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The Longest Boom: An Economic Milestone

Why the Long Boom? It Owes A Big Debt to Capital Markets

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WASHINGTON -- As the U.S. economy enters record territory Tuesday -- beginning its 107th month of uninterrupted expansion -- expect to hear a lot about the usual heroes: new technologies (the microchip, the Web); U.S. Federal Reserve Chairman Alan Greenspan; dumb luck.



But with all due respect, it is time to give credit where credit is due -- to something much harder to appreciate than PCs and people. Thank the capital markets.

Among all the factors bolstering America's economic performance over the past nine years, a less-heralded but equally crucial force has been the evolution in the way money flows from those who have it to those who want it. This new economy, where financial risk is swapped, shared and spread through manifold channels, has more zip -- witness the explosion in technology start-ups -- and it enjoys new protection against the painful attacks that periodically afflicted the old one.

Over the past decade, "we've developed a much more stable financial system -- based almost entirely on markets rather than banks," says Robert Hall, the Stanford University economist who heads the committee of scholars who officially date business cycles. That, he says, "turns out to be a much better way to run things."

A Haunting Vulnerability

Yet the same capital markets that have fed the boom may also be planting the seeds of the next bust. For all their advantages, derivatives and the other financial tools of the new economy have injected unprecedented leverage and complexity into the system -- elements that could transform a minor economic dip into a calamity. That's why the stock-market jitters of late haunt celebrations of the record economic boom, raising fears that a mere correction could spiral into something far worse.

"Every time you solve one problem, you create a few new ones," says Gary Gorton, a derivatives expert at the University of Pennsylvania's Wharton School, who warns of "new vulnerabilities in the system."

What's unnerving is that no one knows which forces in this new financial world -- the stabilizing or the destabilizing -- will dominate. This grand experiment, conducted during a long period of tranquility, has yet to be fully stress-tested.

The signals from the biggest test to date -- when problems in Asia and then Russia precipitated a crisis in U.S.

credit markets in the fall of 1998 -- are mixed. It is telling that the crisis was worsened by the bad bets of financial whizzes and Nobel Prize-winning economists at the Long-Term Capital Management hedge fund -- a group of investors who, in theory, should have better understood the risks they were taking. Yet a few months after President Clinton declared "the worst financial crisis in half a century," market conditions had returned to normal with no signs of lasting damage.

Indeed, America's capital markets appear to be evolving into resilient animals. Traditional banking has faded in importance, and savings-and-loans much more so. Instead, even Americans of modest means can enjoy the benefits of 401(k)s and home-equity loans, while more sophisticated players use derivatives, asset-backed securities, initial public offerings and venture-capital funds to raise money and to hedge their financial risks.

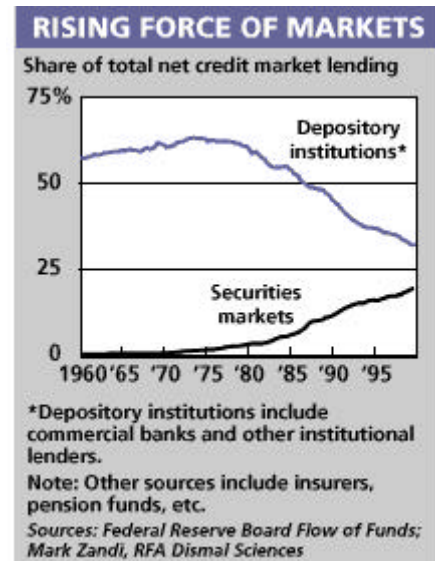
Technology is as much a benefactor as a beneficiary of the 1990s financial revolution: The plunging cost of computing power has made it possible -- and profitable -- to conduct the countless calculations that underlie new financial products. Among the most important of these tools are derivatives -- contracts that allow an investor to buy protection from, or to gamble on, changes in the prices of stocks, bonds, currencies or just about anything else. The "notional," or face, value of all derivatives contracts outstanding at the middle of last year was \$92 trillion, according to Swaps Monitor, an industry newsletter. That was nearly quadruple the \$24.6 trillion outstanding at the end of 1992.

For global companies, such instruments have become essential for the smooth running of their operations. **Merck & Co.**, for instance, does about half its business overseas, so the dollar's surge in the 1980s "really put a crimp in the performance of the company" as the dollar value of foreign revenue fell, recalls Chief Financial Officer Judy Lewent. In response, the New Jersey-based pharmaceutical company was repeatedly forced into sudden cutbacks in planned research and development spending and capital investments.

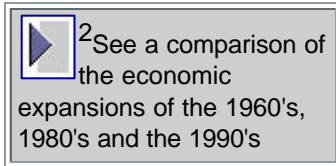
Beginning in 1989, Merck started hedging against foreign-exchange movements, a practice honed throughout the decade. Thus, even as the dollar surged against the euro last year, Ms. Lewent says, "we were able to go through the year and continue our budget commitments to our operating people."

The list of risks that derivatives allow companies to insure themselves against keeps growing. Wichita, Kan., energy company Koch Industries Inc. set up a weather derivatives group about two years ago and soon after started offering "temperature" hedges to other energy providers. When a New England winter is warmer than normal, participating utilities there can receive a payout from Koch to ensure a steady revenue stream. If the winter is colder than average, the firms pay Koch some of the windfall. Last summer, Koch started offering derivatives based on heat and rainfall that let amusement parks protect against weather-related drops in business. This winter, it is peddling snowfall derivatives to ski resorts worried about light accumulation.

Another important element of the financial revolution has been the spread of asset-backed securities -- securities that banks and other lenders issue backed by their own loan portfolios. In the third quarter of last year, the total value of mortgage and other asset-backed securities outstanding in the U.S. stood at \$2.96 trillion, according to the Bond Market Association trade group. That's up from \$374.5 billion in 1985. The market was once dominated by home mortgages, but has expanded to include commercial mortgages, loans to business, credit cards and auto loans.



Before asset-backed securities, or securitization, the heavy risk of lending used to land solely on the bank making the loan. But when banks turn around and sell their loans as securities, countless investors around the world each take on a small portion of that risk.



When oil prices plunged in the mid-1980s, many Texas drillers went bust, dragging a good number of local creditors with them. "The lights went out at the local banks," says Jeffery Gunther, a researcher at the U.S. Federal Reserve Bank of Dallas. As a result, other businesses and households with no ties to the oil industry "had a hard time getting credit."

Today, however, if a major Texas borrower goes bust, "that property is just a \$1,000 commercial mortgage-backed security bond in some portfolio manager's portfolio in Boston, and the rest of his portfolio is fine," says Reilly Tierney, a research analyst specializing in asset-backed securities for Fox-Pitt, Kelton Inc. in New York. "The risk is shared among so many more risk-takers that people don't stop lending."

The expansion of capital markets by such methods means that the U.S. now has more of what Mr. Greenspan calls "spare tires" in its financial system, with money available from many different types of lenders and investors. That lowers the odds that any one pothole -- a banking crisis, for example -- will bring the economy to a screeching halt.

When a real-estate bust forced U.S. banks to curtail lending in 1990, "the then recently developed mortgage-backed securities market kept residential mortgage credit flowing, which in prior years would have contracted sharply," the Fed Chairman noted in a recent speech. "Without the capital-market backing, the mild recession of 1991 could have been far more severe." Since then, those recession-dampening markets have grown even bigger and more sophisticated.

Many economists argue that the more evolved financial markets are also better at nurturing new companies with good ideas. Clubby bankers, who are more likely to support large, established companies than struggling start-ups, have less control over capital. Venture capitalists, eager to find the next Netscape, have more.

Investments by venture-capital funds reached \$28.6 billion in the first nine months of 1999, compared with \$5.8 billion for all of 1995, according to Boston research firm Venture Economics. Such investments have fueled the rise of purveyors and users of untested technologies, such as Amazon.com. Venture capital and initial public offerings have also helped keep various product markets competitive by providing quick funding for new rivals to domineering giants. Hot IPOs last year bolstered bids by VA Linux Systems Inc. and one of its distributors, Red Hat Inc., to chip away at Microsoft Corp.'s operating-system monopoly.

Still, while the broader, deeper capital markets of recent years shift and spread risk, they don't eliminate it. And indeed, in some areas, they seem to be creating new dangers.

For one, while the new instruments allow some players to reduce their risk, they have also multiplied the opportunities for others to gamble. Derivatives often are a zero-sum game: For every global company hedging against currency movements and every amusement park hedging against light snow, there typically is someone willing to bet on the opposite outcome.

And many of these bets are highly leveraged, meaning the amounts invested represent only a small fraction of the potential loss on the investment. When hedging against adverse changes in interest rates, or a drop in the value of the Standard & Poor's 500-stock index, an investor often doesn't put down upfront anything close to the full value of what is being hedged. That makes such transactions potentially far more calamitous for investors than deals fully

paid-for: A wrong bet can mean having to cough up many times more than the initial investment.

An Alarming Spread

The expansion of stock ownership -- to nearly 50% of American households in 1998 from 32% in 1989 -- through the spread of 401(k)s and mutual funds, as well as direct investment, has yielded annual double-digit returns for the masses, but also has exposed more people to risk.

High risk is one reason why IPOs have traditionally been the preserve of institutional investors and wealthy individuals. No more. Last spring, for example, Friedman, Billings, Ramsey Group Inc., of Arlington, Va., launched a drive to "put the public back in initial public offerings" with an online investment bank that allows the little guys -- people making as little as \$50,000 a year -- to buy into some of the start-ups the firm underwrites.

Fbr.com (www.fbr.com)⁴ estimates that such "mid-networth individuals" snapped up 20% of the 3.3 million shares in the IPO of NetCreations, a New York e-mail marketer that went public in November. (Fbr officials say they screen potential investors and reject bids from those who seem inappropriate for the IPO, based on net worth, investment experience and investment goals.)

Stock investors are borrowing at record levels, too. Margin debt -- loans issued by brokers to clients to buy stock -- hit a record \$228.5 billion last year, nearly doubling from 1998. At a congressional hearing last week, Mr. Greenspan said the Fed was growing worried about the recent jump in leverage fueling the stock market. "We're doing a good deal of thinking about the whole process," he said.


The ever-increasing complexity of choices makes it hard for even the most sophisticated investors to understand what they are buying. Consider the derivatives debacles of '90s: Orange County, Calif.; Procter & Gamble; Barings PLC, among other victims. Orange County and P&G accused their bankers, Merrill Lynch & Co. and Bankers Trust New York Corp., respectively, of misleading them about the amount of risk involved in their complicated investments. Orange County Treasurer Robert Citron and 28-year-old Barings trader Nicholas Leeson were lured by the prospect of ultrahigh returns, and were able to hide from overseers the perils of their strategies.

Just last week, the Bank for International Settlements, the Switzerland-based consortium of the world's major central banks, issued a report fretting that banks were once again letting standards slip in lending to hedge funds, after a brief period of tightening following the Long-Term Capital Management fiasco. "Many banks remain keen to trade" with hedge funds, the report said. "Business levels could increase again without appropriate changes in risk management."

Herd Mentality

The growing role of market-based financing means large sectors of the economy now are susceptible to mass mood swings. That's what happened with emerging markets in 1997 and 1998, when shaky Russia was showered with funds during the bull market, and even stable economies such as Mexico got trampled on during the retreat.

The breadth of the markets makes it harder for regulators and leading financiers to contain the damage. Robert Rubin, a former Goldman, Sachs & Co. co-chairman, a former Treasury secretary and currently an executive at



3 Join the Discussion: What do you think is responsible for the U.S.'s extraordinary economic expansion? How long do you think the boom will continue? Would the end of the boom definitely lead to recession or just a cooling down of the economy?

Citigroup Inc., recalls a crucial step in limiting the fallout from the Asia crisis: phoning a handful of top bankers on Christmas Eve and persuading them to roll over outstanding loans to South Korea.

That agreement prevented Seoul from defaulting, an event that Mr. Rubin believes could have triggered a world financial crash. The agreement was made possible by the fact that South Korea still depended largely on a relatively small number of banks -- something that is becoming less and less common as capital markets become more dominant.

"You used to be able to organize a relatively small number of banks in order to develop some kind of temporary relief so the banking system could work through its problems," Mr. Rubin says. With banks increasingly replaced by millions of bondholders, "there's no equivalent way to organize the creditors," he says. "There's no way to organize a standstill that might prevent things from cratering."

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