Robert J. Samuelson

J. P. Morgan Rises Again

PHOTOGRAPH BY CHARLES OMMANNEY FOR NEWSWEEK

ONE IMPROBABLE IRONY OF THIS SUMMER'S financial turmoil has been the quiet rehabilitation of J. P. Morgan—the most powerful private banker in the nation's history and, for many years, a poster boy for the dangers of concentrated wealth. But now Morgan is emerging as an emblem of something that seems too scarce in corporate America: character.

In his day, Morgan (1837-1913) was admired and reviled for his immense influence. In the 1880s and 1890s, he reorganized many railroads to restore their profitability by curbing competition. (Railroads so rearranged were said to be "Morganized.") Later, Morgan consolidated the steel industry by merging Andrew Carnegie's operations with competitors and creating U.S. Steel. In 1895, when the government's gold reserves were falling rapidly, Morgan replenished them with a $65 million loan. In 1907, he stemmed a banking and stock-market panic by marshaling loans from strong to weak banks.

At various times, this man played roles now assumed by the Federal Reserve, the Securities and Exchange Commission, the Treasury and government agencies yet to be created—because no one would empower them to reshape entire industries. But he had a saving grace, notes Jean Strouse (on whose splendid biography, "Morgan: American Financier," this column relies heavily). He exercised his power with a sense of "moral responsibility," as she wrote recently in The New York Times.

Morgan was a conduit for capital. He connected wealthy investors, American and foreign, with railroads and industrial enterprises that needed money for expansion. But once transactions were complete, Morgan did not withdraw. He saw himself as the guardian of investors' wealth. If the enterprise went bad, Morgan intervened. He installed new managers, revamped industries, had his partners sit on corporate boards. The point was to ensure that his investors got repaid. Morgan felt bound by moral obligation.

Here is the contrast with the present. In the late 1990s, Wall Street's investment banks sold hundreds of billions of stocks and bonds that later became worthless, notably in dot-com and telecom companies. The same investment houses blessed dozens of mergers whose stock prices subsequently collapsed. Unlike Morgan, who regarded his investors' money as his own, Wall Street's present overlords see investors' money as a commodity to be pursued and processed—but not necessarily protected. The bankers take their fees. Big institutional investors (mutual funds, pension funds, insurance companies) are presumed to be sufficiently sophisticated to protect themselves.

Morgan always denied that his most critical decisions were based mainly on financial calculus. In one congressional hearing, the committee's counsel asked, "Is not commercial credit based primarily upon money or property?"

What America's most powerful of private bankers taught us is that, in business, finance and in life, it's character that really counts

"No sir," Morgan replied. "The first thing is character."

"Before money or property," the skeptical counsel asked.

"Before money or property or anything else," Morgan said. "Money cannot buy it."

In today's climate, character seems a quaint consideration. Deals go forward if the numbers add up (and sometimes if they don't). This change may reflect greater competition. One harsh criticism of Morgan was that his bank, with a few others, controlled too much of the nation's investment capital. They were "the money trust." By contrast, businesses can now—in good times at least—raise money from many sources. If one seems too reserved, it might get bypassed to the point of oblivion. The custodians of capital find it harder to play gatekeepers when so many are fighting for the same business.

Present business leaders doubtlessly believe they operate by a moral code. And they do. In some ways, it's stricter than in Morgan's day, because it is defined by more government regulations and laws. Moreover, Morgan's code was controversial and self-serving. He believed that access to capital was indispensable for the nation's industrial development. Therefore, it was vital to ensure that investors got a return. If this meant curbing competition, so be it. But many farmers and small businesses felt oppressed by railroad freight rates. Shippers wanted rate wars.

Similarly, Morgan thought the gold standard was essential to attracting capital. Investors wanted to be repaid in money they trusted. Here, too, there was ample opposition. Borrowers felt victimized. For them, Morgan's morality meant tight credit and falling prices.

It is hard to judge one era's behavior by another's moral standards. No one would now cede so much economic power to a private individual. Still, Morgan's conduct offers lasting lessons. One is that in business (and most activities) all the laws and regulations cannot entirely substitute for human judgment about what's right and wrong. A second is not to mistake money for character. The first measures creativity, ambition, talent, effort—and perhaps luck, inheritance or criminality. The second, though more intangible and sometimes not easily recognized, is priceless.

Robert J. Samuelson

The Media's Heavy Hand

PHOTOGRAPH BY CHARLES OMMANNEY FOR NEWSWEEK

IN HIS CLASSIC BOOK "MANIAS, PANICS, AND Crashes," the economic historian Charles P. Kindleberger divides all financial manias into three rough phases. In the first, people discover the world has improved in some unanticipated way. The second phase features euphoria, when overoptimism stimulates a furious rush to buy stocks, bonds, land or raw materials. Finally comes the crash. People realize their delusion. Down come tumbling the "prices of commodities, houses ... stocks ... whatever has been the subject of the mania."

To Kindleberger's cycle has now been attached a parallel news cycle. Stage one is Revelation. The scribbling and chattering class proclaims some seismic economic change: say, the Internet revolution. Next comes a Heroes phase that names—and worships—the architects of the wondrous upheaval. The end, of course, is Recrimination. Utopian visions vanish. Time to round up the usual suspects.

We are now firmly in Recrimination. It's open season on anyone who might have illicitly caused the stock bubble or profited from it—Martha Stewart, Enron executives, dishonest stock analysts, wimpy accountants, greedy investment bankers. The press is enthusiastically beating up on these people, many of whom deserve it. But what the press isn't doing is reflecting on its own role in creating, and now popping, the speculative bubble.

It's considerable. In 1999, Time made Jeff Bezos, founder of Amazon, its Person of the Year. (Amazon's stock was then about five times its present level.) BusinessWeek, in an October 1999 cover story, announced "The Internet Age" and equated the new technology with railroads and telephones in significance—a judgment at best premature. And NEWSWEEK, too, was sometimes guilty of running stories whose gaga enthusiasm for the new technologies fed the stock boom. Here's one cover in early 2000: "The Amazing PlayStation 2—How Sony Will Change High-Tech Fun Forever."

Whatever print journalism's sins (and, to be fair, NEWSWEEK and some others wrote cautiously about the market), they were easily eclipsed by the electronic media, as Washington Post reporter Howard Kurtz shows in his book "The Fortune Tellers." Analysts' sensational stock forecasts were relentlessly "touted by CNBC and other media outlets," Kurtz notes. Some of these forecasts became temporarily self-fulfilling.

In this hothouse of exaggeration and techno make-believe, speculative practices flourished. Stock options soared. Companies were taken public (that is, their stock was sold to ordinary investors) too quickly. Day trading exploded. Corporate executives became increasingly obsessed with meeting or beating profit forecasts. How else to keep stock prices up—and realize huge profits from options?

Will the press spook stocks on the way down, just as it hyped stocks on the way up? Good question. But hardly anyone is asking it.

A sober stock market and a speculative market differ fundamentally. In the first, most investors can win, because stocks rise for sound business reasons (usually higher profits). We had this sort of market through much of 1997. By contrast, a speculative market must mean big winners and big losers. It must breed huge resentments, because stocks prices rise to artificial and unsustainable heights. Those who sell near the top will win; those who don't won't.

By 1998, the market—and the news cycle—were moving from sobriety to speculation. The controlling Revelations were the Internet breakthrough and the New Economy. Heroes were anointed: techno-entrepreneurs and Alan Greenspan. The reigning moral climate was permissive. In a rising market, most investors could win. Few cared about ethical niceties.

Moral rectitude revived only with mounting losses. In 1999 and 2000, there were about 800 IPOs (initial public offerings of stock). On their first trading days, these stocks jumped an average of 65 percent, reports University of Florida finance professor Jay Ritter. Since then, about 45 percent have gone bankrupt, been merged out of existence or had their stocks delisted, he says. As the market falls, popular outrage rises. Given the speculative excesses, there's ample cause for outrage.

Up to a point, the Recriminations are useful correctives. People don't like bad publicity, let alone hostile congressional hearings, subpoenas, lawsuits and possible jail time. The threat of these retributions may promote, more than concrete "reforms," at least temporary self-restraint. It may inspire fewer accounting abuses, less greed in executive compensation and more candor in analysts' recommendations.

But there's also another possibility. It's that pack journalism may distort the market on the way down, just as it did on the way up. Will the legions of reporters and talking heads that sensationalized the Internet and New Economy now sensationalize corporate dishonesty? Will genuine crimes and mistakes be generalized to criminalize all of business? Will the press worsen the loss of confidence that it implicitly claims to be combating? Will the market, as a result, be unduly depressed?

Good questions. Hardly anyone in the press is asking them, because pack journalism means that almost everyone is chasing the same story.

Debunking the Digital Divide

It's spontaneously shrinking—and with it, the exaggerated popular notions of the harm it did

By Robert J. Samuelson

It may turn out that the "digital divide"—one of the most fashionable political slogans of recent years—is largely fiction. As you will recall, the argument went well beyond the unsurprising notion that the rich would own more computers than the poor. The disturbing part of the theory was that society was dividing itself into groups of technology "haves" and "have nots" and that this segregation would, in turn, worsen already large economic inequalities. It's this argument that's either untrue or wildly exaggerated.

We should always have been suspicious. After all, computers have spread quickly, precisely because they've become cheaper to buy and easier to use. Falling prices and skill requirements suggest that the digital divide would spontaneously shrink—and so it has.

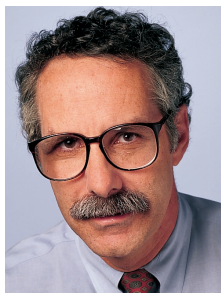
The Census Bureau's latest survey of computer use reports narrowing gaps among different income and ethnic groups. In 1997 only 37 percent of people in families with incomes from $15,000 to $24,999 used computers at home or at work. By September 2001, that proportion was 47 percent. Over the same period, usage among families with incomes exceeding $75,000 rose more modestly, from 81 percent to 88 percent. Among all racial and ethnic groups, computer use is rising. Here are the numbers for 2001 compared with similar rates for 1997: Asian-Americans, 71 percent (58 percent in 1997); whites, 70 percent (58 percent); blacks, 56 percent (44 percent); Hispanics, 49 percent (38 percent).

The new figures confirm common sense: many computer skills aren't especially high tech or demanding. The point-and-click technology allows computers to be adopted to many business and home uses without requiring people to become computer experts. Just as you can drive a car without being a mechanic, you can use a computer without being a software engineer.

Now, a new study further discredits the digital divide. The study, by economists David Card of the University of California, Berkeley, and John DiNardo of the University of Michigan, challenges the notion that computers have significantly worsened wage inequality. The logic of how this supposedly happens is straightforward. Computers (the logic holds) raise the demand for high-skilled workers, increasing their wages. Meanwhile, computerization—by automating many routine tasks—reduces the demand for low-skilled workers and, thereby, their wages. The gap between the two widens. Economic inequality increases.

Superficially, wage statistics support the theory. Consider the ratio between workers near the top of the wage distribution (at the 90th percentile) and those near the bottom (at the 10th percentile). In 1999, the first earned $26.05 an hour and the second, $6.05 an hour, reports the Economic Policy Institute in Washington. The ratio of the two—workers at the top compared to workers at the bottom—was 4.3 to 1. By contrast, the ratio in 1980 was only 3.7 to 1. Computerization increased; so did the wage gap. Case closed.

But wait, say Card and DiNardo. The trouble with blaming computers is that the worsening of inequality occurred primarily in the early 1980s. In 1986, the ratio of the high-to-low paid worker was also 4.3—the same as in 1999. With computer use growing, the wage gap should have continued to expand, if it was being driven by a shifting demand for skills. Indeed, Card and DiNardo find much detailed evidence that contradicts the theory. They conclude that computerization doesn't explain "the rise in U.S. wage inequality in the last quarter of the 20th century."



Of course, not all economists accept this brushoff. To Lawrence Katz of Harvard, the spread of computers does promote wage inequality. But few economists have ever believed that new technology is the only influence on inequality, he argues. It can be overwhelmed by other forces. For poor workers, he contends that the economic boom of the 1990s offset the depressing effect of computers on their wages: "Firms were searching high and low for new workers—and they bid up the wages of the unskilled."

Either way, the popular perception of computers' impact on wages is hugely overblown. Lots of other influences count for as much, or more. The worsening of wage inequality in the early 1980s, for example, almost certainly reflected the deep 1981–82 recession and the fall of inflation. Companies found it harder to raise prices. To survive, they concluded that they had to hold down the wages of their least skilled, least mobile and youngest workers. High joblessness allowed them to do so. In 1982, unemployment averaged 9.7 percent.

As a slogan, the "digital divide" brilliantly united a concern for the poor with a faith in technology. It also suggested an agenda: put computers in schools; connect classrooms to the Internet. Well, the agenda has been largely realized. By 2000, public schools had roughly one computer for every four students. Almost all schools were connected to the Internet, as were about three quarters of classrooms. Some students get computer skills that they might miss. Among 10- to 17-year-old students from homes with less than $15,000 of income, about half use computers only at school, reports the Census Bureau.

But whether education and students' life prospects have improved is a harder question. As yet, computers haven't produced broad gains in test scores. As for today's computer skills, they may not be terribly important, in part because technology constantly changes. Frank Levy, an economist at the Massachusetts Institute of Technology who studies how computers alter work, emphasizes the importance of basic reading and reasoning abilities. Often, new computer skills can be taught in a few weeks. But people have to be able to read manuals and follow instructions.

The "digital divide" suggested a simple solution (computers) for a complex problem (poverty). With more computer access, the poor could escape their lot. But computers never were the source of anyone's poverty and, as for escaping, what people do for themselves matters more than what technology can do for them.

An Education In Cynicism

Colleges' early-admissions policies serve their interests—but not those of students or society

By Robert J. Samuelson

College admissions in America has become an overwrought and frenzied ritual, driven by the anxieties of striving students and middle-class parents who worry that if Stephen and Suzie don't get into the "right" college their lives will be ruined. This is a myth, but one hard to demolish and especially at this time of year, when most applications are being completed. Worse, all the pressures and absurdities of the process are now needlessly magnified by colleges that resort more and more to "early admissions"—a practice rightly characterized as a "racket" by writer James Fallows in a recent Atlantic Monthly.

The most selective colleges and universities sin the most. In the fall of 2000, there were about 1.2 million entering freshmen at four-year schools. Of these, only 163,004 applied for early admissions, according to the College Board. But Harvard routinely admits 55 to 60 percent of its freshman class early; at the University of Pennsylvania the proportion is 40 to 50 percent. The College Board found 41 schools where the share exceeded 30 percent and 464 four-year schools—a fourth of the total—that offered some sort of early admissions. (Early admissions means that students submit their applications before the standard January deadline and are typically admitted in December or January, rather than in the spring.)

Let us now count early admissions' drawbacks:

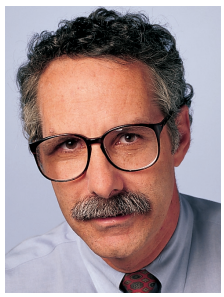
■ *It's unfair, because it discriminates against students who apply later.* A study of 14 of the country's most selective schools by researchers at Harvard found that applying early gave students a significant advantage, equal to about a 100-point jump in their SAT scores. (The researchers couldn't reveal schools' names, but they presumably included many Ivies and schools like Amherst and Stanford.)

■ *It forces students to make premature choices about where to apply.* They haven't visited enough schools, talked to enough friends, thought about it enough. "There's a tremendous growth that occurs in the 12th grade," says Dean Strassburger, a college counselor at Lincoln Park High School in Chicago. "Early decision is rushing this along."

■ *It inflicts unnecessary cruelty.* Getting rejected once is bad enough. Now students can get rejected twice. The most selective schools still don't accept most early-admissions candidates. Harvard admits about one in six (the acceptance rate for "regular" admissions is about one in 18).

■ *It worsens "senioritis"—the academic letdown after college acceptances are received.* "A lot of these kids, the second they get their decisions, are in your office saying, 'I want to drop Modern European History'," says Scott White, a guidance counselor at Montclair High School in New Jersey.

Sure, students accepted under early admissions benefit. Their ordeal is over. But in general, the practice has "adverse effects on high-school students," says Yale president Richard C. Levin. Although Yale now admits about 40 percent of its class through early decision, Levin has become an open (and rare) critic among college and university leaders. The problems and contradictions will multiply, because as more students and parents become aware of the advantages of applying early, more will do so. More early choices will be made with less conviction. Already, Yale's early applications have doubled since 1996. If colleges accept more early candidates, discrimination and premature senioritis will increase. If the rejection rate rises, so will gratuitous cruelty.



What motivates colleges and universities? Mainly self-interest that, at most, is only partially defensible. The University of Pennsylvania is one of the few schools candid enough to admit that it favors candidates who apply early. "The majority of students on campus at Penn are here because it's their first choice—that changes the tone of the campus," says Lee Stetson, dean of admissions. When he first came to Penn in 1978, only 35 to 40 percent of freshmen picked it as their first choice. "It's a whole different attitude," he says.

But there are other, less commendable reasons for using early admissions, as Fallows shows. It improves colleges' "yield" (the percentage of students accepted who actually attend). Because yield is one factor in U.S. News & World Report's annual college rankings, that can boost a school's position. Early admissions also improves "enrollment management"; it minimizes the chances that too many or too few students will show up in the fall. Finally, early admissions may allow colleges to attract more upper-middle-class students who don't need financial aid, though a recent College Board study disputes this. (The study found that freshmen, regardless of when admitted, got similar aid packages.)

All this expediency comes at a growing moral cost. Many colleges—including Harvard—contend that students who apply later do not reduce their personal odds of admission. This is almost certainly false, and colleges that maintain the fiction are being misleading and even dishonest. Bad show.

It is true that, compared with most social problems, the sins of early admissions are small potatoes. Most students will get over any disappointments, just as they will get over not being admitted to Dartmouth or Duke. But it is also true that, unlike most social problems, this one could actually be fixed. If a dozen or more top schools—Yale, Harvard, Stanford, Williams—denounced and dropped the practice, it would lose respectability and critical mass. If only one or two colleges do so, as Levin says, little would change.

What we have, for the moment, is the spectacle of some of America's most prestigious educational institutions engaged in behavior that can only be described as antisocial. They have subordinated students' interests to their own. This is hypocritical and indifferent to any larger social good. The message they're sending to students is, "Get used to it; this is the way the world works." Colleges might argue that they're providing something useful: an introductory course in cynicism. But no college has yet offered this defense, which would at least have the virtue of honesty.

Economic forecasters may be deluding themselves if they are counting on a quick, strong recovery

Optimists—Or Just Dreamers?

By Robert J. Samuelson

We need to avoid the nostalgia factor—a longing for the late lamented economic boom that clouds our vision and corrodes our judgment. People understandably yearn to return to the good old days of the late 1990s. It won't happen any time soon, and those who suggest it might are engaging in wishful thinking. They're telling us what we want to hear. There's a lot of that these days. Beginning a new year, when economic forecasts are flying furiously, it's important to grasp their limits.

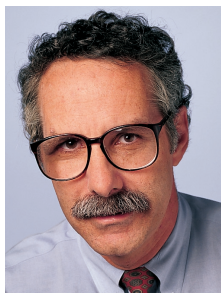
If you believe the conventional wisdom—which seems reflected in the stock market's recent rise—the recession is almost over. The Blue Chip Economic Indicators, a newsletter, surveys 53 forecasters and finds that about 70 percent think the recession will end no later than April. The latest average forecast predicts 0.4 percent growth in the gross domestic product (the economy's output) in the present quarter. By the fourth quarter, GDP should expand at a respectable 3.9 percent annual rate. Could happen. But if it does, it will be luck as much as anything else.

Truth be told, most economists don't really understand this peculiar recession especially well. We know this because most of them didn't predict it, which wasn't surprising, because most didn't understand the preceding boom, either. They constantly underestimated its strength and only belatedly recognized that some of its powerful driving forces—extravagant investment in new technologies, widespread stock-market speculation—were not altogether good. Forecasters' recent record has been dismal.

Let's look back. In January 1996, the average Blue Chip forecast was that GDP would increase 2.2 percent that year. The actual increase was 3.6 percent. Here are the January predictions and actual outcomes for the next four years: 1997, 2.3 percent versus 4.4 percent; 1998, 2.5 percent versus 4.3 percent; 1999, 2.4 percent versus 4.1 percent; 2000, 3.6 percent versus 4.1 percent. You might say that these are minor mistakes, just a few percentage points. But the economy usually grows between 2 and 4 percent a year. To have value, a forecast must be closer to the actual numbers. Forecasters were missing GDP growth by as much as 48 percent. (A 2 percent forecast against a 4 percent outcome is a 50 percent underestimate.)

If you didn't understand the boom, why would you better understand the bust? No obvious reason.

A year ago, the Blue Chip consensus saw 2.6 percent GDP growth for 2001. The actual figure will be about 1 percent or maybe less. (The Commerce Department releases the first official estimate on Jan. 30.) But if September 11—something no economist could have predicted—caused the recession, don't forecasters have an excuse? This defense sounds better than it is. Although September 11 worsened the economy, the recession had already started. The National Bureau of Economic Research (a group of academic economists) dates the onset to early spring.



All this suggests that you should treat the present recovery forecasts with skepticism. The standard post-World War II recession has followed a familiar pattern: (a) while the economy is expanding, inflation rises; (b) to dampen inflation, the Federal Reserve increases interest rates; (c) as the economy slows, businesses develop unwanted inventories (excess supplies of unsold goods); (d) to reduce inventories, companies cut production and lay off workers; (e) higher inventories and unemployment cause price and wage increases—a.k.a. inflation—to subside; (f) the Fed then trims interest rates and the economy recovers. The process usually takes less than a year. Since World War II, the average recession has lasted 11 months.

By this schedule, the recession must nearly be over. It started almost a year ago. Time for recovery. Unfortunately, this recession didn't follow the familiar pattern. True, inflation did rise (very slightly) in 1999 and 2000, and the Fed did increase interest rates beginning in mid-1999. But the economy's main problems weren't—and aren't—inflation and excess inventories, which could be speedily remedied.

The economic euphoria of the late 1990s caused consumers to go on a spending spree and businesses to go on an investment binge—and the rest of the world fed off the American boom. Consumers spent by skimping on savings, borrowing heavily or cashing in stock profits. At year-end 2001, consumer debt payments were a near-record 14.3 percent of disposable personal incomes, according to Moody's Investors Service. Similarly, excessive corporate investment has left enormous unused factory capacity. According to the Fed, the surplus is greater than at any time since 1983.

What's now occurring is a period of "payback." Corporate investment dropped during 2001. In early 2000, consumer spending grew at an annual rate of 5.9 percent; by the third quarter of 2001, the gain was a meager 1 percent. This twin retrenchment represents a huge drag on the economy that spills into other sectors. Corporate profits have already plunged. State and local government spending will suffer as tax revenues falter. Nor is the rest of the world helping. Japan is in recession; Europe is in or near one. Argentina just defaulted on its debt; many developing economies are weakening.

It's easy to sympathize with forecasters. So many unfamiliar forces are now tugging at the economy that a coherent outlook is hard, maybe impossible. No one truly knows what will happen—especially, how long it will take consumers and businesses to recover from their recent frenzied spending, and how the economy will react to the Fed's 11 interest-rate cuts in 2001.

But the forecasters crank out their numbers, and there's a tendency to see the recession simply as a brief and unpleasant interruption to unspoiled prosperity. This may be too glib. The central reason economists misinterpreted the 1990s boom was that they assumed that the economy would follow historical patterns. It didn't. If economists repeat their error—and they may be doing just that—then they will be surprised, probably unpleasantly, by the pattern of recession and recovery. And that could be bad news for us all.