dollar. In an interview in Germany's weekly *Der Spiegel* on Feb. 23, Brittan said that the hegemony of the dollar as a world reserve and trade currency will end with the introduction of the euro. "Europe's weight as an international player will grow," he noted, as the "euro developed into a world reserve currency."

In mid-January, a U.S. Senate fact-finding group, led by Sen. Pete Domenici (R-N.M.), met with Bundesbank President Hans Tietmeyer, who reportedly told the shocked Senators in no uncertain terms that the euro will come, and will be a "strong" currency.

### A fundamental shift

Ironically, Tietmeyer, Strauss-Kahn, and leading European financial institutions such as Deutsche Bank, Dresdner Bank, or France's Crédit Lyonnais, are clearly planning to make Tietmeyer's forecast of a "strong" euro come true, with the help of a lot of American savings. In a new study on the effects of the EMU, Dresdner Bank notes, "The euro will derive strength against the dollar from public and private portfolio inflows."

Dresdner calculates that there could be as much as "$750 billion of net inflow diverted from the U.S. dollar into the euro." It adds, "Creation of the euro may lead to some $50-75 billion of annual portfolio and deposit inflow into the euro." Whether it takes place over ten years, as this suggests, or sooner, the shift in capital flows out of the dollar would be potentially enormous.

In short, leading European banks are calculating that U.S. mutual funds, pension funds, and banks will be the major source of new liquidity which will bring a flood of capital into Europe. A recent study by Reuters predicted that a huge single European stock market will emerge, making the euro zone into "the world's largest emerging market" into the next century.

In 1996, U.S. investment into emerging markets totalled near $250 billion. Now, with Asian markets largely gone up in smoke, most U.S. fund managers are desperately looking for new areas of high profit. Certain European banks such as Dresdner are making propaganda to convince U.S. fund managers that the coming euro market is the place to go. A shift of $750 billion over a short time, out of the dollar into the euro zone, would detonate a financial and monetary crisis in the United States beyond any in history. And that, using the savings of mostly unwitting American mutual fund investors who are hoping to save for their child's college or their retirement through a high-return mutual fund. Little wonder that Domenici and some others are beginning to show concern over how the new euro proceeds.

Referring to recent calls by Japanese and U.S. officials for some form of New Bretton Woods system, on March 8 London *Observer* financial editor William Keegan wrote, "For the moment the only new fixed exchange rate system on offer is European Economic and Monetary Union." The next weeks will tell what kind of offer for Europeans and for the rest of the world that will be.

# Financial crisis drives merger mania

by John Hoefle

Merger and acquisition activity hit new records around the world in 1997, fuelled by dangerously high equity markets and the assumption of record levels of debt. Leading the charge was the rapid consolidation of the financial sector—commercial banks, investment banks, and non-bank institutions such as insurance and finance companies. Worldwide, a record $1.6 trillion in mergers and acquisitions (M&A) were announced, spurred by records in the United States, Europe, Asia, and Ibero-America, according to Securities Data Corp.

In the United States, $919 billion in mergers were announced in more than 10,700 deals, easily topping the old record of $626 billion in 10,340 deals in 1996, and the $519 billion in 1995 (**Figure 1**). Leading the way in 1997 was the largest merger in world history, the $42 billion takeover of MCI Communications by WorldCom; overall, $91 billion in mergers were announced in the telecommunications sector.

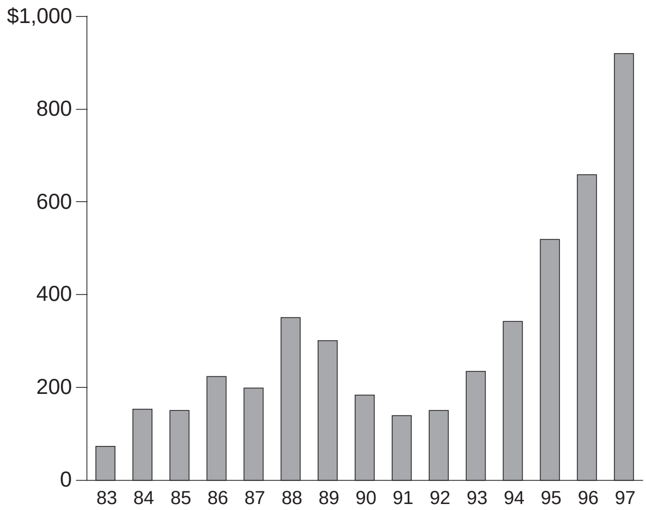
In second place domestically, was the commercial banking sector, with $75.3 billion from 384 deals, topping the 1995 record of $68.5 billion from 739 deals. The 1997 activity included the two largest bank takeovers in U.S. history, in terms of price paid: First Union's $17 billion bid for Philadelphia's CoreStates Financial, and NationsBank's $14.8 billion takeover of Florida's Barnett Banks.

In third place, was the investment banking and securities dealers sector, with $59 billion in announced mergers, led by Morgan Stanley's $10.6 billion merger with Dean Witter Discover, and Travelers Group's $8.9 billion purchase of Salomon, the two largest deals in investment banking history. The 1997 total represents 38% of all investment bank/securities dealer mergers since 1980, and easily surpassed the $16 billion recorded in 1996.

Combined, the commercial banks, investment banks, and securities dealers accounted for over $134 billion in announced mergers in 1997, or 15% of the total.

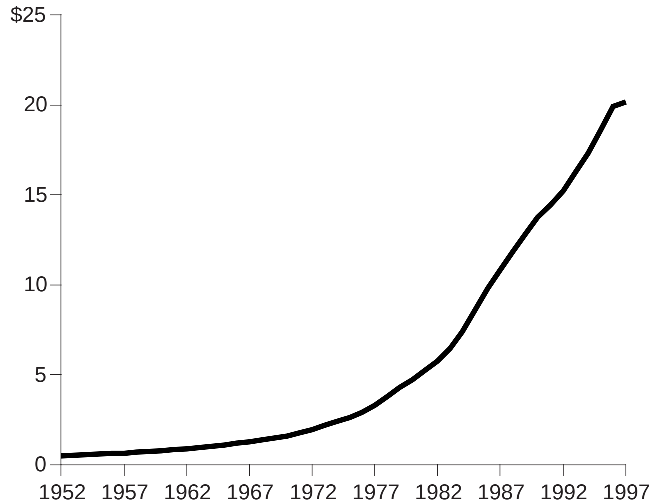
The financial sector also led the pack in M&A activity worldwide, where commercial banks topped the list with over $83 billion from 400 deals, including the top non-U.S. merger, the proposed $23 billion merger of Union Bank of Switzerland and Swiss Bank Corp., to form the new United Bank of Switzerland. In second place worldwide was the insurance sector with nearly $73 billion from 325 mergers, led by Zurich Insurance's $18.4 billion purchase of BAT Industries Plc's financial subsidiary. Third place worldwide was the electric, gas, and water utilities sector, with over $57 billion from 256 transactions.

FIGURE 1
**Value of announced U.S. mergers**
(billions $)




Source: Securities Data Corp.

FIGURE 2
**U.S. credit market debt**
(trillions $)




Source: Federal Reserve.

Among geographic regions, Europe was second to the United States, with $322 billion in completed deals, compared to $253 billion in 1996, followed by Asia (excluding Japan) with $74 billion in announced deals, and Ibero-America with $71 billion.

Hong Kong led the (non-Japan) Asian list with $22.4 billion in announced deals, up 71% from 1996, followed by Malaysia with $16 billion. Malaysia's total was down 11% from its record, as merger activity slowed dramatically in the second half of the year. China announced $8.9 billion in mergers in 1997, compared to $3.9 billion in 1996; M&A activity in South Korea totalled $7.7 billion, up 500% from 1996, and Indonesia recorded a 98% increase in mergers. Real estate and mortgage banking led all sectors in Asia with $6.2 billion in deals, followed by the electric, gas, and water utility sector with $7.5 billion, and the food industry with $7.5 billion.

In Ibero-America, Brazil led with a record $24.9 billion in M&A transactions, up 141% from 1996, followed by Argentina with $17.2 billion, up 188% over 1996; and Mexico, up 95% to $13.3 billion. Nearly half of the Ibero-American deals ($31.4 billion) involved privatizations, of which 53% were in Brazil, including big stakes in the Companhia Vale do Rio Doce (CVRD) and Companhia Paulista de Força e Luz (CPFL). Argentina was second in privatizations, thanks to the $5.3 billion privatization of the national postal system, followed by Colombia with $3.5 billion. Among sectors, the utility sector led the pack with $18 billion from 58 deals.

## Pile on the debt

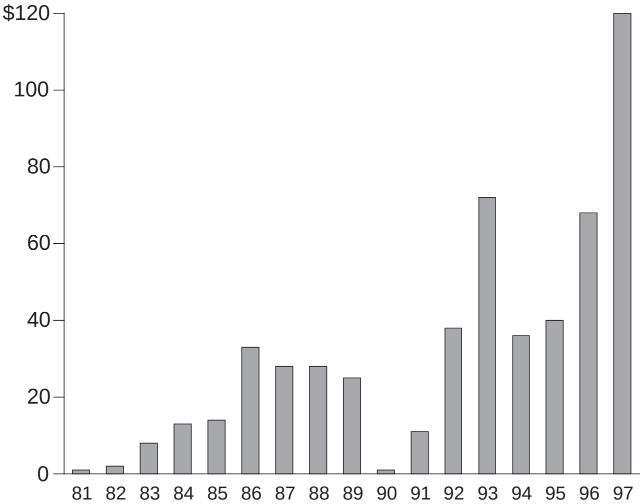
One might be tempted to think that, with $20.7 trillion in credit market debt in the U.S. as of Sept. 30, 1997, companies and individuals would be hesitant to take on more (**Figure 2**), but no such caution was manifest. A record $1.3 trillion in debt and equity deals were completed on Wall Street in 1997, beating the previous record of $1.1 trillion set in 1993. In the words of Securities Data, "for Wall Street, it was a case of having nearly all their dreams come true."

One marker for the insanity gripping the markets, is the explosion of junk bond issues. In 1997, some $119 billion in junk bonds were issued, more than three times the $32 billion issued in 1986, at the peak of the Drexel Burnham Lambert era (**Figure 3**). Today, the junk bond business is more evenly distributed: Donaldson, Lufkin & Jenrette took the top spot in 1997 with $12.6 billion from 66 issues, followed by Merrill Lynch with $12.2 billion from 77 deals, and Morgan Stanley Dean Witter with $11.9 billion from 59 issues. As if they didn't have enough problems with their derivatives portfolios, the commercial banks have also leapt into the junk bond fray: Chase Manhattan took fourth place in 1997, with $9 billion in deals; J.P. Morgan underwrote $6.1 billion, Bankers Trust $5.7 billion, and NationsBank $2.2 billion.

Corporations also issued some $150 billion in "investment grade" debt, $195 billion in mortgage-backed securities, and raised a record $118 billion from 1,335 stock issues, including $19 billion from real estate investment trusts. Another $43 billion was raised from initial public offerings.

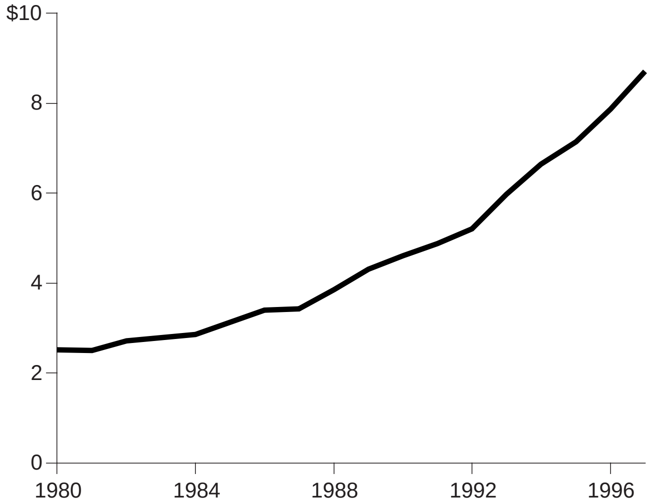
Some companies have adopted the opposite approach, of buying back large quantities of their own stock. During 1997, there were $179 billion of such stock repurchases, up from $176 billion in 1996. The largest such buyback was by Philip Morris, which announced it would buy back up to $8 billion of its own stock, raising its announced buybacks to $22 billion

FIGURE 3
**Junk bonds issued in the United States**
(billions $)




Source: Securities Data Corp.

FIGURE 4
**Financial claims per $1 of GDP**
(dollars of claims)




Sources: Federal Reserve, EIR.

since 1991. Merck announced a $5 billion buyback plan, bringing its total to $10 billion since 1994. Such buybacks tend to raise the price of a company's stock, and it is not coincidental that both Philip Morris and Merck are among the 30 companies on the Dow Jones Industrial Average.

## Default, anyone?

With some $8 of financial claims for every $1 of GDP in the U.S. economy (and only about one-third of GDP represents productive activity) (**Figure 4**), and $12 in financial claims for every $1 of the U.S. M3 money supply, the question of debt defaults should never be far from anyone's mind. According to Moody's Investors Service, 64 issuers of debt defaulted on $8.6 billion of long-term, publicly held corporate debt in 1997, up from $5.0 billion in defaults from 26 issuers in 1996 (but far short of the record $18 billion in 1991). The default rate accelerated during the last half of 1997, with 41 defaults on $5.5 billion in the second half, compared to 20 defaults on $3.1 billion in the first six months of the year. Half (32) of the defaulters were domiciled in the United States, followed by 10 in Korea, 8 in Thailand, 3 in Hong Kong, 2 each in Argentina, Mexico, and Canada, and 1 each in the Cayman Islands, Japan, France and Switzerland.

The default by Yaohan Inc., a Japanese grocer, was the first public bond default by a Japanese firm since World War II. Japan also saw the failure of Yamaichi Securities and the Hokkaido Takushoku Bank, although neither firm has defaulted on its bonds, thanks to a Japanese government bailout.

By dollar volume, the industrial sector had the most defaults in 1997, with $2.2 billion, or 27% of the total, followed by hotel, gaming, and leisure with $2 billion, non-bank financial institutions with $1.3 billion, and consumer products and technology with $1 billion each (**Figure 5**). According to Moody's, investment grade corporate debt has an average cumulative default rate of 6.4% over 20 years, while junk bonds average 43%, and the worst grade of junk (rated Caa-C) showed an average cumulative default rate of 66%.

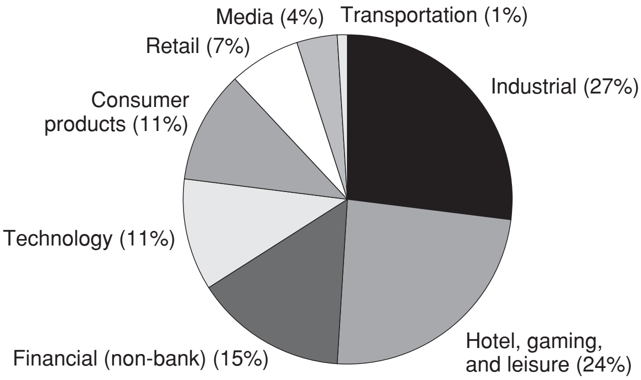
Corporations are not the only ones defaulting. During 1997, a record 1.4 million bankruptcies were filed in U.S. courts, of which 1.35 million were personal bankruptcies (**Figure 6**).

In the United States, the consolidation of the banking system took an ominous turn with the acquisitions by several commercial banks, of investment banks and securities dealers. Among the deals announced were: Bankers Trust's purchase of Alex. Brown and portions of Britain's NatWest Markets; BankAmerica's acquisition of Robertson Stephens; NationsBank's takeover of Montgomery Securities; First Union's buyout of Wheat First; and Fleet Financial's purchase of Quick & Reilly.

That such deals were allowed by regulators, despite being illegal under the Depression-era Glass-Steagall Act, reflects a desire by elements of the establishment to dramatically increase the size of the top U.S. banks, by allowing them to eat the smaller ones. It is widely believed in financial circles that the Federal Reserve would like to reduce the number of major banks in the U.S. to about 20, and the scramble is on among the banks to make the cut. This environment has led to record numbers of bank mergers in recent years (**Figure 7**).

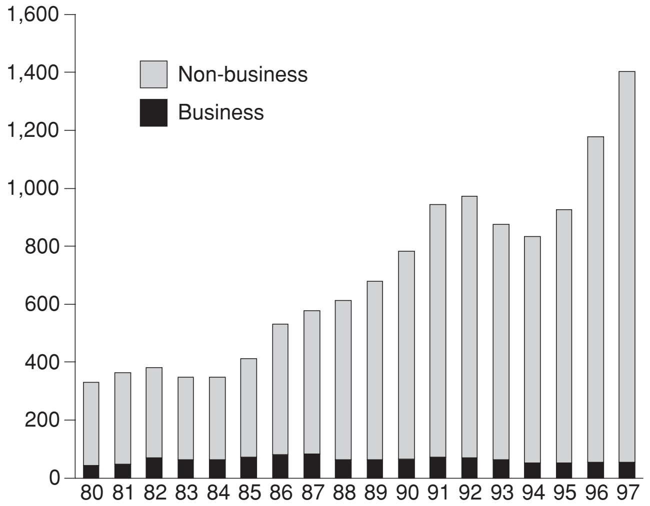
To pave the way for this consolidation, regulators are moving rapidly to reduce what they euphemistically call "regulatory burdens" on banks. Federal Reserve Chairman Alan

FIGURE 5
## U.S. corporate defaults in 1997, by sector



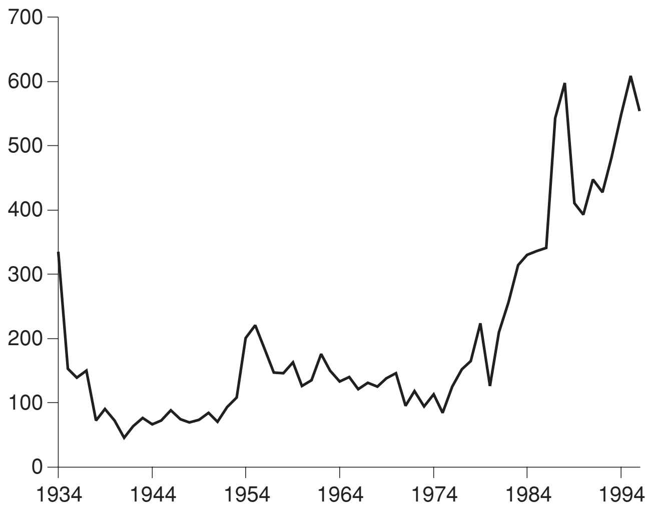

Source: Moody's Investors Service.

FIGURE 6
## U.S. bankruptcy filings
(thousands)



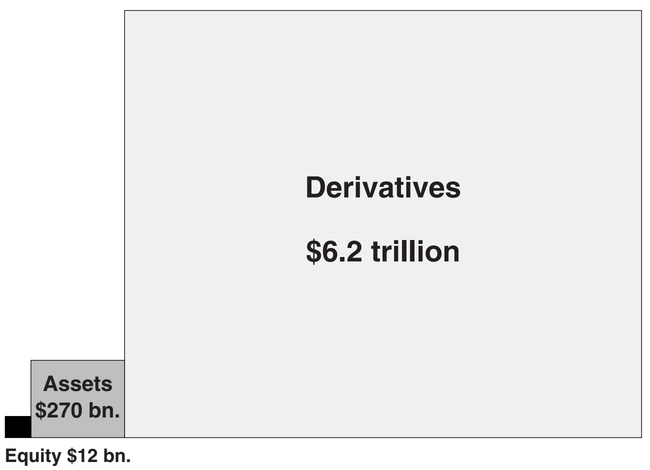

Source: Administrative Office of the U.S. Courts.

FIGURE 7
## Number of U.S. bank mergers, 1934-96




Source: Federal Deposit Insurance Corp.

FIGURE 8
## J.P. Morgan & Co.'s derivatives, assets, and equity compared
(as of Sept. 30, 1997)




Greenspan is leading a fight to remove the 8% capital reserve requirement of the Bank for International Settlement's Basel Committee, claiming the reserve requirement is "economically inefficient" and that banks should be allowed to determine their own reserve levels. The Orwellian phrasing of the rush to deregulate pervades the discussion of bills currently before the House and Senate—for example, Senate bill S. 1405 is named "The Financial Regulatory Relief and Economic Efficiency Act." In the House, the move to abolish the Glass-Steagall prohibitions against commercial banks owning investment banks, advanced on March 10, when the House Republican leadership announced a compromise which would eliminate the barriers between the banking, securities, and insurance sectors, opening the door to a new wave of mergers.

The claims that banks are afflicted with "regulatory burdens" is absurd—the truth is that the banks are already out of control. J.P. Morgan and Chase Manhattan, for example, each have off-balance-sheet derivatives exposures more than 20 times greater than balance-sheet assets, and hundreds of times their equity capital (**Figure 8**). What the regulators are proposing, is virtually total deregulation, to hide the bankruptcy of the entire system.