PART I

IN PERSPECTIVE

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Past Blunders and Future Choices

In March 1988, less than six months after the stock market crash of 1987, I extolled the value of financial history to an audience at the New York University Graduate School of Business Administration, and reviewed the key linkages between the explosion of debt and the financial crisis. It would seem pedestrian to exclaim now, 20 years later, that the more things change, the more they stay the same. In 1988, there were too few financial historians, yet the need for them was great (and more so today). Consider the many financial mishaps, abuses, and official policy mistakes that might have been avoided if our financial managers and leaders had gained from these scholars a well-rounded historical financial perspective.

The need for such a perspective was great in 1988 and remains so. Our financial structure both in the United States and abroad continued to change radically. The willingness to take risks remained high, while credit quality deteriorated. Indeed, we were not terribly clear about what we really wanted from our financial system then (a situation that worsened in the intervening 20 years), and how and to whom it was to be held accountable. The occasional stringencies, extreme volatility, and abuses in our financial markets consumed our attention and sometimes induced official inquiries—such as the Brady Report of 1987.

Prior to becoming U.S. Treasury secretary in 1988, Nicholas F. Brady chaired the Presidential Task Force on Market Mechanisms, which was charged with looking into the causes of the 1987 stock market crash. By and large, however, little was—and continues to be—done through constructive policy changes.

I reminded the audience that financial change was continuing at an extraordinary pace, leaving in its wake opportunities that many sought and high risks that few chose to acknowledge, with the main antidote (at least within the first six months after that crash) from the academic and business worlds a call to teach business ethics. This was not enough then (nor is it enough now). Attempts to deregulate morality have long been part of man's struggle against evil. Ethics and morality are forged in our early upbringing and can, at best, be rekindled at a university, while the lessons of financial history can be fully grasped only with further study.

Many of the distinguishing features of financial life in the twentieth century had historical counterparts. For example, the difficulties our financial institutions experienced periodically with their loans to developing countries such as Mexico, Argentina, and Brazil over the past three decades hardly are unprecedented. International debt had been a recurring problem. Financial history is full of moratoriums, defaults, and confiscations—even though some took false comfort that their loans were safe because sovereign powers, in contrast to business corporations, cannot disappear through insolvency.

A few illustrations over many centuries should make the point clear. In the fourteenth century, when Florence was the world's key banking center, the two leading banking houses collapsed because they had extended too much credit to Edward I, Edward II, and Robert Anjou, King of Naples. The lenders never could get at the collateral that was to secure the loan. As Professor Benjamin Cohen related in his book on this incident, *In Whose Interest? International Banking and American Foreign*

Policy (New Haven, CT: Yale University Press, 1986), "Instead of being repaid, the lender was willy-nilly forced to lend more and more and to throw good money after bad in the hope of saving what he had already lent." When England pioneered new horizons in international finance in the nineteenth century, many initial successes were followed by debt problems. There were widespread losses and defaults during the numerous crises in that century involving countries and financial institutions. For example, Baring Brothers, one of the most famous British banking houses, had to be bailed out by the Bank of England and by other institutions when it overextended itself to a weakening Argentina in 1890. All this did not change much in the early part of the twentieth century. Nearly $12 billion of foreign bonds was floated in the United States between 1920 and 1931—a huge sum by the standards of that time—but by 1935, nearly 40 percent of the value of the foreign bonds listed on the New York Stock Exchange was in arrears.

The excessive use of leverage, an ongoing theme throughout financial history, contributed to the failure of 14 railroads during just one panic and to the collapse of 600 banks in another panic during the nineteenth century. The immediate predecessor to the wave of leveraged buyouts and high-risk debt financing that swept the U.S. markets in the 1980s was probably the activities of public utility holding companies in the 1920s. Many of these holding companies financed the acquisitions of independent operating units through the excessive use of debt. When financial problems surfaced for these companies, they were often caused by their subsidiaries' going into arrears on their preferred stock dividends and eliminating their common stock dividends. This choked off all the cash flow to the holding companies, which, in turn, had their own heavy debt burdens and preferred stock dividends to meet.

In their heyday, the public utility holding companies employed new financing techniques with the same zeal that the corporate issuers began to embrace in the 1980s, then just beginning to be known as innovative financing or financial engineering. The techniques employed back in olden times to secure legal control over operating companies included the following: (1) the issuance of a huge volume of bonds; (2) the issuance of nonvoting preferred stock; (3) the issuance of different classes of common stock, with only one having the controlling voting power; (4) the establishment of voting trusts with the shares in the hands of a few voting trustees; and (5) the issuance to the controlling interests of large numbers of stock-purchase warrants.

We also should not be surprised when financial heroes of the moment eventually turn out to be villains who contribute to the corruption of finance. In the eighteenth century, John Law rose to fame; he helped to stabilize the tottering financial situation in France by having his private bank redeem all of its notes in gold at a fixed rate. Yet he later fell into disrepute when he decided to devalue the currency, following a spectacular career in which he manipulated, among other things, the stock of his Mississippi Company. Charles Ponzi is noted for his financing scheme, wherein he paid off existing investors with new funds obtained from others until this pyramid finally fell apart in 1920. Ivan Kreuger, known as the Match King, was a powerful industrial leader in the early twentieth century, especially in the 1920s. He amassed huge debts to finance his sprawling empire in matches. However, much of the vital information regarding his companies and their assets was not documented, but rather was stored only in his head. Many confidants, subordinates, banks, and even some accountants never questioned his methods. When he committed suicide in 1932, he probably left behind the largest bankruptcy recorded up to that date.

The world of the late 1980s was, in many ways, strikingly different from the past. Rapid changes swept the landscape, and national governments found it increasingly difficult to cope in that environment. In this sense, the private sector was leading and governments were lagging. The integration of world economies continued at a fast clip. World markets established prices of commodities such as wheat, coal, and oil, along with clothing, automobiles, and semiconductors. Since the 1960s, satellites, fiber-optic communications, airplanes, and container ships had contributed much to a more integrated world economy. To my audience in 1988, the changes that had occurred in 20 years were hardly noticeable, but they were worth mentioning—for the historical perspective and reference.

On the financial side, one feature that distinguished this time from earlier periods was the rapid and large growth of debt, without intervening periods of debt rollbacks. This rapid increase had occurred in all major sectors—households, businesses, and government. During the 1980s alone, the growth of debt exceeded that of nominal gross national product (GNP)—an unprecedented trend. In earlier times, large increases in debt were stemmed by financial crises and panics, which induced large debt liquidations through bankruptcies and reorganizations. Although the United States had experienced several financial crises within the prior 25 years, the overall accumulation of debt continued unabated. The crises in those times were contained by improved official policy management and official international monetary cooperation to a larger degree than were crises in the pre–World War II period. The success of those policies, however, made market participants more confident. Few entities actually failed, and many survived.

The ability to overcome these crises thus contributed to the growth of debt and the liberalization of credit standards. We had come to accept the rapid growth of U.S. government debt, far beyond any level thought possible by policy makers just a decade or two earlier, and households and businesses had assumed debt burdens that absorbed huge shares of their income. Among our financial institutions, we had some very large banks that had bonds that barely merited investment-grade ratings and a few with bonds that had fallen below that level. Without deposit insurance, these institutions would have been out of business. How could they attract deposits at very low costs and make loans to borrowers who had credit ratings higher than the banks themselves?

In the business sector, in particular, the so-called decapitalization of corporations, mainly through the substitution of debt for equity through mergers and leveraged buyouts, became a dominant feature of corporate finance. From 1984 to 1988, this activity resulted in an unprecedented number of corporate bonds having their credit ratings downgraded. Indeed, the financial crises that took place in the 1960s and in 1970, when interest rates (by the standards of the day) were relatively low, made a greater impression on market participants than did the crises that occurred during that decade. For example, when, for the first time in the postwar period, institutions experienced substantial disintermediation during the credit crunch of 1966, fears abounded. A kind of a paralysis came over the financial markets, even though the prime loan rate at its peak reached only 6 percent and high-grade corporate bonds moved to 6.3 percent. When the Penn Central Railroad failed in 1970, the market went into deep shock. At the time of both crises, the financial system was closer to being immobilized than when the prime loan rate reached 21½ percent early in the 1980s.

Thus, it should not be surprising that the volatility of securities prices and of currencies had become a deeply rooted feature of our new financial world, and that this, too, was markedly different from earlier times—especially in the fixed-income markets. The dramatic increase in volatility is readily apparent if we consider the differences between the high and low yields of high-grade corporate bonds for each year since 1920. This difference averaged well under 50 basis points from 1920 through 1969, rose to 98 basis points in the 1970s, and then jumped to 273 basis points in the 1980s.

There were at least five causes for the dangerous volatility in securities and currency prices I pointed to at the time: I ranked as first and second of these causes financial deregulation and innovation. They combined to make money and credit highly mobile. Many securities were deemed marketable and readily priced; portfolio performance was monitored closely; and many derivative instruments—the simplest of which are futures and options—were created and could garner large rates of return (and also losses) through only moderate price movements. As the Brady Report of 1987 pointed out, some of the then new techniques, such as portfolio insurance, could exaggerate a near-term price trend even though the approach was supposed to limit the risk of the user.

Third, I also identified the globalization of financial markets as a major factor in increased volatility. The U.S. stock market did not collapse in a vacuum on October 19, 1987. On the contrary, major markets abroad all fell, and some plunged even more than the U.S. market. The withdrawal of investors from markets foreign to their own countries had a significant negative impact around the world. Similarly, foreign bond buyers exerted a powerful influence on the U.S. bond market. For example, when Japanese institutions were large buyers in the U.S. Treasury's quarterly financing operations, the bond market strengthened. When they and other foreign investors hesitated—as they do when the financing occurs during a period of U.S. dollar pressure in foreign exchange markets—the bond market quickly gave ground. Even foreign official institutions' buying of dollars to stabilize the price did not necessarily steady the price swings in securities markets for two reasons: Official intervention does not cure the fundamental underlying disequilibrium; and market participants may sell securities in anticipation of tighter monetary policy in the United States to ameliorate the imbalance.

Fourth, there was the secular underlying trend of the institutionalization of savings, which, combined with the increased securitization of markets, continued to contribute to big swings in market prices. Securitization is the vehicle through which financial assets can move in and out of institutional portfolios, and the institutionalization of savings is concentrating portfolio and investment decisions in the hands of fewer participants. Thus, we came to have a fundamental anomaly: On the one hand, the market, through securitization, created an increasing proportion of supposedly marketable credit instruments; on the other hand, the investment decision came to rest with large institutions rather than with a wide range of participants who may have held diverse market views. The Brady commission report hinted at this phenomenon when it described the hectic trading activities of that October shock. As this concentration of investment decision making continues through the institutionalization of savings, marketability, in its truest sense, will regress, and volatility will continue to rise until institutions and markets take on new forms and structures.

Finally, in the new financial world of the latter part of the twentieth century, the prices of securities had become much more a vehicle for trying to achieve economic stability. At first blush, this seems incongruous: the quest for economic stability through financial market volatility. But, as I pointed out in 1988, the reality is that there were no real financial circuit breakers that would assist the Federal Reserve in its task of stabilizing economic activity. Obviously, fiscal policy is not timely enough. Therefore, market participants had become extremely sensitive to the slightest shifts in monetary policy, both in the United States and abroad, as they tried to benefit by anticipating whether the Federal Reserve was moving toward higher or lower interest rates. As a result, I explained, we would continue to experience dramatic responses in market prices when the Fed eased or tightened.

The intransigence of volatility had also been a powerful contributor to the high level of inflation-adjusted (real) interest rates in that 1980s environment. Although there had never been a constant real interest rate, the high level of real rates at the time was nevertheless striking and markedly different from earlier periods.

Inflation-adjusted high-grade corporate bond yields had averaged 5.8 percent in the 1980s (a period in which volatility had been very high) and 1.1 percent in the 1960s and 1970s (a period in which yield volatility was moderate). It is, of course, reasonable to conclude that there will be additional compensation for the additional risk that results from increased volatility.

Where did this leave us in 1988 in terms of what to expect for the future? I then lectured and wrote that the transformation of the economic and financial markets would continue, and while the powerful forward movement of world economic and financial integration might occasionally face obstacles, the trend could not be denied.

The world would be linked even closer in the coming decades, as we reaped the benefits of ongoing technological progress. It seems almost quaint to recall that at the time some experts claimed that by the year 2000 microcomputers would be as powerful as a 1988 mainframe and that industrial countries would be covered by digital communication networks that communicate among businesses and homes with high-powered fiber-optic links.

Other economic developments would challenge our world. Despite improvements, manufacturing would not likely be a major factor in GNP growth over the 1990s. The shift of production from goods to services would continue. Economic development tends to follow an irregular trend from agriculture to manufacturing and then to services. I noted that we would have to adjust to significant changes in the labor force. According to studies being issued in the late 1980s, for the rest of that century the composition of the workforce would change more slowly than at any time since the 1930s. As a result, the average age of the working population would rise, and the number of young workers would shrink. Moreover, minorities would probably comprise a larger percentage of the newcomers into the labor force.

In the financial arena, harnessing the dynamism of the financial markets to the constructive use of society was an urgent problem that had to be addressed to avoid a major economic and financial calamity. The primary benefits of these changes are supposed to be lower financing costs and the offering of a wide range of investment alternatives to savers. Although these are laudable benefits, I told my audience that we could not afford to be beguiled by them.

In the new financial world, the fundamental issue is what mechanism to put in place to govern it effectively. Very little progress had been made on this front, because the real governor of a deregulated and competitive financial world is market discipline. Those who choose well will prosper and those who err will fail. In the financial markets, this discipline is not totally operative. The risk to society is deemed to be too high. The failures of large institutions, with numerous transactions and relationships with other institutions both in the United States and abroad, are considered essential and could induce systemic risks if allowed to flounder into bankruptcy. The arrangement at that time, therefore, encouraged excessive risk taking, because market discipline was not allowed to work and no other governing approach, through new forms of regulation, was being implemented quickly enough.

This problem was complicated by a group of archaic official regulatory and supervisory agencies. Most had segmented financial market responsibilities at a time when market segmentation was rapidly disappearing. Time would encourage an amalgamation of these supervisory responsibilities into one governing body over financial markets and institutions that can then promulgate integrated roles and conducts of financial behavior. And, I then hoped, such a change would occur before a major financial mishap.

Internationally, a similar, but more intricate, problem confronted us in 1988. Regardless of where domiciled, all major institutions and markets exhibited the complex interplay of money and credit. Nevertheless, there were vast differences among countries in terms of their trading practices, accounting and reporting standards, and capital requirements, among other things. Official international cooperation among major industrial nations would be helpful in dealing with these matters, but it would not be enough.

The dilemma in 1988 was this: How do we overcome the structural rigidities among nations to get the best out of the ongoing economic and financial changes? This is not to say that comparable problems did not exist in the past. The transition from feudalism to the nation-state that came into power with the industrial revolution was difficult, to be sure. However, changes in business and finance happened more quickly in the late twentieth century (and now) and therefore required more finely honed and timely reforms in national policies. Instead, we heard new voices with old themes and prescriptions, especially on economic matters. Fair trade instead of free trade is not a new concept. Calls for denying foreign dollar holders the freedom to express their investment choices are just another step backwards. In the financial arena, it would probably take a long time before the key industrial countries would be willing to relinquish some sovereignty to an official international institution that could oversee and set uniform rules and regulations for all key markets and institutions.

In the meantime, financial markets would continue to be highly volatile. All the forces that contribute to volatility remained operative: financial deregulation, innovation, the trend toward financial globalization, the institutionalization of savings, and a monetary approach that requires huge swings in the value of financial assets to stabilize economic behavior. Prices of financial assets were bound to flare with shifts in monetary policy, around cyclical turning points in the economy and in response to market bubbles, which were likely to be an endemic feature of our new financial world.

The setting in 1988 raised perplexing issues for the Federal Reserve. Could the Fed, for example, correctly gauge the market's response to a tightening of policy and the consequences for the economy of such tightening actions? When the Fed firmed policy in 1987 in response to the weakening dollar and heightening inflation expectations, the negative market reaction was concentrated in the fixed-income markets for nearly a half a year, while the stock market crumbled only belatedly. The quick, substantial monetary easing that followed in late October 1987, together with other factors, muted the impact on the economy. A business recession was averted, and inflation expectations were dampened.

However, the likely firming in monetary policy in 1988 would take place under somewhat different circumstances. Considering the political realities of 1988 and the uncertainties about the economy, a firming in policy would come reluctantly—and only when resource utilization rose and renewed inflation actually showed up in the numbers.

Nevertheless, any delay in monetary firming, or the prospect of a delay, would not be ignored by the bond market. Given the different environment in 1988, the stock market would not be likely to stand by idly as long as it did in 1987 before it reacted adversely again. A synchronized drop of bond and stock prices could thus provide the early warning sign of another business recession.

For the Federal Reserve, the new financial landscape would also mean that its function as lender of last resort would expand, unless we accepted the discipline of the marketplace, which was highly unlikely. This would reflect the blurring of distinctions among institutions, the continued large volume of open market transactions, and efforts to hold marketable assets rather than longer-term financial arrangements. These, during moments of difficulty, would force the Fed to intervene and provide comfort beyond the traditional commercial banking link. Moreover, as long as the U.S. dollar continued as the key reserve currency, the Federal Reserve would also have to be a much bigger international lender of last resort, which could become extremely difficult as long as the rapid changes in the international financial markets outpaced the skills, the knowledge base, and the authority of the prevailing informal cooperative effort among central banks.

Events eventually tend to meet countervailing forces, and the financial world is no exception. One of these was a massive consolidation of financial institutions as a result of increased deregulation, innovation, and technological costs of doing business. Having let the genie out of the bottle, many traditional financial institutions had assets and liabilities that served them well in the segmented markets of prior times but that were cost-embedded and came to create new losses. They would not survive the changes that were under way.

To the Federal Reserve, an eventually greater concentration of financial institutions would ease the complexity of monetary policy for two reasons. First, by definition, it is easier to carry out policy effectively when it involves few instead of many. Second, the huge financial institutions that I saw coming would be vertically integrated, thereby keeping in-house many activities that in the mid-1980s were transacted in the open credit markets. Thus, financial concentration would ultimately diminish open market activity. Although a financial system dominated by a few large institutions could make it easier for the Fed to implement policy, it might not serve the public best. The financial system would be less competitive and one step removed from substantial government domination.

In 1988 I suggested that the first evidence of greater government involvement in the marketplace was probably only a few years away, and that it would occur when the next recession hit. Alleviating the debt burden would be difficult in the short run. Never in the postwar period had so many been so excessively leveraged. The entire explosion of the high-yield, low-quality junk bond market was the product of the economic expansion of that time. And while financial institutions still held a large and questionable volume of foreign loans, they were massive lenders to a deteriorating corporate sector. At a minimum, monetary policy would have to ease decisively and broaden the official safety net. Moreover, monetary policy would probably have the sole burden of resuscitating the economy. Fiscal policy may not be sufficiently stimulative right away, because the U.S. government would have a huge budget deficit of its own before the start of the next recession.

The transformation of financial markets is a natural attribute of a changing world. After all, the essence of life is continuous change. Nevertheless, we should be aware of whether what we consider to be new has actually occurred before. At a minimum, poor financial practices should not be repeated. Here, knowledge of history can be instructive. The profound financial changes that came about in the 1980s posed substantial challenges that needed to be addressed: (1) the rapid growth of debt, which was generally deteriorating in quality; (2) the sharp increase in the volatility of financial assets and currencies; (3) the absence of effective official governing bodies for markets and institutions both in the United States and abroad; and (4) the lack of a code of conduct in the financial markets.

A code of conduct is as essential for financial markets as it is for society as a whole. After all, we in financial markets have a great public trust. We hold the savings and temporary funds for all of society. How well we carry out this responsibility has a great impact on economic progress and, as history clearly shows, we in the financial markets will never escape public scrutiny and judgment.