**ECONOMIC LIFE**

# After boom, a bust exposes Wall St. ethics

**By Charles Stein, Globe Staff, 5/19/2002**

In a 1990 essay he wrote about the savings & loan scandal, the economist Paul Krugman wondered why there seemed to be so many crooks in that business in the late 1980s. "Americans in general are neither better nor worse people than they used to be," wrote Krugman. "So the real question has to be: What made socially destructive behavior in this industry so much more attractive than it used to be?"

The same question could be posed today, only this time it wouldn't be aimed at one industry but at the entire business community. In case you haven't noticed we are in the midst of a full-blown ethics crisis. The business pages of the newspaper suddenly read like the police blotter. A long list of American companies, including blue-chip names, are under investigation for engaging in deceptive practices.

Enron is accused of cooking its books and scheming to exacerbate California's energy crisis; Arthur Andersen has admitted shredding Enron documents; Xerox was fined $10 million for booking phantom revenue; CMS Energy, a Houston company, last week became the latest energy firm to say it participated in phony trades to boost trading volume.

If Krugman is right and Americans aren't worse people than they used to be, you have to ask: What made the business environment of the past few years fertile ground for cultivating unethical behavior? The answer is simple and depressing. Booms encourage people to cheat and the subsequent busts expose their sins.

"The propensities to swindle and be swindled run parallel to the propensity to speculate during a boom," wrote MIT economist Charles Kindleberger in his classic book, "Manias, Panics and Crashes." "In a boom, fortunes are made, individuals wax greedy and swindlers come forward to exploit that greed."

Kindleberger demonstrates that throughout history, from the South Sea Bubble of 1720, a disastrous British plan to invest in the slave trade, to Wall Street in the 1920s, bad guys took advantage of "irrational exuberance" to fleece investors. In those overheated periods both investors and businesspeople sensed an opportunity to get rich. Investors dropped their guard; some businesspeople dropped their ethical standards.

The late 1990s certainly qualifies as a boom time, but it was a boom with a slight twist. This time around the trick was to show rapid growth. If you were a fast-grower, Wall Street loved you. Slow-growers were ignored.

So how did companies respond? They found ways to look as if they were growing fast. Xerox's business was dead in the water. Rather than own up to that, management changed its accounting assumptions and magically produced $3 billion in improper revenue between 1997 and 2000, according to the Securities and Exchange Commission. The scheme deceived investors but enriched executives who sold stock at high prices.

The energy traders such as CMS engaged in swaps. They sent energy to another company, which in turn, sent the energy back. The swaps were bogus transactions that created the illusion business was booming. The companies were like those snakes you see on National Geographic specials - the ones who puff themselves up to appear bigger than they actually are. The snakes do it to fool enemies. The reptiles in the corporate world did it to impress investors.

"People were out to make a lot of money in a short time and they cut corners to get there," said Jay Lorsch, a professor at the Harvard Business School.

The tricks only work when the market is rising. When the market crashes, the truth emerges. At that point - and we are there right now - angry investors want to see the miscreants punished.

That is not new either. According to Kindleberger, after the South Sea swindle was exposed, a member of Parliament recommended that the perpetrators be subjected to an old Roman punishment: to be sewn into a sack with a monkey and a snake and drowned. As Kindleberger dryly noted, "It sounds excessive, despite modern concern that white-collar crime is let off lightly."

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