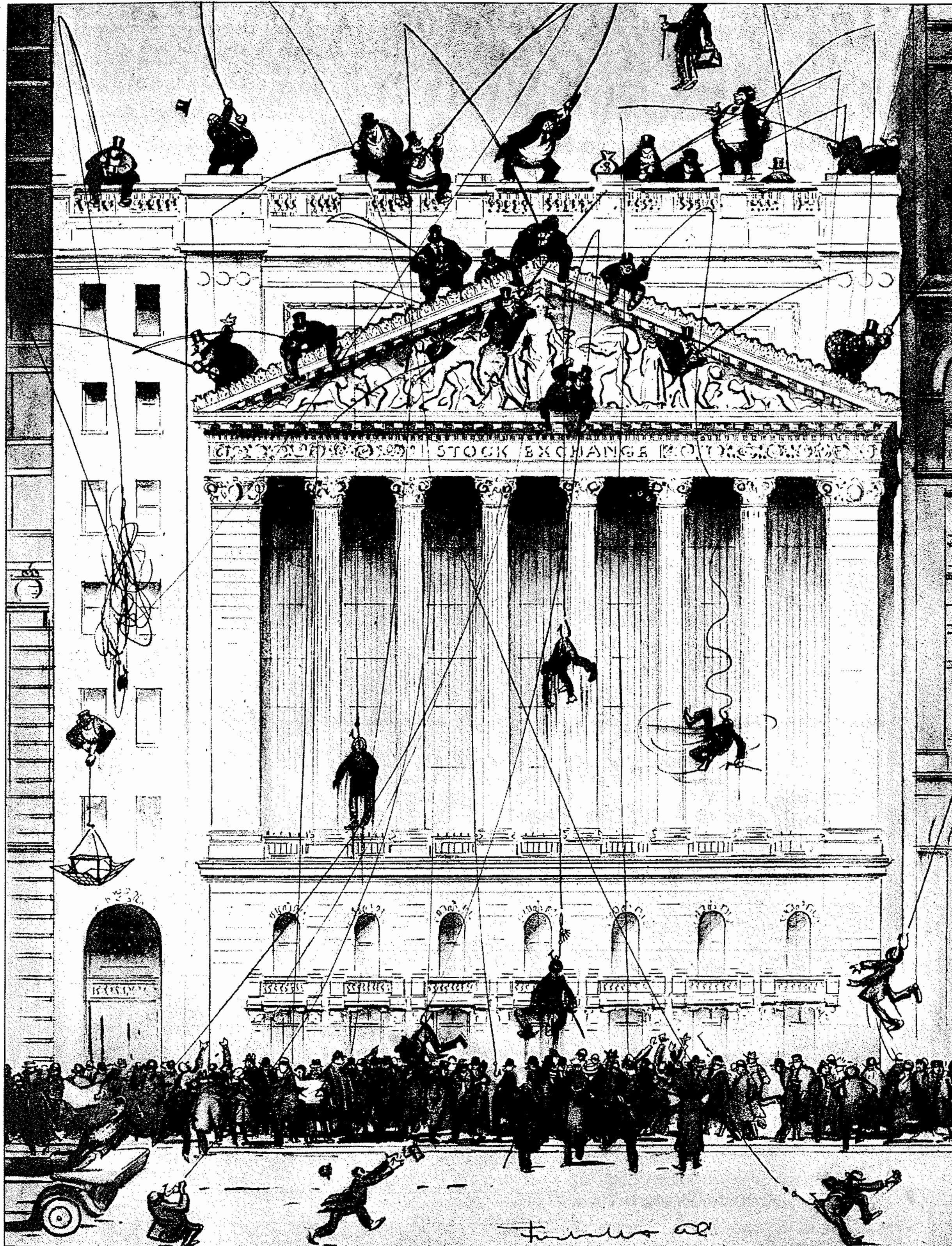


A warning ignored: This 1921 cartoon showed Wall Street operators fishing for suckers.

American Finance

Michael Milken, the erstwhile junk-bond king who is now serving time in a federal prison, will likely go down in history as a symbol of the sins of the 1980s—greed, excess, and worse. Yet he also was the most significant figure in American corporate finance since J. P. Morgan. From Morgan's time to Milken's, financiers have sought the best way to finance, and by extension to manage, American business. That search, J. Bradford De Long argues, has been a hapless departure from sound beginnings; Roy C. Smith, however, contends that it has helped to create a more competitive U.S. economy.

WHAT MORGAN WROUGHT

by J. Bradford De Long

"They control the people through the people's own money," thundered future Supreme Court Justice Louis Brandeis in 1913. Brandeis, then a Boston corporate lawyer and an adviser to President Woodrow Wilson, was trying through a series of articles in *Harper's Weekly* to rally progressives for a political offensive to break the financial stranglehold that he thought the infamous Money Trust created by J. Pierpont Morgan held over turn-of-the-century America.

One year earlier, during the sensational Pujo committee inquiry into the Money Trust on Capitol Hill, Brandeis's fellow progressive, chief investigator Samuel Untermyer, had argued that Morgan, his partners, and their peers at a handful of smaller banks were directors, voting trustees, or principal shareholders of corporations capitalized at $30 billion—the equivalent, in proportion to the size of the economy, of $7.5 trillion today. Perhaps 40 percent of all industrial, commercial, and financial capital in the United States was in some way under the penumbra of this Morgan-centered Money Trust. The small fraternity of Money Trust bankers reaped immense profits. The commissions they earned on the creation of U.S. Steel in 1901 constituted as large a share of the economy then as $15 billion would today. The investment bankers of the 1980s did not reap even a fifth as much from the largest Wall Street deal of the decade.

Brandeis and other progressives saw the Money Trust's dominance as much more dangerous than any of the nation's other monopolies. Unlike the Sugar Trust or other one-industry monopolies, the Money Trust might ultimately subject every industrial firm in America to its will. Any

American corporation that sought to raise more than $10 million in capital in the early 20th century was forced to do so by hiring J. P. Morgan & Co. or one of a handful of smaller, and according to the reformers, loosely allied banks—such as Kuhn, Loeb; Kidder, Peabody; the National City Bank—to underwrite its stocks or bonds. If Morgan did not think a corporation deserved money, money would not be raised. The firm's expansion plans would not be carried out. The flow of investment in the United States was thus directed to industries and firms that Morgan and his counterparts wished to see expand, not elsewhere. The New York Central; Northern Pacific; Erie; and Atchison, Topeka & Santa Fe railroads issued their bonds under Morgan auspices and had Morgan representatives on their boards of directors. Morgan partners had strong voices in the selection of management and corporate strategy of American Telephone and Telegraph (AT&T), General Electric, and Westinghouse. Morgan masterminded the merger that created U.S. Steel in 1901. He helped gather the individual railroads of the United States into continent-spanning systems. Overall, Morgan and a small band of fellow financiers exercised a degree of control over corporate America not even remotely paralleled by any group since World War II. In Japan and Germany, however, the comparable forms of "finance capitalism" that arose in Morgan's day survive today more or less intact.

The rise of the House of Morgan matched the growth of the U.S. industrial economy. The half century before World War I saw America's population and standard of living both multiply fourfold. New capital and new businesses arose at a pace never seen before or since. Before 1890 the stock and bond markets were overwhelmingly dominated by railroads and government borrowings, and Morgan's father, Junius Spencer Morgan (1813–90), operating in London, became the leading banker channeling British savings into American railroads. When industrialization accelerated, pushing the stocks and bonds of U.S. Steel, International Harvester, General Electric, and other new corporations into prominence, the Morgan partnership rode the crest of the wave. And early in the 20th century, when the transatlantic flow of capital reversed, the House of Morgan was at the forefront, funneling American capital to Britain.

Junius's son, J. Pierpont Morgan (1837–1913), superintending the Morgan interests at 23 Wall Street in New York, was already the nation's leading railroad financier and maestro of industrial reorganization by the 1880s. The imperious Pierpont was, moreover, a leading banker not only for foreign governments wishing to borrow money in the United States but for the U.S. government itself. And at times, J. P. Morgan & Co. (or Drexel, Morgan & Co., as it was called before 1894) appeared more powerful than the government. When Congress temporarily refused to pay U.S. Army salaries in 1877, the House of Morgan did so. In 1894–95, when a sudden outpouring of gold from the U.S. Treasury threatened to create a domestic and international economic crisis, J. P. Morgan stepped in. And when the month-long Panic of 1907 left several important banks—and possibly the rest of Wall Street—teetering on the brink of disaster, Morgan, by then 70 years old, led a small group of bankers who did what Washington alone could not, lending enough money to the endangered institutions to see

J. Bradford De Long is an associate professor of economics at Harvard University and a Faculty Research Fellow at the National Bureau of Economic Research. *Copyright © 1992 by J. Bradford De Long.*

J. P. Morgan at the funeral of a U.S. senator in 1911. Often in the headlines, he was rarely photographed, in part because a nose enlarged by a skin disease made him self-conscious.

them through the crisis. So great was Morgan's influence that it seemed he could only be a god or a demon. On Wall Street he was worshipped (and feared). It was said that crowds parted for him as he barged down the narrow sidewalks of the financial district during the crisis of 1907. "God made the world in 4004 B.C.," *Life* magazine said, "but it was reorganized in 1901 by James J. Hill, J. Pierpont Morgan, and John D. Rockefeller." In Washington, Senator Robert M. La Follette (R.-Wis.), accusing Morgan and his peers of tripping off the panic themselves to further their own interests, claimed they had the power to "withhold and dispense prosperity."

Progressives were alarmed by the sheer size of the Morgan firm's interests. Brandeis, an advocate of small-scale capitalism, warned that the nation's future depended on "the freedom of the individual. The only way we are going to work out our problems in this country is to have the individual... free to work and trade without the fear of some gigantic power threatening to engulf him every moment."

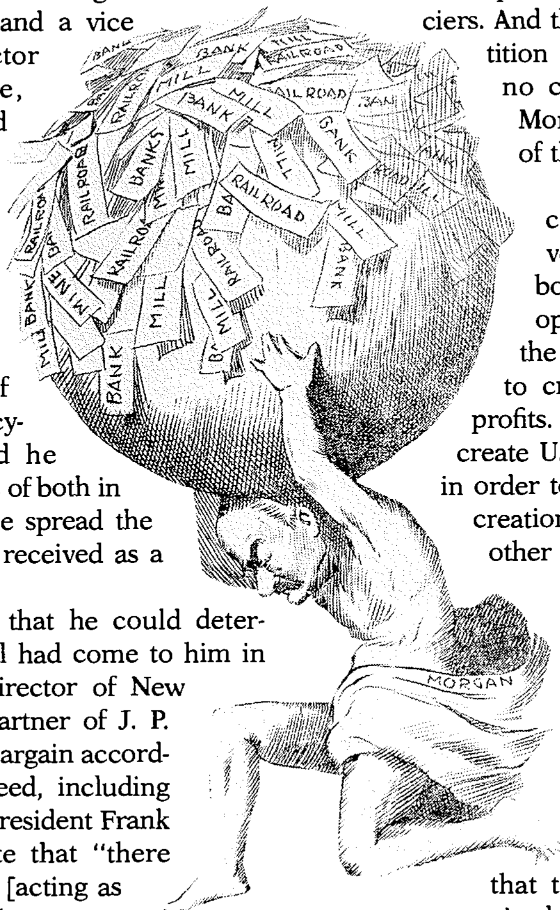
To Brandeis and his allies, the greatest danger was posed by the many conflicts of interest caused by the Money Trust's methods. First National Bank Chairman George F. Baker, a close Morgan friend and ally who was called Morgan's secretary of the

treasury on Wall Street, sat on the boards of six railroads that together owned 90 percent and carried 80 percent of Pennsylvania anthracite. How cutthroat was competition among these railroads likely to be?

George W. Perkins, a charming master manipulator of politics and finance, was both a Morgan partner during the first decade of the century and a vice president and director of New York Life, which invested heavily in securities underwritten by the Morgan partnership. Would Perkins advance the interests of his clients in his role as Morgan partner, or of New York Life's policyholders—or would he sacrifice the interests of both in order to increase the spread the Morgan partnership received as a middleman?

Perkins claimed that he could determine whether a deal had come to him in his capacity as a director of New York Life or as a partner of J. P. Morgan & Co., and bargain accordingly. Others disagreed, including National City Bank president Frank Vanderlip. He wrote that "there were times... when [acting as a board member of the Union Pacific Railroad] I opposed underwriting fees because I felt they were too high." Vanderlip's fellow directors then "pointed out to me, in a hurt tone, that the City Bank [of which Vanderlip was then president] was sharing in those underwriting profits that I thought were too fat."

Progressives saw the Money Trust's seats on corporate boards of directors, its control over new issues of securities (stocks and bonds), and its high profits as the three corners of an iron triangle of conflicts of interest. High dividends voted by Money Trust-dominated boards generated funds to reward those who cooperated with the Money Trust. Fear of the Money Trust restrained competition from other financiers. And the absence of competition gave industrial firms no choice but to accept Money Trust domination of their boards.



THE ATLAS OF FINANCE

THE NEW YORK PRESS

OCTOBER 27, 1907.

Courtesy of the Archives, The Pierpont Morgan Library, New York

A "Morganized" company, with an investment banker on its board, would seek every opportunity to jack up the prices of its products to create large monopoly profits. Morgan was eager to create U.S. Steel, for example, in order to protect his previous creation, Federal Steel, from other producers and to generate such monopoly profits. Even when no formal merger occurred, common directors and cross-ownership of shares created a "community of interest."

It is surprising that the Money Trust survived as long as it did. It was the subject of two major congressional investigations and innumerable polemics. Senator Gerald P. Nye (R.-N.D.) charged the bankers with having conspired with munitions makers, the "merchants of death," to drag the United States into World War I in order to protect their investments in British bonds. But the debate over the Money Trust was resolved only by the stock

market crash of 1929 and the Great Depression, which left the securities industry virtually without political defenders. Indeed, it was Republican president Herbert Hoover, believing that Wall Street had the power to restore prosperity, who triggered the 1932–33 Senate Banking Committee investigations that finally curtailed the influence of the Morgan bank—ruled since Pierpont's death in 1913 by his son, J. P. ("Jack") Morgan, Jr. Hoover used the threat of an investigation to prod the bankers into action. Instead, the old guard of progressives won during the 1930s what they had not been able to win for three decades.

The Glass-Steagall Act of 1933 said that investment bankers could no longer be commercial bankers: Depositors' money could not be directly used to support the prices of newly issued securities. Glass-Steagall said that directorates could not be interlocked: Bankers could not serve on the boards of firms that were their clients. Glass-Steagall said that the bankers who issued and priced securities for a firm could not serve as fiduciaries for investors who bought the securities.

The links that the Morgan partnership had used to gather information, raise capital, and exercise influence were thus broken. Investment bankers could continue to float stocks and bonds for corporate customers, but they could not invest depositors' money in those securities. Nor could they serve on the corporations' boards and oversee management. They could only serve as middlemen in financial transactions. Since World War II, the two pieces into which Morgan's American empire were divided—J. P. Morgan & Co. and Morgan Stanley & Co.—have continued their business as commercial and investment bankers, respectively. They have earned high profits. But their earnings have been an order of magnitude lower and their influence over American industrial development nonexistent compared to what would have been had the pre-Depression order continued.

Today, finance historians debate whether the Money Trust was real or imagined—a product of what the historian Richard Hofstadter called the "paranoid style" in American politics. Vincent Carosso of New York University, for example, argues that financiers did not "purposely act together; and even if they had, they would have been unable to impose their will upon the other directors . . . [who were] always more numerous than the representatives of Wall Street." Untermyer and other investigators, says Carosso, were unable even to demonstrate the existence of a Money Trust in the narrow way they defined it: not a conspiracy but a "close . . . understanding among the men who dominate the financial destinies of our country and who wield fabulous power."

Citibank's official history depicts Untermyer as an aspiring politician guilty of bad faith. Two years before the investigation, he had said that "monopolies and substantial domination of industries could be counted on the fingers of your hand." In the same speech, Untermyer attacked "political partisans who seek to make personal and Party capital out of a demagogic appeal to the unthinking."

But neither the progressive's "paranoid" vision nor the rebuttal provides a complete picture of the Money Trust. If, as the progressives had it, the Morgan partnership was little more than a very large financial-protection racket, why did so many firms willingly enter its embrace? But if the financial market was as competitive as historians like Carosso believe, why were Morgan's profits so high?

Even Morgan's supporters did not argue that the Money Trust was a fiction. John

'MORGANIZING' A RAILROAD

J. P. Morgan developed many of his financial techniques as a reorganizer of troubled railroads in the late 19th century, a time when railroads were not only the nation's leading growth industry but were as essential to growing communities as water.

The Richmond & West Point Terminal line was not unlike many other railroads of the day when Morgan was approached to reorganize it in 1891. Mismanaged and run down, its treasury plundered by its officers, its stock, as J. P. Morgan, Jr., put it, a "football of speculation" in the hands of a few insiders, the railroad was on the verge of bankruptcy. The elder Morgan summoned three of the company's major stockholders to 23 Wall Street, where the Morgan firm occupied a single large room on the ground floor. At one end, Morgan sat in his own glass-walled office. The banker told his visitors that he would step in only if a majority of the company's bondholders and stockholders deposited their securities at the Morgan bank to guarantee against speculation. Few men had the nerve to say no to J. P. Morgan, nearly as large a presence physically as he was financially, brusque and self-assured, but William P. Clyde did. "I've bought the Richmond Terminal at seven or eight and sold it at 15 twice in the last few years—and see no reason why I should not do it again," he drawled.

But Clyde was forced to relent after several other banks turned down Richmond Terminal. The Morgan plan was announced in May 1893, having been drawn up by partner Charles Coster, a nervous wizard with numbers who, like most Morgan partners then, worked himself into an early grave. A new company, Southern Railway, would be created to take over Richmond Terminal and two of its subsidiary lines; other less profitable lines would be excluded, left to fend for themselves. To slash debt, many bondholders were forced to accept new, lower-interest bonds in place of their old securities; shareholders were forced to contribute fresh capital to finance improvements in the Southern Railway's lines; and new stock was issued. The lynchpin of this and many other Morgan deals was the creation of a voting trust: Shareholders were required to surrender their votes to a new trust controlled by Morgan and his allies George F. Baker and Charles Lanier. They would select the corporation's directors and officers. A trusted Morgan associate, Samuel Spencer, of the Baltimore and Ohio Railroad, was installed as president.

"Contemporary commentators were enthusiastic in praising Morgan's work," notes historian Vincent Carosso, "several of them asserting that the reorganized property promised the start of a 'new era' for railroading in the South. And indeed it did." Initially covering 7,000 miles, the new Southern added track, reacquired some of the lines left out of the original deal, more than doubled its rolling stock, and invested millions in roadbed and other improvements.

Who benefited? Certainly the line's passengers and business customers throughout the South. So did the Morgan partnership. It reaped commissions worth $850,000 and acquired a virtual lock on Southern's future banking business, as well as a strong voice in the firm's management. Stockholders suffered in ways not likely to be repeated today. They were forced to pay assessments, to surrender their authority over the firm's man-

Moody, the founder of Moody's Investor Services, maintained that it did exist—and that it was a good thing. Individual shareholders simply were not capable of monitoring or evaluating the performance of corporate managers, he said. Others made similar arguments. Investment banks exercised control and influence over firms because doing so put investors' minds at ease. Companies welcomed the bankers' oversight because their stamp of approval made it possible for them to tap investors' savings for expansion. As New York, New Haven, and Hartford Railroad president Charles Mellen said, "I wear the Morgan collar, but I am proud of it."

Mismanagement was not the only thing investors had to fear in a firm where no one wore the Morgan collar. Among other things, corporate insiders were known to

agement, and to sacrifice short-term returns to allow the railroad's modernization.

By the turn of the century, the nation's railroads were concentrated into six huge systems controlled by Morgan and a few others—and Morgan held seats on the boards of several railroads he did not control. It was as if one person today controlled IBM, Apple, and several other major computer manufacturers. Morgan labored to assure that the systems did not compete, not always with success. His war with Edward H. Harriman for control of the Northern Pacific line in 1901 led to a stock-market panic that caught up speculators and innocent bystanders alike. When asked by a reporter if he did not owe the American people an explanation of the struggle, Morgan shot back, "I owe the public nothing." The public, however, writes one Morgan biographer, was beginning to think "that it owed Morgan too much."

manipulate stock prices, to "play bulls and bears," in Wall Street argot. Morgan had little patience with such shady practices, telling one executive who did not know his place: "Your railroad? Your railroad belongs to my clients."

Thomas Lamont, the most politically adept of the Morgan partners, told Louis Brandeis during a famous meeting that he and his partners had only reluctantly joined boards of directors: "As you realize, we have drifted onto these various boards because we had first undertaken to place a large block of the corporation's securities with our [investor] clients, and we felt a sense of responsibility to those clients which we fulfilled by keeping an eye on the corporation in which they had invested. We have felt that this was a strong factor in enabling us to market these securities, and

while the responsibility was a very onerous one, nevertheless, we shouldered it."

Another Morgan partner, Henry Davison, argued that the extent of Morgan control over investors was exaggerated. If another firm proved a superior judge of risk, or if the Morgan firm lost its reputation for "character" by recommending securities that profited it at the expense of investors, then Morgan influence would quickly disappear. (The banks likewise claimed to look for "character" in their clients. In a famous exchange during the Pujo hearings, J. P. Morgan was asked by Untermyer, "Is not commercial credit based primarily upon money or property?" The old man replied: "No sir; the first thing is character.") The big firm's hard-won reputation also explained its ability to charge high fees and reap great profits. Moreover, because the continuing success of J. P. Morgan & Co. depended on its reputation for "character," it was not tempted by quick profits; a smaller or less-established firm might be tempted to take the money and run.

Morgan's great antagonist, Untermyer, was himself reportedly the victim of just such a firm. In 1899, Standard Oil magnates H. H. Rogers and William Rockefeller capitalized the new Amalgamated Copper Corporation at $75 million, traded on their reputations as the financial wizards behind the growth of Standard Oil, and sold about half of the company off to other investors. It then developed that the only assets of Amalgamated were copper companies that the two had recently purchased for $40 million. When the dust cleared, Rogers and Rockefeller held half of Amalgamated—worth $20 million in fundamental value—and outside investors had put up $40 million but had acquired in return only the other half of Amalgamated. The two promoters' reputations as investment bankers were shot, but they had not been interested in investment banking in the first place.

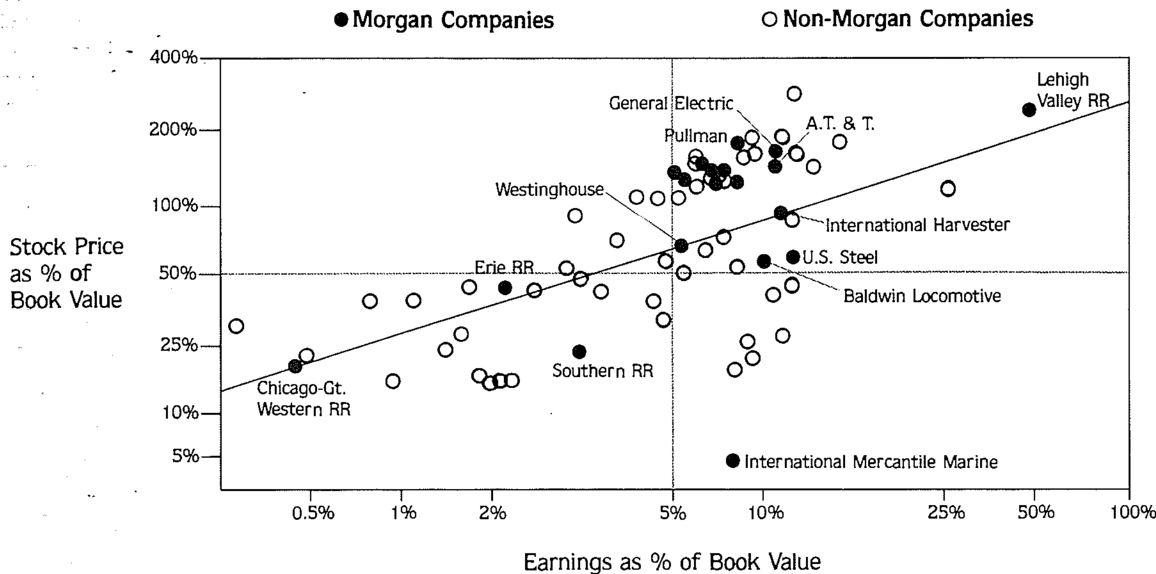
It is ironic to find stout defenders of private privilege and property such as Moody and Davison advocating a system of allocating investment that might be termed "socialist." The Morgan partnership had about a dozen partners and 145 employees. The partners approved and vetoed proposed top managers for individual firms and decided which firms' securities they would underwrite, and thus implicitly which lines of business should receive additional capital and so expand. The effect is not dissimilar to what would be done by a centralized investment-planning directorate. Of course, there are major differences. Morgan and his partners were not a bureaucracy; nor were they paid like bureaucrats. And the Morgan partnership felt itself under severe pressure to run an efficient operation and make investment decisions that would profit investors—for in the long run it faced competition.

Was there any truth to the Morgan partnership's self-justification? Or was it just another plausible but specious argument thrown up to protect power and privilege against democratic reform?

In fact there was considerable truth to the partnership's claims. A chart showing the ratios of earnings and stock price to book value among big American companies around 1910 (facing page) establishes that companies with Morgan partners on their boards made higher profits and fetched higher stock prices than other companies.

Book value is an accounting concept that roughly captures the value of a firm's assets: how much it would cost to replace its machines, buildings, liquid assets, and intellectual property (patents, etc.). The ratio of earnings to book value is thus an index of a corporation's efficiency as a profit-

MORGAN VS. NON-MORGAN COMPANIES, 1910–1912



making engine. The ratio of stock price to book value shows what investors think of the firm's management and prospects. The more positive their view, the higher the premium over book value they are willing to pay. By both of these standards, Morgan firms fared extremely well. The average non-Morgan firm was assessed at half of its book value by the stock market and had earnings equal to five percent of book value. Of the 19 Morgan firms, 16 performed better than this average.

It is a point against the progressive position that Morgan companies had high ratios of earnings to book value. One of Brandeis's most frequent criticisms of the Money Trust was that it "watered" stock to overstate book values—as the two promoters of Amalgamated Copper did in 1899. Stock-watering would inflate book values and tend to move Morgan companies down and to the left in the chart. Yet they are clustered in the upper right.

The chart also shows a solid line that plots the relationship between earnings and stock prices for non-Morgan companies. Of the 19 Morgan-influenced companies, 15 lie above this line. They had higher stock prices than would be expected given their earnings. In short, investors believed they had better growth prospects than other companies.

On average, adding a Morgan partner to the board of directors appears to have raised the value of common stock by roughly 30 percent. Such an increase does not seem out of line if one considers how much Morgan's financial services cost. For the creation of International Harvester in 1902—a simple and straightforward deal—the investment bankers collected about four percent of the capital value floated; for U.S. Steel the investment bankers' share was 10 percent. Such enormous fees can be justified—if they can be justified—only if the unique value added by this particular group of financiers was substantial, and it appears that it was.

The presence of a Morgan partner was a signal that good things were happening to a company. Good managers were being promoted. Bad managers were being fired. The organization had free access to capital for expansion when it needed it, and thus could take advantage of the opportunities open to it. Experienced businessmen were giving executives advice and warning them of pitfalls.

One famous example of banker intervention is the return to the Bell System of Theodore N. Vail. First hired by Alexander Graham Bell's father-in-law, Gardiner Hubbard, at the end of the 1870s, Vail oversaw the initial expansion of the telephone network to the urban East and Midwest. In 1887, however, he resigned. Vail wanted to plow retained earnings back into the rapid creation of a single national telephone network, but the major stockholders had a different view. They saw that the telephone company was a money machine, and they wanted to milk it for generous dividends.

After Vail's departure, the Bell system did pay high dividends. It also steadily lost market share to local telephone networks. When AT&T tried to raise money for renewed expansion, its massive financing requirements and the approach of the Panic of 1907 brought the Bell system close to default. The Morgan group of investment bankers, led by George F. Baker, was willing to finance the Bell System's expansion drive only if its new president would be someone they were confident could do the job. Who better than Vail?

Vail did for AT&T what he was installed to do. He oversaw its expansion into a true nationwide telephone system. He also turned out to be very skillful at keeping the government and public convinced that AT&T was a productive "natural" monopoly, not an exploitative artificial one. By choosing Vail, the investment bankers enhanced not only shareholders' long-term interests but the long-term economic growth of the United States.

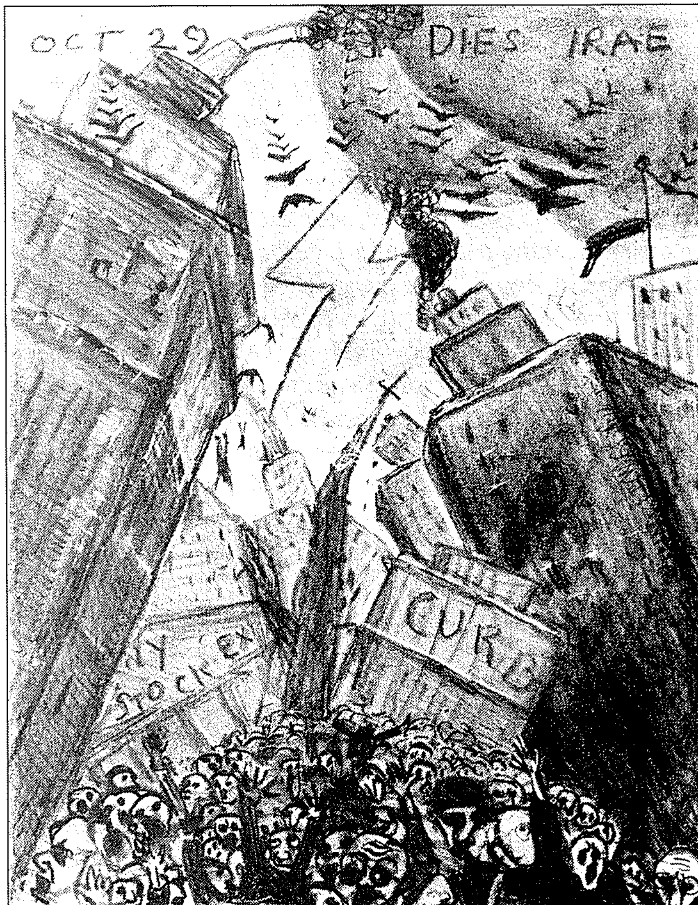
The eve of World War I saw the high-water mark of both the Morgan partnership and the financier-centered system that it dominated. The half century before 1914 had seen Morgan and his peers channel new capital into railroad construction and combination, into steel, into electricity, into telephones, and into the other high-tech growth industries of the day. Investors had followed their lead. And the horses that Morgan had bet on had run well. Thanks in part to the skill with which Morgan had selected industries for expansion and selected executives for large, rapidly growing firms, the United States on the eve of World War I had surpassed Great Britain as the world's economic leader and richest industrial nation.

So why did the Morgan era end? As historians such as Robert Sobel see it, the decline of the House of Morgan occurred in three stages, beginning during World War I. Morgan had always sold bonds quietly to institutions and to relatively wealthy individuals, waiting for them to come to him and ask what securities he might recommend. During the war, however, the federal government's unprecedented deficits created a huge supply of bonds that could not easily be sold by the old means. Enterprising firms, notably Charles Mitchell's National City Bank, seized the opportunity to sell government bonds through aggressive door-to-door sales campaigns, and after the war Mitchell applied the lesson to sell bonds to people who had never thought of buying them before.

The investment banks' imprimatur lost more of its weight during the decade-long bull market of the 1920s. In books such as Edgar Smith's *Common Stocks as Long Term Investments*, middle-class Americans were told that they could reap high profits

by investing in just about any collection of common stocks. Many investors became willing to bet on the genius of financial celebrities such as utility king Samuel Insull even without the implicit warranty of J. P. Morgan & Co. or Kuhn, Loeb.

The third stage was the Glass-Steagall Act in 1933. It forcibly divorced the commercial bankers who had the capital to take substantial long-term positions in firms from the investment bankers who issued securities and set prices. And it removed both from their places on the boards of directors of operating companies, from which they had monitored managerial performance and exercised control.



J. P. Morgan's heirs tried in vain to halt the Crash of 1929, hoping to repeat his 1907 miracle. Financial institutions have never fully regained the public confidence the Great Depression cost them.

The upshot was that after the Great Depression and World War II, American finance looked very different from how it had looked in 1913 or even in 1929.* Investment banking was still an oligarchy, and investment bankers still became rich. But in relative terms they were much less wealthy than Morgan and his partners had been at the turn of the century. And they no longer exercised substantial power over individual companies. No executive of any major American corporation in the 1950s, '60s, or '70s would have said under any circumstances that he wore the Morgan—or the Goldman Sachs, or the Salomon Brothers—collar, as Charles Mellen had said before World War I. America had moved from a loose form of "finance capitalism" to a new "managerial capitalism."

After World War II, the fact that corporate executives no longer answered to investment bankers raised a new question: To whom *did* they answer? Even as the grip of investment banks was being loosened before the war, Adolf Berle and Gardiner Means had suggested in *The Modern Cor-*

*Two developments after World War II further diminished the financiers' power: the rise of Merrill Lynch and other brokerage houses that attracted masses of relatively small individual investors through advertising and provided them with investment advice and tips of dubious value, and the boom of 1945–73, which provided corporations with ample profits for reinvestment, sparing them the need to go to the capital markets, and thus investment banks, for additional funding on a regular basis.

poration and Private Property (1932) that corporate executives had become effectively independent. They could use the resources of the firm to get their candidates elected to the board of directors, but there were no effective channels for those who opposed them. Before 1929, stockholders or others seeking a change in a company's management could have gone to talk to one of the Morgans or their partners. If their arguments were convincing, the old management might soon be gone. After Glass-Steagall, such challengers had to find some way of reaching and persuading a scattered and ever-changing cast of shareholders. The lack of a long-term relationship between investors and managers led John Maynard Keynes to these musings in 1936: "The spectacle of modern investment markets has sometimes moved me towards the conclusion that to make the purchase of an investment permanent and indissoluble, like a marriage, except for reason of death or other grave cause, might be a useful remedy for our contemporary evils. For this would force the investor to direct his mind to the long-term prospects and to those only."

Not surprisingly, management teams and boards of directors became inbred. Corporation presidents were no longer appointed because someone in the Morgan partnership had confidence in their skills and energy but because they had built a coalition of supporters within the executive ranks and won an internal tournament for the succession. By the 1970s, government regulators, economists, and others were beginning to ask if American corporations were producing the most value possible for shareholders and if they were maximizing the pace of industrial development. The self-replacing oligarchies of managers often seemed to follow the paths that gave them the highest salaries, the largest empires, and the least risk. As economist John Hicks wrote, "The best of all monopoly profits is a quiet life."

In recent decades there have been two unsuccessful attempts to restore balance to the relationship between owners and managers. The conglomerate movement of the late 1960s and early '70s, for example, created a new form of economic organization with many parallels to the old "finance capitalism." Conglomerates such as ITT combined many different operating units, each pursuing independent businesses, under one top financial management that provided the units' capital, chose their executives, and monitored their performance. A chief executive like ITT's Harold Geneen would deal with the bosses of the conglomerate's operating companies much as J. P. Morgan and George F. Baker had dealt with Theodore Vail and others.

The first conglomerates worked reasonably well, but those created in the 1970s did not. In fact, the leveraged buyout (LBO) movement of the '80s was in many respects a partial undoing of the previous decade's conglomerate-creating mergers. The LBO movement was also sold as a way of forcing discipline on corporation managers: Corporations took on extraordinarily high levels of debt, and managers set to work to repay it under the implicit threat of losing their jobs and their savings if they failed. Economist Michael Jensen of the Harvard Business School proclaimed the end of the public corporation and the coming of organizations in which financiers would be the bosses. "In effect," Jensen wrote in 1989, "LBO partnerships and the merchant banks are rediscovering the role played by active investors prior to 1940, when Wall Street banks such as J. P. Morgan & Co. were directly involved in the strategy and governance of the public companies they helped create." But the LBO era was coming to a close even as Jensen wrote. The first LBOs, like the first conglomerates, were success-

ful, but later ones were not.

These two waves of financial innovation got as far as they did in part because financiers believed there was money to be made by correcting flaws in the post–World War II system of American finance and by imposing new forms of supervision on corporate executives. The fact that both waves ultimately failed suggests that there remains a need for something new—or perhaps something old—in American finance.

The Morgan partnership had a vision of industrial development in which corporate executives had relatively little discretion and in which "community of interest" was to replace "competition" as the watchword. Progressives believed that this was the wrong vision of economic development for America's future—and that, indeed, its worst flaw was that Morgan could come close to implementing it. In the generation after World War II it appeared that the progressives had been completely correct. American companies earned high profits. American technology and productivity levels were the best in the world. Economic growth was strong.

But no longer. Economic growth in recent years has been lackluster. American technology has not been as dominant as it once was. And productivity growth in U.S. industry now lags behind that of Germany, Japan, and other major competitors. These setbacks have triggered a reexamination of how the American industrial order works, and a reconsideration of the Morgan model.

That German and Japanese securities markets to a large degree still hew to the turn-of-the-century "finance capitalist" pattern suggests that such a reconsideration is not unrealistic. The growth of "finance capitalism" in Germany paralleled the rise of the House of Morgan in the United States: The largest of the German *Grossbanken* (great banks), the Deutsche Bank, had representatives on the boards of 159 companies in 1912. Germany's "great banks" played a Morgan-like role in monitoring and supervising corporate managements. Yet while the Morgan partnership had perhaps a few dozen analysts and partners, the Deutsche Bank had analysts, engineers, and industry experts by the hundreds. It was capable of doing much more thorough and detailed analyses, and of providing much more soundly based advice, than the Morgan bank. Morgan railroad expert Charles Coster was a director of 59 railroads. How thorough could his knowledge of each have been? The German system, though weaker than it once was, is still relatively strong. In corporate elections individual German shareholders routinely authorize the Deutsche Bank to vote their shares for them as it sees fit.

In Japan, the prewar *zaibatsu* and their more diffuse postwar *keiretsu* replacements played similar roles at the turn of the century and do so today. Banks and trading companies in these "enterprise groups" exercise influence over the policies and senior-personnel appointments of the affiliated companies. Should an industrial company run into trouble, the enterprise group is there to assess the situation, shift directions, and pump in additional expertise and resources. In 1973, for example, the tripling of oil prices suddenly knocked the bottom out of the market for Mazda Motors. Mazda had bet heavily on its technologically sophisticated Wankel rotary engine, but the Wankel required more gasoline per mile than conventional engines. The enterprise group examined the corporation, concluded that its problems were the result not of bad management but of bad luck, and financed its reorganization and restructuring. It was quite a different story when Chrysler ran into trouble in the late 1970s. A lobbying campaign yielded

government money and restrictions on competing imports that restored the company to short-term profitability. But as analysts Jack Donahue and Robert Reich have pointed out, the government did not require the kinds of internal changes needed to rapidly improve the corporation's productive efficiency.

In Britain, finance followed an entirely different course. As historian Alfred Chandler notes, Britain at the turn of the century clung to a form of "personal capitalism:" Founding families kept large stakes in their companies and continued to manage them. Investment bankers and salaried managers, so important in the United States, Germany, and Japan at the time, played only a small role in Britain. And Britain commenced a relative industrial decline at the turn of the century. In Arthur Lewis's words, by the end of the 19th century, "organic chemicals became a German industry; the motor car was pioneered in France and mass-produced in the United States; Britain lagged in the use of electricity, depended on foreign firms established there, and took only a small share of the export market. The telephone, the typewriter, the cash register, and the diesel engine were all exploited by others."

Yet even as this was happening, British investment overseas surged. Britain had vast amounts of capital, but British investors did not believe that it was worth investing in British industry.

Comparisons across nations and across eras are tricky. Nevertheless, industrial economies that grew extraordinarily fast—Germany and Japan before the Great Depression and after World War II, the United States before the Great Depression—had "finance capitalist" forms of organization. Countries that grew more slowly—Great Britain, the post–World War II United States—did not. And the continued viability of "finance capitalism" in Germany and Japan suggests that the system's relative decline in the United States was not a "natural" development of the market.

The ills of the contemporary American corporation—the near-autonomy of management, the influence of the skittish stock market—appear to call for large-scale financial institutions to take an interest in corporate management by establishing and holding major long-term positions in individual companies. The ills of the corporation appear to call for more waves of financial innovation and reform, such as the conglomerate and LBO movements, to alter the balance between financier control and executive autonomy. Among liberals in particular there is wide agreement on the need for such a readjustment. The Glass-Steagall restrictions, already being eroded by Washington regulators, seem to have little remaining purpose. Lester Thurow of MIT now calls for the rise of "merchant bankers" in the United States who will do for American industry what the Deutsche Bank does for German industry or the Mitsubishi *keiretsu* does for Japanese industry—or what J. P. Morgan & Co. did for American industry nearly a century ago. It is an irony that today the intellectual descendants of the progressives are among the strongest voices calling for a return to "finance capitalism."

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-

Roy C. Smith *is a professor of finance and international business at New York University and a Limited Partner at Goldman, Sachs & Co. He is the author of* The Global Bankers *(1989) and* Money Wars *(1990). His new book* Comeback: The Restoration of American Banking Power in the New World Economy, *will be published in February by Harvard Business School Press.*

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."

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.

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.

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

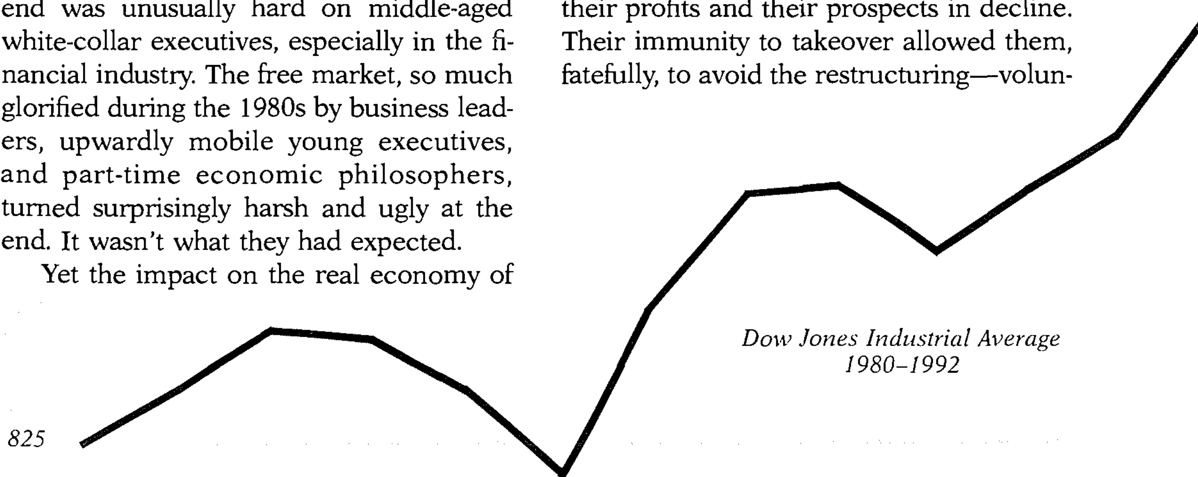
new man, who has his way to make in the world, knows that such changes are his opportunities.... The rough and vulgar structure of [such] commerce," Bagehot said, "is the secret of its life."

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."

3350

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

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.

Copyright © 1990 by *Harper's Magazine*. All rights reserved. Reproduced from the September issue by special permission.

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.

From *Money of the Mind: Borrowing and Lending in America from the Civil War to Michael Milken* by James Grant, published by Farrar, Straus & Giroux.
Copyright © 1992 by James Grant. All rights reserved.

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.

BACKGROUND BOOKS

AMERICAN FINANCE

In the hands of a creative scholar, the history of the United States could be rewritten as a continuing struggle over money and credit. The historian might argue that the contest has pitted "hard money" men, the industrialists and centralizers, against democrats, the advocates of decentralized power and "soft" money.

The writer might begin with Secretary of the Treasury Alexander Hamilton's 1790 Report on Public Credit, which proposed that the new federal government repay all the Revolutionary War debts of the states at full value. Hamilton prevailed over those who howled that the measure benefited the "moneyed interests" only by agreeing to locate the new national capital far from the perfidious money men of New York City, on the banks of the "Potoumac." And there in the national capital, two centuries later, the thread might end in today's recriminations over the treatment of the "moneyed interests" in the savings-and-loan crisis and other affairs. Between these two points the narrative would wind through the battles over the first and second national banks, the memorable assault on the "cross of gold" by William Jennings Bryan, and the New Deal.

In fact, that is a highly simplified (and chronologically altered) version of the history that *was* written by Charles A. and Mary R. Beard in **The Rise of American Civilization** (1927, 1930, 1933, since revised and reprinted many times) and other works. The Beards' thesis has long since been found wanting in the counting houses of academe—the interests were never so neatly divided as the Beards thought, historians say—but on the centrality of contests over money and credit much agreement remains.

Arthur Schlesinger, Jr.'s **The Age of Jackson** (1945, reissued 1988), for example, casts the epic battle over the Second Bank of the United States (1816–36) as a defining episode in American politics. The Philadelphia-based bank was chartered in 1816, empowered to create a more uniform national currency by indirectly regulating the many banks throughout the country that issued their own bank notes. Arrayed against it, Schlesinger notes, were a variety of interests: "hard money" Jeffersonians such as President Andrew Jackson, who opposed paper money in principle, and other democrats, mainly in the West, who only wished that there were more paper money to go around. Jackson spoke for many when he declared, "The Bank of the United States is in itself a Government.... The question between it and the people has become one of power." Jackson finally destroyed the bank, but Schlesinger believes that the victory hobbled American liberalism with an anti-statist legacy for the rest of the century.

Out of the bank crisis emerged what economist John Kenneth Galbraith calls the "great compromise." In the settled states, he explains in **Money: Whence it Came, Where it Went** (Houghton Mifflin, 1975), there was "hard money": gold, silver, or bank notes issued by state-regulated banks "with a firm disposition to redeem them" for specie. On the frontier, banks and bank notes alike were more plentiful and correspondingly less reliable. The mainstay scholarly histories of these matters include **A Monetary History of the United States, 1867–1960** (1963), by Milton Friedman and Anna Schwartz; **Financial History of the United States** (1952), by Paul Studenski and Herman E. Krooss; and **Banks and Politics in America** (1957), by Bray Hammond.

The debate over paper money and related issues, observes Irwin Unger in **The Greenback Era: A Social and Political History of American Finance, 1865–1879** (1964), "set the terms of American political conflict" from the Civil War to the turn of the century. **Money and American Society, 1865–1880** (Free Press, 1968) by Walter T. K. Nugent is another major study of the era. During and after the Civil War, the federal government did several things that set the stage for conflict. It restricted the ability to issue bank notes to some 1,600 banks, mostly in the East, with new national charters. It also attempted to withdraw from circulation the "greenbacks," not backed by specie, it had issued to pay for the war effort. These and other measures shrank the money supply and caused farm prices to drop. They also helped the Greenback Party to elect 14 of its candidates to

Congress in 1878.

An even more formidable political movement, populism, gained impetus from the 1873 abandonment of silver as a monetary standard. Washington's great effort to appease the populists, ironically, would ultimately cause a run on the Treasury's gold reserves and force Congress to turn for help to J. P. Morgan, the personification of everything the populists detested. When Morgan was again pressed into service as a private central banker during the Panic of 1907, the country had finally had enough. In 1913 Congress established the Federal Reserve System to control the currency, regulate banks, and act as lender of last resort.

Nearly 80 years after his death Morgan continues to be an object of fascination. He has had more biographers than most U.S. presidents. Two of the livelier older portraits are Lewis Corey's **The House of Morgan** (1930), which is all angry debits, and Frederick Lewis Allen's **The Great Pierpont Morgan** (1949), all graceful credits. Vincent Carosso's recent **The Morgans: Private International Bankers, 1854–1913** (Harvard Univ. Press, 1987) is a scholarly yet very readable account of the Morgans and their enterprise; Ron Chernow's **The House of Morgan: An American Banking Dynasty and the Rise of Modern Finance** (Atlantic Monthly, 1990) follows the fortunes of the original Morgan firm's progeny to the present.

President Franklin D. Roosevelt surely had the Morgans in mind when he declared in his first inaugural that "the money changers have fled from their high seat in the temple of our civilization." FDR vastly expanded public control over credit through the provision of farm loans, federal deposit insurance, and the like. The long history of the "democratization" of credit is reviewed with gallows cheer by James Grant in **Money of the Mind: Borrowing and Lending in America from the Civil War to Michael Milken** (Farrar, 1992).

The Beards would have been hard put to fit the 1980s into their scheme. The decade produced a cascade of chronicles and interpretations (reviewed by Michael M. Thomas in *WQ*, Winter 1992). It found a Republican administration presiding over an expansion of public and private credit so explosive as to kill a 19th-century populist with joy. True enough, financial wheeler-dealers were bathing in Dom Perignon in gold-plated bathtubs, but it was possible even for the average American's pet dog to obtain generous credit. And although some Democrats helped open the taps, most have wagged their fingers at all the mischief as sternly as . . . as J. P. Morgan might have.

The strongest endorsement of reviving Morgan-like methods today is Lester Thurow's **Head to Head: The Coming Economic Battle Among Japan, Europe, and America** (Morrow, 1992). But there is a considerable spectrum of opinion about the future of American finance. In **The Work of Nations** (Knopf, 1991), Harvard's Robert Reich advocates a federal investment bank to channel capital into selected industries. Glenn Yago, an economist at the State University of New York at Stony Brook, argues for a laissez-faire approach in **Junk Bonds: How High Yield Securities Restructured Corporate America** (Oxford Univ. Press, 1991), a scholarly vindication of Milken's great innovation.

Among those staking a claim to the middle ground are Michael E. Porter of Harvard Business School, whose forthcoming book (due next year from Harvard Bus. Sch. Press) is previewed in his *Harvard Business Review* (Sept.–Oct. 1992) essay, "Capital Disadvantage: America's Failing Capital Investment System." Like Thurow, Porter argues that corporate America needs long-term investors to function properly: "The most basic weakness in the American system is transient ownership." But while Thurow looks to a new breed of financier to remedy this deficiency, Porter argues that corporate executives themselves must recruit long-term "owners" from the ranks of investors.

What all of these writers seem to agree on, however, is that the post-Morgan era of "managerial capitalism" is over. The effort to make business executives more accountable to owners will powerfully shape the future of American finance.