The Bubble For Dummies

by Harley Schlanger

dot.con: The Greatest Story Ever Sold
by John Cassidy
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On Dec. 5, 1996, Federal Reserve Chairman Alan Greenspan surprised an audience of the American Enterprise Institute, a gang of triumphalist free-trade ideologues come to honor him, by questioning whether the rapid appreciation of U.S. stock markets over the previous three years had been good for the country. While praising the U.S. economy, comparing it favorably to Japan's "so-called bubble economy," Greenspan asked, "But how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade?"

This question, which dominated financial news for the rest of the year, triggered a flood of propaganda, whose gist was that the exuberance was in fact rational, as the U.S. economy had entered an era of the "New Economy." Typical was a feature in *Business Week* on Dec. 30, 1996 by Michael Mandel, "The Triumph of the New Economy," which argued that, "Underlying the equity boom is the emergence of a New Economy, built on the foundation of global markets and the Information Revolution."

A signature moment in this post-"irrational exuberance" propaganda offensive was the publication of an influential piece in *Wired* magazine, in July 1997, "The Long Boom: A History of the Future, 1980-2020," by Peter Leyden of *Wired* and Peter Schwartz, co-founder of Global Business Network. In a burst of euphoria, they wrote that "We are watching the beginnings of a global economic boom on a scale never experienced before. We have entered a period of sustained growth that could eventually double the world's economy every dozen years and bring increasing prosperity for—quite literally—billions of people on the planet. We are riding the early waves of a 25-year run of a greatly expanding economy that will do much to solve seemingly intractable problems like poverty and to ease tensions throughout the world."

The New Economy

In this piece, and in countless others that mimicked it, economists, Wall Street brokers and analysts, and journalists, fell over themselves to be overheard agreeing with the (Wired scenario: The industrial era is over, replaced by a new era ushered in by globalization and the Information Revolution.

The New Gospel was being preached even from the established houses of Wall Street. For example, Mary Meeker, an analyst at Morgan Stanley, argued that a new model had to be developed to measure "valuation" of Internet stocks. Traditional valuations could be misleading, she proclaimed. Current earnings should be replaced as a measure of a company's success, by "earnings potential," which can be assessed through determining the "mind share and market share" of a company.

Morgan Stanley's release of "The Internet Report" in February 1996, prepared by Meeker and an assistant, helped fuel the flood of Initial Public Offerings (IPOs) beginning in 1996, which made multi-millionaires of those who launched them. For example, in the IPO of Yahoo!, on April 12, 1996, 2.6 million shares were sold. The shares were issued at $12 per share, opened at $25 per share, and closed that day at $33 per share. Thus, Yahoo!, a company with 68 employees at the time, was valued at $850 million!

These absurd stock valuations soon became one of the leading arguments for those promoting the idea of the New Economy. In *Business Week's* Nov. 17, 1997 issue, the Editor-In-Chief, Stephen B. Shepard wrote, "We have the most powerful gauge of all telling us that something profound is going on: the stock market."

One of the other great gurus of the New Economy was Goldman Sachs' Abby Joseph Cohen, the bull's bull, who became one of the chief ideologues of the movement. Cohen argued, in the Spring of 1996, that what was driving higher corporate profits—and therefore, generating higher stock prices—was a previously unmeasured increase in productivity. "I believe the government's productivity figures are wrong," she said, pressing this point during frequent interviews with the financial press.

New Paradigm or Bubble?

The story of how Wall Street hypesters like Meeker and Cohen, in collaboration with "venture capitalists," anti-government free trade academics, and the financial media—especially the new networks, such as MSNBC—combined to snooker the American public into literally betting the house on the "new economic paradigm," is the subject of John Cassidy's appropriately titled book, *dot.con: The Greatest Story Ever Sold.* Cassidy has written an interesting anecdotal chronology, from the invention of the microprocessor by an Intel engineer in 1971, through the go-go 1990s, to the market crash which was well under way by Sept. 11, 2001.

Along the way, Cassidy offers ample evidence to demonstrate that the wild upward curve of the markets beginning in 1995, followed the classical pattern of a speculative bubble. He provides, in the Prologue, what he calls the four stages of a bubble. First, there is "Displacement," in which something occurs which changes investors' expectations (in this case,

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the computer/Internet "high-tech revolution"). Second comes the "Boom Stage . . . when prices are rising sharply and skepticism gives way to greed." Third is "euphoria," when "established rules of investing and often mere common sense, are dispensed with." Fourth, "Finally, inevitably, comes the bust," when everyone asks, "How did that happen?"

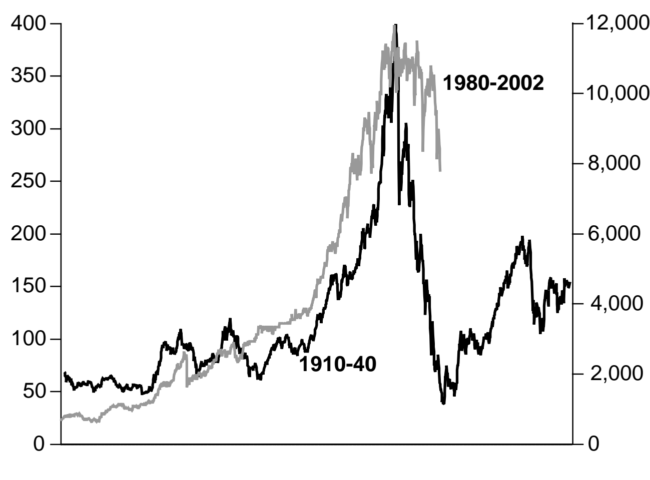
By the third stage, he writes, "most observers have a vested interest in avoiding stating the obvious—that delusion has replaced reality." Among those he includes in this category are "Wall Street bankers eager to cash in on an unprecedented source of revenues;" journalists and the media companies, which cover financial news; economists and economic policymakers, "who refused to learn the lessons of history;" and Federal Reserve Chairman Greenspan, "who had convinced himself that miraculous things were happening to the American economy."[1] And, of course, there could not be a bubble without the suckers, those "ordinary Americans, enticed by the prospect of instant wealth, parting with their hard-earned money for worthless pieces of paper."

Cassidy's book is filled with examples of how the bubble was created and encouraged. As legislation to deregulate the practices of Wall Street investment firms and commercial banking was passed by Congress, the first 401(k) plan was set up, in November 1981, to encourage employers and their employees to put retirement and pension funds into stocks. By 1985, ten million employees had 401(k) plans; by 2000, more than 40 million Americans had them, with $1.7 trillion in (since shrunken) assets.

At the same time, again as an offshoot of deregulation, the number of mutual funds grew from 665 in 1981, to 1,527 by 1985. By the mid-1990s, there were 130 million mutual fund accounts and, by 2001, these funds contained more than $7 trillion, with more than $4 trillion of that total in stock funds.

FIGURE 1

Dow Jones Industrial Average: Great Depression vs. Today



Source: Dow Jones.

Author John Cassidy does a scholarly job of showing that the "New Economy" was nothing but a stock bubble guaranteed to collapse; but he refuses to admit the reality, that that collapse is a new depression, worse than the Great Depression set off by the stock collapse of 1929-33.

The 'New Valuation' and Productivity

Cassidy offers numerous details of how these funds were sucked into the new Internet companies, many of which had not recorded any profits. Take the IPO of Netscape, which released its first Web browser—Netscape Navigator 1.0—in December 1994. At its IPO on Aug. 9, 1995, five million shares of stock were offered, with a recommended price of $28 per share. It opened at $71 per share, closed at more than $58. In its first day of trading, its value (measured by stock price) reached $2.2 billion, almost the total value of General Dynamics!

For Wall Street, Cassidy writes, "the Netscape IPO had legitimized a new business model—one in which earnings and balance sheets didn't matter. In the new Internet era, the game was to raise money from investors, clamber aboard an exponential growth curve, and worry about revenue and profits later." He shows most of the IPOs in the "high-tech" sphere never made any profits.

However, the speculative profits made by Wall Street firms led to a drumbeat to recognize a "new valuation," one which ignored the traditional measures, such as making a profit. It was not long after his irrational exuberance speech that Alan Greenspan began promoting the idea that a new way to measure the value of corporations is needed, which, he argued—in support of high-tech cheerleaders Meeker and Cohen—is to be found in the alleged growth of productivity caused by these "new technologies."

With the bull market soaring in 1997, Greenspan told the Senate Banking Committee on July 22 that the economy's performance is "exceptional," and might represent a "once or twice in a century phenomenon that will carry productivity trends nationally and globally to a new, higher track. . . . What we may be observing in the current environment is a number of key technologies, some even mature, finally interacting to create significant new opportunities for value creation."

Greenspan seemed to be embracing in public the outlandish claims of Meeker, Cohen, *Business Week's* Mandel, and others, that the huge volume of funds flowing into Internet, telecommunications, and related stocks was due to "productivity." The problem, they argued, was that the productivity

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1. A transcript of a meeting at the Fed on Sept. 24, 1996 indicates that Greenspan acknowledged even then that there was a stock bubble. In the transcript, in response to Lawrence Lindsey's assertion that "this emerging bubble is nonetheless real," Greenspan said, "I recognize that there is a stock market bubble problem at this point, and I agree with Governor Lindsey that this is a problem we should keep an eye on." (Lindsey is now President Bush's senior economic adviser.)

gains were not being measured; the old measures of productivity were outmoded, and new means were needed to measure "intangible" wealth creation.

Meeker, et al. were confusing increases in price, with productivity. Cassidy quotes a Morgan Stanley Dean Witter review prepared by Meeker in September 1997: "We have one general response to the word 'valuation' these days: 'Bull market.' We have been in the technology sell-side trenches for about a decade and simply—we believe that we have entered a new valuation zone." This "new valuation" was nothing but millions of people's willingness to pour money into buying stock in companies with no prospects to make a profit!

As the delusions continued through 1998, Greenspan increasingly aligned himself with the hypesters. He asked Fed officials to find a new way of measuring productivity, so that the soaring share prices could be seen as rational. On Jan. 28, 1999, Greenspan gave his cautious endorsement of the runaway market, saying, "there is at root something far more fundamental—the stock market seeking out profitable ventures and directing capital to hopeful projects before the profits materialize. That's good for our system. And that, in fact, with all its hype and craziness, is something that, at the end of the day, probably is more plus than minus."

By July 2000, Greenspan was less cautious, as at the National Governors' Association: "With the adoption of information technology, the share of output that is *conceptual* rather than *physical* continues to grow. . . . As a result, information technologies have begun to alter significantly how we do business and *create economic value*" (emphasis added). The only problem with Greenspan's analysis, was that it was dead wrong.

Productivity Comes From the Physical Economy

A major weakness of Cassidy's book is his assumption that every one of the protagonists of the New Economy—brokers, financial journalists, policymakers, and investors—should have known it was a bubble, but fell victim to "collective insanity" and "herd behavior." Further, that the "New Economy thesis would never have become so widely accepted if Greenspan hadn't seized upon it and made it his own." But after reviewing this descent into collective lunacy, Cassidy ends his book by embracing it! On the economy's overall prospect after the market crash which continued from March 2000 through the end of 2001, he writes that there is a "depression scenario." However, a "reasonably rapid recovery" would likely occur, if Americans "could be persuaded to return to the airports and the shopping malls pretty quickly."

The continuing collapse of markets, which has accelerated again in September 2002, mocks Cassidy's conclusion. This grows lawfully, however, from the book's fatal flaw: Cassidy has left out the work of the only economist in the United States who correctly argued, from the beginning of the 1990s, that the "New Economy" was a wholesale fraud, and that the speculative growth of the stock markets expressed a deadly dangerous delusion. That economist is Lyndon LaRouche, whose writings in *EIR* have provided the most in-depth analysis, and dead-on forecasting, of any economist in the world, for 35 years.

Take the question of productivity, which Cassidy identifies as a central problem for the New Economy. LaRouche repeatedly has pointed to the Aug. 15, 1971 decision by Richard Nixon—which formally ended the successful post-war Bretton Woods monetary system—as the take-off point for the shift from an economy based on physical production, to a consumer society. In the ensuing 30-plus years, productivity, as measured by the Bureau of Labor Statistics (BLS), had fallen to levels of less than half of that from the end of World War II until 1971. Under pressure from Greenspan and others, the BLS changed its productivity measurement, beginning in 1997, to show productivity increases, to match the hype pushed by promoters of the "New Economic Paradigm." In August 2002, the BLS admitted this was an example of "accounting fraud," and revalued down productivity "gains" from 1997-2000.

In an April 2000 paper, "Information Society: A Doomed Empire of Evil," LaRouche defined the only sensible measure of productivity, premised upon "1.) What percentile of the total labor-force, is engaged in either a) applying new physical principles to increase mankind's per capita power over nature, or b) generating the new physical principles and technologies being employed 'at the point of production'? 2.) What is the rate of net increase of physical output per capita and per square kilometer of the Earth's surface-area, as being expressed at the point of physical production of the basic economic infrastructure, agriculture, and manufacturing?"

He continued with advice which might have aided Cassidy, or any future, more serious report on the death of the New Economy: "Do not confuse price with physical reality; rather assess the meaning of prices, by subjecting them to the standards of physical reality."[2]

Had LaRouche's writings on physical economy over the last 35 years been studied, and adopted to shape policy, we could have avoided the catastrophic collapse of the financial system we are facing now. Failure to learn from him will doom civilization to a Dark Age. It is not simply greed and delusion which placed us in this precarious position, but the fear of challenging accepted "popular opinion." including such policymakers as the fallen guru, Alan Greenspan.

Unfortunately, Cassidy ultimately did not have the courage to break with that popular opinion that he so properly skewered for more than 300 pages.

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2. Lyndon H. LaRouche, Jr., "Information Society: A Doomed Empire of Evil," in *EIR* Special Report, *Why the New Economy Is Doomed,* June 2000, and also in *EIR,* April 28, 2000. The collapse of productivity is also expressed by LaRouche in his Triple Curve Collapse Function (see p. 23), which serves as a pedagogical device to demonstrate how a speculative bubble is premised upon the destruction of the productive economy.