


This Letter's
Mainpage


This Letter's
Features


This Letter's
Diary


Index to
Back Letters


Search this
Website


Statistics


Hotlinks

The Dot.Com Crash

... after Wall St's biggest fall in history

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- On Friday 14th April, Wall Street experienced its biggest one-day fall in history, ending a week in which US markets lost \$2 trillion in value — the equivalent to Germany's entire economy. Worst hit was Nasdaq, the stock exchange favoured by hi-tech companies such as Microsoft. Bill Gates saw his personal fortune drop \$30 billion in a few hours ... and Amazon.com and other famous e-commerce companies started laying off staff.

But, in the following weeks, it soon became clear that the dot.com crash was not going to be the beginning of a stockmarket Armageddon. Despite the heavy losses, most stock traders were accepting the fact that the new technology shares were grossly over-valued.

- Several weeks before the crash, Larry Elliot commented in The Guardian that every financial bubble has the ingrained belief that "this time it will be different". And there were plenty of signs that the dot.com bubble was going to burst.

According to research before the crash by HSBC, the divergence in price-earnings ratios between old and new economy stocks was the largest for any market ever. Even by a very optimistic forecast of growth rates, new economy shares were overvalued by 40%. Similarly, Sushil Wadhani of the Bank of England's Monetary Policy Committee calculated that 133 internet companies which have gone public since 1995 would need to expand their revenues by an average of 80% a year for the next five years to justify their values before the crash. Even Microsoft has averaged only 53% a year.

- How did things get so over-valued? Most of it has been put down to plain old hype and speculation. But there has also been a powerful new myth at work in financial circles: that the dot.com age is re-writing the basic laws of economics.

One central theory of the new technology-driven economy is the concept of the "network effect" — a belief that "... as the number of nodes in a network increases arithmetically, then the value of the network increases exponentially". The workings of this theory can be seen that when you only have one mobile phone, fax machine or website ... the product is fairly worthless. But as you add greater numbers of connections to these new technologies ... then they each make the earlier connections more valuable. It is this "network effect" that has driven up the perception of the values of shares in new technology ventures. It has also generated a host of free products — from email programmes to web browsers — each trying to get as many network users as possible to establish their overall "value" in the marketplace.



But, as David Bennahum remarks in a recent issue of *Strategy & Business* : "The real "network effect" is this: in the end, booming subscriber lists cannot camouflage the fact that "cashflow is cashflow". Investors want a return on their money — and no economy, new or old, can continue to support loss-making businesses."

- How will the dot.com crash effect jobs? The current deflation of new technology stocks could actually prove to be a benign move for employment in those traditional businesses that were being starved of investment capital during the dot.com hype. Anatole Kaletsky of *The Times* comments: "A reduction in tech stock investment might be desirable in its own right, since there were signs of a Soviet-style misallocation of resources as money floods into companies that are never likely to make a profit. The availability of virtually free capital to internet businesses that never think of making a profit wastes resources, starves the old economy of funds and distorts competition, putting unhealthy pressure on otherwise sound bricks-and-mortar businesses..."

- **VOICE: VON HOFFMAN ON GLOBALONEY**

"Car drivers have been wheeling into petrol stations throughout America to discover that their vehicles don't run on information, but on fuel. This may come as a shock to a nation now awash in "globaloney" — a belief in a global economy in which we Americans get to do all the buzzy-jazzy stuff, and everyone else does the work. We have settled comfortably into this post-industrial, gravity-free existence: we sell ingenious things such as hedge funds, movies and intellectual property to the rest of the world, while they sell us food, clothing and shelter in return. It doesn't matter that, as a result, we now buy far more than we sell — manufacturing goods is a job for others, not for Americans, because it's all dirty, low-paid work..."

— *Nicholas von Hoffman, The New York Observer 29 April 2000*

Sources - *The Week* 22 April 2000 "Stock Market tumbles" by the editors. *The Guardian* "A crash would be no bad thing" by Larry Elliot *The Week* 4 March 2000; *Strategy and Business* "The myth of the network effect" by David S Bennahum *The Week* 12 February 2000; *The Times* "The bursting bubble is good for business" by Anatole Kaletsky *The Week* 8 April 2000; *The New York Observer* "The global economy is a lot of baloney" by Nicholas von Hoffman *The week* 29 April 2000.



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[This Letter's Main Page](#)

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