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In a Bubble Economy, Recognition Comes Too Late

In Euphoria, Key Players Looked Away

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Sunday, November 10, 2002; Page A01

Mention the Bubble Economy and, for many Americans, it now conjures up images of shredded documents and half-built Houston mansions, depleted pension accounts and executives being led off in handcuffs. But it didn't start out that way.

Roughly from 1995 through the end of 2000, the Bubble Economy was known as the new economy, and nearly everyone thought it was a marvelous thing.

Billions of dollars poured in from all over the world from people hoping to get in on the ground floor of the Internet, a medium that held the promise of transforming not only the economy, but life as we knew it. Stock prices rose higher and faster than at any time in history, making the ups and downs of the Nasdaq Stock Market a national obsession.

Now, of course, we know it wasn't all real, and it certainly wasn't enduring. Twenty months after it tipped into recession, the economy is barely growing. Stock prices are back where they were four or five years ago. And nobody is sure how much of the revenue and profit growth during the bubble was real.

How could this have happened? Why did otherwise honest people resort to obfuscation, game-playing and outright fraud just to keep going? Where were the safeguards that were supposed to warn against the dangers and prevent the excesses?

This week, The Post will explore these questions in a series of stories that focuses on six individuals and companies at the center of the Bubble Economy. The theme running through all of them is that many of the key people involved in the economy got so caught up in the euphoria, so blinded by the financial rewards dangled in front of them, that they stopped doing their jobs -- or convinced themselves that the nature of their jobs had changed.

First and foremost were the corporate executives, the subject of today's installment, who began to focus more on managing their stock prices than managing their businesses. They were encouraged by pension and mutual fund managers who shed their roles as patient custodians of capital to make it big in the quarterly rankings game. And they were egged on by a money culture that lionized CEOs who could reliably deliver quarter after quarter of double-digit earnings growth.

The list of culprits hardly ends there.

Near the front of the line were the corporate directors who grew so comfortable with the pay, perks and status that the bull market had conferred on them that they became even more quiescent than they had been before.

There were the accountants who set their sights on becoming strategic partners and advisers to the executives whose books they were auditing, forsaking their traditional role as nitpicky eyeshades hired to look out for the interest of shareholders.

And it was during this period that stock analysts began to think and act like investment bankers, investment bankers like venture capitalists and venture capitalists like masters of the financial universe.

"In all the euphoria of the bubble, the gatekeepers were so unwanted that even they began to see their roles as redundant," said John C. Coffee Jr., a corporate law expert at Columbia Law School. "They were paid handsomely to look the other way -- and many did."

A bit harder to explain is the acquiescence of the regulators who might have earned medals had they used their still-considerable powers to blow the whistle on some of the more egregious examples of corporate fraud that many sensed was going on. Ditto for business and financial reporters who, by and large, suspended their natural skepticism to join the cheerleading squad.

In these cases, it was not greed that was at play so much as an unwillingness to become the skunk at the economic lawn party -- the all-too-human desire not to be dismissed as an out-of-date crank who "doesn't get it" or called on the carpet by a congressional committee or network president who just got an earful from an angry corporate CEO.

If any one of these groups had acted the way they were supposed to and blown the whistle, it is likely the bubble would never have grown so big -- or perhaps never developed at all. But it is in the very nature of a bubble that the lapses are simultaneous and widespread.

"It was the perfect storm," said Nell Minow, a corporate reformer who heads the Corporate Library here in Washington. "A lot of things failed at once."

An Economic Mirage

Crucial to this system failure was the belief that because of globalization, deregulation or new technology the world had changed so much that the old rules need no longer apply. Suddenly bribes became incentive-based compensation, lies became aggressive accounting and conflicts of interest became "synergies." Little indiscretions and envelope-pushing by one company spawned little ones elsewhere -- and in time little ones gave way to bigger ones in places where the corporate culture was most accommodating.

"As long as everyone was making money hand over fist, people were willing to overlook things," said Richard Sylla, a financial historian at the Leonard N. Stern School of Business at New York University. "It was a good party. Everyone wanted to keep it going."

Of course, not everyone bought in to the mania. There were, as there always are, jeremiads warning that the prices were too high, the underlying assumptions ridiculous, the books cooked. And they weren't just from kooks. Detractors included respected investors and money managers such as Warren E. Buffett of Berkshire Hathaway Inc., hedge fund manager Julian H. Robertson Jr. of Tiger Management and Bill Miller, who runs giant mutual fund Legg Mason Value Trust. Even Microsoft's Steve Ballmer said the software giant had become overpriced.

But during bubbles, people pay more attention to profits than to prophets.

What bubbles prove is that if enough people believe something to be true, they can will it to be true, at least for a while. A bubble is a collective economic mirage generated by otherwise savvy people who first con themselves and then con others -- legally, in most cases, but sometimes not. So widespread is the "buy-in" that even after the bubble bursts, the recognition that it *was* a bubble doesn't come in one moment of epiphany, but rather in a series of smaller, begrudging acknowledgements.

When the air began to be let out of the bubble in March 2000, for example, everyone said it was just the dot-coms that were the problem, a few thousand over-financed companies whose disappearance would hardly be noticed in a $10 trillion economy. Then it was "just" telecoms, then "just" computer makers, and, oh, well, maybe the entire manufacturing sector, and so on, each line of defense eroding like the walls of a sand castle confronting the rising tide.

The reality is that in an investment bubble as big as this one, what begins in one or two sectors eventually spreads through the rest of the economy. Flush with cash pushed at them by investors, all those dot-commers and telecom executives not only bought computers and built office buildings -- the things picked up as "fixed investment" in the national income accounts -- they also used the invested cash to fly in airplanes, stay in hotels, retain investment bankers and consultants, take out ads in newspapers and magazines, and buy themselves fancy cars and vacation homes. In what became a frantic search to hire employees, they wound up creating shortages, pushing up wages in all corners of the labor market. And by paying exorbitantly to acquire other companies, they created a force that pulled up the price of all stocks.

Before long, it was impossible to tell where the Internet money stopped and the rest of the economy began. It had insinuated itself everywhere in the economy. And everywhere, people came to believe not only that the increased sales were real, but that their upward trajectory was assured.

Familiar Pattern

Bubbles don't develop at random. They generally require the presence of two crucial ingredients.

The first is investment capital -- and by the mid-1990s, the U.S. economy was awash in it.

This was partly the result of the democratization of finance in the past two decades, which has driven up the percentage of American households that own stock from less than a quarter to more than half at the height of the bubble. The investment surge also coincided with the arrival of the baby boom generation into that period of life when incomes are high and money starts getting saved for retirement. Much of that money ended up in stock mutual funds, which went from taking in about $125 billion in new money in 1995 to $300 billion in the peak year of 2000.

In addition to that domestic capital was a flood of foreign money from investors burned in the Asian financial meltdown or disillusioned by Europe's slow progress in deregulating its economy and reforming its labor markets. From 1995 to 2000, $1.2 trillion more investment capital flowed into the United States than flowed out. Some of that money went directly into the stock and bond markets; but just as much came in the form of the direct purchase of American companies by foreign ones -- Daimler-Benz AG's purchase of Chrysler Corp., for example, or Vivendi SA's takeover of Seagram Co. Both types contributed significantly to the run-up in stock prices, in the process lowering the cost of capital for U.S. firms and stoking over-investment in new companies, plants and equipment.

The other crucial bubble ingredient was a new and economically transforming technology. The railroad, electricity, the automobile and the radio all spawned investment bubbles when first introduced, with each bubble giving way to

a market panic or crash -- and revelations of corporate fraud and misconduct. So, too, would the breakthroughs in computer software, hardware and telecommunications technology that would come together under the rubric of the Internet.

The pattern each time was about the same. With too much money chasing too few good investment opportunities, too many companies got started and too much capacity was added, driving prices down to unsustainable levels. In the end, virtually none of the long-term investors made money. In the case of the railroads, for example, so much was spent on duplicate tracks and excess rolling stock that it wasn't at least until the 20th century that the industry finally turned a collective profit. And in the case of the Internet, one need look no further than the 75 percent decline in the Nasdaq to understand that very little of the economic benefit of this new technology has flowed to any but the earliest investors.

In the end, according to J. Bradford DeLong, an economic historian at the University of California at Berkeley, it turns out that consumers are the big winners -- initially, consumers who enjoy the low prices that flow from the ruinous competition, but eventually, consumers who reap the benefit of lower prices and improved products and services that result when companies use new technology to operate more efficiently.

DeLong notes that it was cheap freight rates offered by the railroads that made possible Gustavus F. Swift's model for the modern meatpacking industry and the Sears national catalogue operation. Now, in ways that are just becoming clear, the Internet promises to revolutionize activities from auto sales and fashion design to education and entertainment.

Already, DeLong says, advances spurred by the computer and the Internet have boosted the economy's rate of productivity growth by 1.5 percentage points a year, beginning in 1995. Through the magic of compounding, that translates into close to a trillion dollars a year in higher living standards. Most of that, DeLong argues, has been widely distributed to American workers in the form of higher pay, to American consumers in the form of cheaper goods and services, and to American investors in industries largely outside of tech and telecom.

"The big benefits to these transforming technologies go to those who use them, not those who invest in them," DeLong said.

New technology, over-investment, economic boom, market crash, corporate scandal, recession -- in each bubble, the pattern is pretty much identical. That hardly means it's easy to predict bubbles, or to tell when you're in one.

After all, if people knew it was a bubble, it would never happen in the first place.

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