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Best Business Books 2004: The Bubble

Reconsidering the Boom and the Bust

by John R. Patrick

As Internet companies began to implode in large numbers during the final months of 2000, an early warning sign of the extent of their difficulties was a *Wall Street Journal* story about the failure of a European e-tailer, headlined "Boo.com's Collapse Further Darkens E-Tailing Picture." The implication was gloom and doom, and it was prescient. Webmergers.com reported that at least 210 Internet companies folded in the year 2000. By December 27, 2001, the *Journal* reported that the "Dot-Com Death Toll" had more than doubled, to 537. The "bubble" had popped.

The giddy inflation and grim deflation of the Internet bubble had major effects on the broader stock market and the U.S. and world economies. In its aftermath, the bubble continues to influence the way people think about business, technology, markets, and growth. Even now, three years after that crescendo of bad news, it can be difficult to separate the myths from the realities.

Business journalists, historians, academics, and consultants will be analyzing the bubble and its effects for years to come. Two recent books take very different approaches to making sense of the debacle. One -- *Origins of the Crash: The Great Bubble and Its Undoing*, by business journalist Roger Lowenstein (Penguin Press, 2004) -- views the bubble as a morality tale. Another, more interesting, book -- *Rational Exuberance: Silencing the Enemies of Growth and Why the Future Is Better Than You Think*, by Business Week Chief Economics Editor Michael J. Mandel (HarperBusiness, 2004) -- uses the bubble as a backdrop for an examination of its significance for technological growth.

Neither book provides a comprehensive framework for sorting out what went on, and neither sufficiently addresses the potential future effects of the Internet. But a few facts can be asserted: One is that the failures of the Internet companies themselves were not such a big deal by some standard business and economic measures -- it was the ripple effects, which grew to tsunami-like proportions, that make the bubble's memory so painful. Another is that the bursting of the bubble changed, often in overly negative ways, the way many businesspeople and others think about the impact of the Internet on business and the economy as a whole. Indeed, in my view, the visions of some of the most ambitious Web pioneers of the 1990s may ultimately be vindicated, although it will happen in ways that they could not foresee.

Self-Defeating Excess

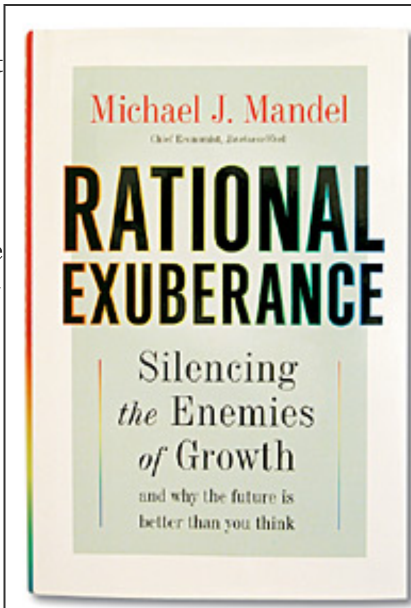
Lowenstein's *Origins of the Crash* allocates many pages to corporate scandals. Talking little about the dot-coms, it instead examines the few but huge failures that made the front covers of major magazines around the world. Although some of these companies, notably Enron and WorldCom, were related in some ways to the Internet phenomenon -- or at least to Wall Street's bubble-induced and untested valuation models -- the demise of these companies had little to do with the Internet itself. Lowenstein reveals details of excessive executive compensation, stock option abuse, naive shareholders, overly friendly auditors, and the era's hyperfocus on short-term financial gain.

The excruciating detail that Lowenstein provides about the collapse of once-major corporations reflects great shame on American business. He explains complex financial reporting in admirably simple terms, but sometimes at the expense of important nuances: It is always easier to second-guess accounting decisions after the fact. And in many respects, he tars all the companies that failed with the same brush. Certainly there were huge abuses such as he describes, but it seems unfair to imply that U.S. corporate management was rotten to the core.

In time we will know even more intimate details of these mega-failures, as a result of the lawsuits currently under way or still to come, but so far it appears that the lack of integrity and the excessive greed were concentrated in a fairly small number of senior executives. A large corporation has thousands of senior managers; most of them were victims, not beneficiaries.

The final chapters in the author's saga of greed and corruption remain to be written. Although some of the executives involved in the stock market bubble have been convicted of serious crimes, what may be the climax of the entire episode -- the trial of Enron Chairman Kenneth Lay and his top lieutenants for their part in the collapse of the former energy-trading company (and for the billions of dollars lost by employees who were encouraged to hold on to their stock) -- won't even begin until 2005.

If nothing else, Lowenstein's book gives you an appreciation for the Sarbanes-Oxley Act and other regulatory reforms. Most executives of U.S. companies agree that some of these reforms were necessary, but there are also critics who consider them to be overkill. Reading *Origins of the Crash*, it's hard not to agree that the reformers have the stronger case. (See "Governance.").



In *Rational Exuberance*, Michael Mandel takes a different and substantially more positive approach to analyzing the bubble and its aftermath. *Business Week*'s Mandel is passionate about the importance of what he calls exuberant economic growth. He makes the case that exuberant growth goes hand in hand with the creation of life-changing technologies like the Internet, even if it also breeds some self-defeating excesses.

During the mid-1990s, Mandel began to write about the "New Economy," describing the positive impact of technology and aggressive financial markets. He was not talking about a new economy in which profitability was an afterthought, but rather an economy that could expand and create both jobs and wealth as a result of innovation. Mandel predicted the Internet bubble in his book *The Coming Internet Depression* (Basic Books, 2000). But the warning he is issuing today should be heeded: Without exuberant, technology-driven growth, the economies of the world will not be able to support the social programs that are needed by their populations.

Mandel systematically builds the case for how technology innovation leads to economic growth and improved standards of living, and how it has the potential to continue to do so. He explores many examples of this potential in the communications, manufacturing, health-care, energy, and transportation sectors. For example, he notes that exploration and exploitation of outer space, already a multibillion-dollar industry, has the potential to be enormous. In all these sectors, he relates, breakthrough ideas are already being worked on that could ultimately employ millions of people.

Mandel worries that America may not be able to maintain its long tradition of technological leadership; the number of graduate students produced by American universities has been declining, he notes, especially in science and engineering. He urges that funding for graduate studies be increased, but writes that new funding, instead of being tied to particular fields of study or specific research grants to faculty members, as is often the case today, should be allocated in a more flexible manner to encourage broad exploration to seek out the next big thing.

Just as *Rational Exuberance* builds the case for technology-based innovation, it also makes an articulate case against the many "enemies" of growth. Some research economists have consistently argued against rapid innovation and growth, with some arguing that these lead to federal deficits. Many political leaders of both parties have been unenthusiastic supporters of investment for technology innovation. More than a few have blamed technology for many of the world's problems, including job dislocations resulting from automation, invasions of privacy and Internet spam, and -- more generally -- for disruptions of the status quo. For many of these antigrowth advocates, the boom and bust of the Internet bubble is a convenient argument for why we should be loath to invest in technology.

Bubble Myths

In weighing the negative message of *Origins of the Crash* against the forward-looking promise of *Rational Exuberance*, it's worth looking back and considering what the Internet bubble was and wasn't. On the surface, 537 Internet-related bankruptcies in 2001 sounds like a huge number, especially compared with the approximately 110 public companies that PricewaterhouseCoopers forecasts will file for bankruptcy in 2004. But what's easily forgotten is that most of the Internet or dot-com companies were not yet public companies. When we examine the *total* number of business bankruptcies, we see a much different picture. In 2001, the year the bubble burst, 40,099 businesses failed. From this perspective, the 537 Web-related failures were a drop in the bankruptcy bucket.

The job losses that followed the bursting of the Internet bubble were serious. Beyond the losses caused by the bankruptcies themselves were many more layoffs, including cuts made by surviving Internet companies trying to convince investors that they could be profitable. Through the end of 2001, dot-com companies had announced nearly 100,000 layoffs, more than double the number in 2000. But although those layoffs were devastating for many people, dot-com layoffs numbered less than 10 percent of total layoffs in the U.S. economy in 2001.

Another fact, often ignored, is that the vast majority of Internet companies did not fail. Webmergers.com estimated near the end of 2001 that 7,000 to 10,000 Internet companies -- more than 90 percent of them -- remained in operation. The survivors learned the lessons of becoming successful companies: to segment their markets and understand the needs and wants of their customers; to set prices that make sense in the market; to manage their costs to something less than the price; to create effective fulfillment systems; and to provide excellent customer service. Those are the factors that have always separated winners from losers.

In retrospect, these books show us that much of what looked like the "new" economy of the bubble years was a false promise. Some CEOs measured their success by how much investor capital they took in, instead of by earning real revenue from real customers. Many companies were formed to use the Internet to link the supply chains across entire industries, even though the supply chain processes and data inside the companies in those industries were still managed in unconnected silos. New companies called application service providers were born to eliminate desktop-computing applications, even though relatively few employees or consumers had reliable high-speed Internet connections. The companies that bought into the bunk were the ones that failed. Since many had famous investors or managers, every move they made -- from small layoffs to restatements of earnings -- made front-page news. The drumbeat of bad news made it appear as though the magic of the Internet was unraveling when, in fact, it was the absence of sound business models that brought the startups down.

The rosy picture painted by Mandel in *Rational Exuberance* may not be rosy enough. I believe we have seen less than 5 percent of what the Internet has in store for our business and personal lives. Soon, a billion people will be using the Internet, empowering themselves to get what they want "on demand." This simple concept, already becoming something of a catchphrase in business circles, in fact, represents a profound change in the way companies do business, and is causing a rebirth of growth in information technology, both for established companies and for startups.

For organizations of all kinds, "on demand" computing will be able to provide access to all the processes and data that are needed by their constituencies -- customers, employees, business partners, analysts, shareholders, and stakeholders -- when they want it, from wherever they are, using whatever kind of device they may be using to connect to the Internet. The most critical requirement for organizations to survive and thrive in this new world is to achieve integration of their strategies, business processes, and technologies, with the Internet as their central nervous systems. By doing this, organizations will be able to present one face to the customer.

Few, if any, businesses have yet delivered on the promise of "on demand," but leaders are moving in that direction. Companies like American Express, GE, DaimlerChrysler, IBM, and UPS are investing heavily to become truly integrated businesses. Many startup companies are emerging to take advantage of "on demand," too. But older companies have significant advantages over startups if they can achieve integration quickly enough. They have loyal customers and employees, access to capital, established channels of distribution, and information technology infrastructure, as well as many legacy applications that could become assets.

The post-bubble backlash against the business models and profit potential of pure Internet companies may continue for some time. The early Internet companies demonstrated both the opportunities of the new technology and the potential mistakes that could be made applying it. Many of the surviving and newer dot-coms have been working to do better ever since.

A business not fully exploiting the Internet today is like a business in the 1950s not having a telephone. Industry by industry, the pacesetters are emerging. Many people who left the established companies to join startups returned to their former employers and are sharing what they learned out on the frontier. This may be the lasting legacy of the Internet bubble. s+b

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