Reality Check: It Is a New Economy — But the Old Rules Still Apply
The high-flying new economy couldn’t defy the laws of gravity indefinitely. But, in the hands of people who really know how to run a company, the new economy business models are ready to take off.

The new economy – defined as a high-growth (4% annual growth in productivity) economy driven by the production and widespread use of Information Technology (IT) – is undergoing a much-needed market adjustment.

The gain in productivity resulting from IT was the central fact around which a considerable amount of hyperbole was fabricated. Investors were convinced that new rules applied in valuing Internet-based businesses. Businesspeople were counseled to abandon traditional management discipline, the better to take advantage of (or defend against) the dot-com way of doing business. The hope of getting rich quickly was a powerful lure; the fear of being left in the dust by the dot-coms a powerful spur to action.

The hot air wasn’t limited to dot-coms. The IT and telecommunications sectors produced their own speculative bubbles. Failure to achieve sustained profitability ultimately caught up with the dot-coms (555 folded between January 2000 and June 2001), the IT sector (which clocked its first decline ever this year), and telecoms (with new carriers seeking the protection of bankruptcy court and equipment vendors seeing their bonds reduced to junk status).

The role of IT in the decelerating economy seems paradoxical: IT systems helped fuel rapid growth in productivity and were supposed to smooth (if not eliminate) the jolts of the business cycle. In fact, the IT systems in place performed as intended. With managers reacting more quickly based on immediate data, the downturn may have been sharper — and the recovery may be faster.

However, IT is not yet deployed as widely as popularly imagined. Nor is it used as effectively as it might be. The quality of the information that drives IT systems is the prime determinant of their performance. Yet many managers fail to make accurate data collection and input a priority. Many fail to check the pedigree of the data they use. Many make the mistake of confusing the Internet with knowledge.

Conversely, many managers presented with very good information indeed chose to ignore it. (Ironically, this was a failing of many in the IT sector). And many business people intent on acting at “Internet speed” simply skipped doing their homework before closing deals. (Another irony: with the information resources D&B provides online in real time, due diligence can proceed at I-speed too.)

On the macro level, economists theorize about what stalled out the new economy’s 10-year up-cycle. For some, recent economic history most closely resembles the boom-bust cycle of the pre-World War II era. Others see misapplied monetary policy as the root cause. For its part, the Fed believes the “soft landing” it was trying to engineer turned into a sharp downturn because of the shock of high energy prices, the bursting of the high-tech bubble, and the collapse in consumer and business confidence.

It would be a mistake to count the new economy as down and out, however. The new business models — for example, portals, online auctions, e-tailing — will continue to redefine commerce, perhaps not as quickly, but as inevitably as predicted. In the new economy’s second act, the new business models will be driven by old economy values to achieve sustained profitability.
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It’s official.

In May, the U.S. Department of Commerce switched from the Standard Industrial Classification – or SIC – codes, in use since 1972, to the North American Industry Classification System.

This new classification system, for the first time, corrals computers and related products, communications equipment, and semiconductors together as an information technology sector officially called “computers and electronic products.”

This is the IT sector that accounted for only 8.3 percent of the U.S. economy’s total output in Y2K but, according to Commerce, nearly a third of real U.S. economic growth between 1995 and 1999.

This is the IT sector that Federal Reserve Chairman Alan Greenspan identified just last April as the engine driving the unprecedented growth in productivity responsible for the new economy.

This new economy was fundamentally different from economies past – and the U.S. was in the midst of a business cycle profoundly different from any other in the post-World War II era. So different, it was not supposed to end.

All this official recognition came after years of skepticism – especially in Greenspan’s case – and gave way to solid research indicating that, yes, at least in the U.S., a new economy had taken hold.

Finally, all this official recognition ...

... just in time to capture the first ever decline in PC sales in the U.S.

... just in time to credit the IT sector with the first quarterly decline in productivity in eight years.

... just in time to see if old-fashioned monetary policy brakes could bring the high-flying new economy in for a soft-landing.

... just in time to be just as surprised as the average investor as some $4 trillion in market value seemed to simply evaporate.

Clearly, something happened, but what?

Before that question can be tackled, there’s a more fundamental question to be answered: What is the new economy?

What is the “new economy”?

Here’s the definition of the new economy supplied by Federal Reserve Board Governor Laurence H. Meyer:

“The narrow definition identifies the new economy with the dramatic acceleration in productivity tied, to an important degree, to innovations in information technology. Productivity refers to output per hour, and it is perhaps the single most important determinant of economic well-being, closely related to real income per capita.”

Given this definition, Meyer said – on June 6 of this year – the U.S. is in a new economy, although it is not without precedent. There have been other periods in American economic history when a bunching of innovations has propelled the economy to a higher rate of growth – for a while.

Commerce concurs: The hallmark of the new economy is higher sustainable growth due to faster improvement in labor productivity. From 1973 through 1995, the annual rate of growth averaged 2.5%; in each of the years from 1996 to 1999 actual growth surpassed 4%.
More, a landmark study by Federal Government economists Steve Oliner and Dan Sichel, released in March 2000, confirms the role of information technology. The Fed economists found that the use of IT and the production of IT products contributed approximately $50 billion in productivity output annually – or about two-thirds of the annual $70-billion productivity gain – over the second half of the ’90s.

Eric Brynjolfsson, a professor at the Center for eBusiness at MIT’s Sloan School of Management, is among those who think the Oliner-Sichel study underestimates IT’s productivity gains. But the Fed’s more conservative conclusion is generally accepted.

So, annual growth in productivity surged to 4% (compared to 2.5% previously), and about two-thirds of the increase is credited to IT. This is the core reality around which so much hyperbole has been generated – by the media, by analysts, by consultants, by PR organizations.

**New rules for a new economy?**

Whether you wanted to buy, sell, or invest in the new economy, you probably read, heard – or paid consultants to advise you – that a new set of rules applied.

Some of the new rules were deduced from the fact that IT had accelerated growth in productivity:

Faster productivity growth would result in faster profit growth – while reducing inflation (and with it interest rates). The risk of investing in equities would fall to inconsequential levels. IT overall would diminish the amplitude of economic cycles.

Some of the new rules were extrapolated from the actual or projected effects of new IT, most especially the Internet.

New rules applied in running – or valuing – a business because the new business models based on the new technologies hadn’t had time enough to produce the kind of results measured by the old yardsticks. Perhaps they never would, and that was all right, too.

Back in 1999, one commentator wrote approvingly of FreePC.com’s business model.

The dot-com gave away a computer to the first 10,000 customers who signed up at its site. Over one million people registered. The company planned to generate revenues by selling advertising on the computers, and by selling information on its customers to other companies.

The writer enthused: “This same basic model is currently being replicated in services like e-mail and Internet access. ... In all probability, it will not be long before companies go beyond free and start paying people to use products or services.”

This from an article that appeared, it is necessary to add, not in Wired, but in the Harvard Business Review.

Now, of course, a swift – and steep – marketplace adjustment has discounted much of the hype.

**Dot-coms in disgrace.**

Investors were assured that there were better ways to shop for equities than the Graham and Dodd method of looking for companies with undervalued assets.

The new and improved method was to look for clues to a company’s future cash flows based on how it exploited IT in general, or the Internet in particular.

And so investors were told to judge an investment’s prospects on the basis of pro forma results – earnings.
figures before such expenses as interest, taxes and depreciation have been subtracted. Or they were urged to look at revenue growth. Or the number of visitors to a company’s Web site, by which they could determine a company’s relative “mind share.” Or the number of “engaged shoppers” – visitors to a Web site who view at least three minutes’ worth of content.

The beneficiaries of much misplaced investor confidence were the so-called “dot-coms” – companies that opened for business in the virtual marketplace of the Internet.

Two start-up strategies were especially popular: Some dot-coms sold goods or services – at prices that undercut those of their bricks-and-mortar competitors – while operating at a loss. This feat made possible by infusions of cash from the capital markets. Others, like FreePC.com, literally gave away the product – although the give-away was more often a non-durable such as “content” – and hoped to make money from third-party advertisers and marketers.

Certainly a lot of hot air pumped up the dot-com bubble. Some dot-com start-ups were offered tens of millions of dollars, with more than 90% earmarked for advertising, according to the Harvard Business School’s D. Quinn Mills.

In first-quarter 2000, fewer than one in five companies were profitable when they went public, as compared to two-thirds in 1995. Remarked Forbes: “It is obvious to us now that probably 90% of companies that made an initial public offering of stock over the last two years were never going to be successful. Arguably, most were never really companies at all – just clever ideas, smart PR and a ton of venture money.”

At least 555 Internet companies have folded since January 2000, with nearly 60% of the casualties occurring during the first half of this year. 53 Internet firms shut down in June, according to consultant Webmergers.com, which pinpoints May of last year as the beginning of the end for dot-coms.

Indeed, the market correction has gone well beyond the dot-coms to include telecommunications, the entire IT sector, and beyond. Old economy companies have been forced to restructure – in some cases under the protection of a Chapter 11 bankruptcy. Widely held companies have seen the value of their shares erode and their bonds reduced to junk status.

The other com: telecom.

There was plenty of hot air to go around.

Believing that the new economy would require bigger and bigger pipes to carry more and more Internet traffic, telecommunications carriers, from the Baby Bells to a host of start-ups, rushed to lay new fiber optic networks. Investment dollars poured into the telecoms sector – $715 billion in 2000.

The resulting long-haul network capacity will be far in excess of demand for a decade or more to come. The immediate effect of over-capacity in these so-called backbone networks has been to push rate structures toward commodity levels. In the wholesale market where long-haul carriers sell carrying capacity, prices are expected to drop 60% this year.

In September of last year, Lehman Brothers warned that carriers and service providers were laying out $1 in capital expenditure for every $2.84 in revenue. Carriers don’t start making money until the ratio approaches $1 to $5.

One year later, Webmergers says that the Internet shakeout that began with e-tailers is now roiling companies that provide Internet access, infrastructure software or consulting services to businesses.
The telecommunications sector is now suffering a rash of bankruptcies. When a carrier goes dark, it can pull the plug on dozens of network services providers — and the hundreds upon hundreds of businesses they provided with virtual private networks and data communications. The failure of one carrier left 100,000 business customers scrambling to get back online — a different spin on “disruptive technology.”

Missing links.

Believing “if we build it, they will come,” telecoms equipment vendors vied to sell optical fiber and network processors to an over-crowded field of real and would-be carriers. They stepped up with the heavy financing carriers needed to purchase their equipment. They invested heavily in corporate “makeovers” — acquiring strings of high-tech companies, often at inflated prices, that would transform them from equipment manufacturers into new economy Internet companies.

By some estimates, there were three times as many network providers as the market could plausibly support. Caught up in the hot race to build the long-haul networks, telecoms companies seemed willfully to ignore the fact that these high-speed, high-capacity networks could be accessed by very few paying customers.

(Some observers see the missing high-speed, high-capacity link between the network and consumers as the source of economic woe beyond the beleaguered telecoms sector. Says Forbes: “The lack of cheap, always-on, last-mile broadband connections to small offices and homes is a short leash around the U.S. economy’s neck.”)

None of this dissuaded equipment vendors. They stayed the course, even as the most venturesome investors and lenders began to shy away from telecoms. While pouring money into network build-outs ($70 billion was spent on long-haul Internet infrastructure over the past few years), telecom carriers ran up some $240 billion in high-yield debt. Only a fraction of that new infrastructure is actually in use — and generating revenues. One carrier, Level 3, estimates it would take an additional $500-billion investment to bring all the optical fiber that has been deployed into service.

So, on the one hand, the long-haul network glut has slashed vendors’ sales; on the other, carriers lack the capital still needed to make these networks pay. With the carriers they financed missing interest payments — or simply folding — and market value of their acquisitions deflating, what remains to shore up the vendors’ market capitalizations is the fact that their shares are so widely held.

More bubbles.

Believing Moore’s Law — processing power doubles every 18 months — would continue to set the pace for business investment and consumer spending on IT, tech companies continued to tell analysts to expect record-breaking earnings growth through the end of 2000 — right up to the eve of the sharpest business downturn in the industry’s history. “December was like somebody turned the lights out,” said one high-tech CEO.

Two perceived threats helped fuel recent growth in demand for computer hardware and software: The threat of the year 2000 making a hash of computer systems based on six-digit dates; and the threat that new economy companies would elbow old economy companies out of the marketplace.

However real those threats may or may not have been when they were first posed, it is certainly clear that they were transitory. A business might invest heavily in new systems in response to both — or either. But it would not be likely to
maintain the same or higher levels of investment in IT year over year.

Certainly, after a two-year spending spree, business managers could be expected to pause to assess their investments to date before committing more. Ominously, in April Mercer Management Consulting reported that its survey found two-thirds of corporate executives disappointed in their ROI in IT.

Beyond common sense, evidence that inventories were accumulating and sales slowing seems to have been ignored by IT companies. As the CEO of one software company told The Industry Standard, “We all got a little fat and sassy. You started believing your own hype.”

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Widening circle.

“Is the nation caught in an IT slump, or is an overall economic slide hurting IT?” InformationWeek leaves the question unanswered – but clearly IT is not in the down-turn alone.

The dot-coms were not the only companies who never quite figured out how to turn a profit on an Internet-based business. For every $1 in Web revenue last year, e-businesses logged $1.49 in Web-related expenses.

Many old economy companies launched e-businesses as stand-alone units – the better to operate by new economy rules (and to attract some of the capital pouring into Internet ventures). But in so doing, these companies forfeited the chance to capitalize on their traditional competitive advantages, such as established brands and customer relationships, as Michael Porter points out in May’s Harvard Business Review. Now many of those stand-alones are being brought back into their corporate folds – although, in some cases, the parent is paying a price: buying back its devalued offspring with its own stronger shares.

More costly, in Porter’s view, is the damage done to the structure of some industries by companies trying to play by new economy rules. Most pioneers of Internet business were single-minded in their pursuit of customers – offering discounts, promotions and give-aways. Unfortunately, they were unable to bring the same focus to sustained delivery of real value to select market segments. They confused acquiring customers with building profitability.

By defining price as the primary, if not the sole competitive variable, these companies “turned competition into a race to the bottom,” Porter says. “Once competition is defined this way, it is very difficult to turn it back.”

Witness the Web “zines” that tried to interest their readers in paid subscriptions before being forced offline. Witness the commoditized pricing in telecoms. Witness the price war in PCs.

Blue skies.

Nor were the dot-coms the only companies to tout pro forma earnings, or enhance earnings reports with gains from pension plan investments, or embellish earnings announcements with impressive – but irrelevant – statistics about market reach or sales leadership.

“Public relations is driving financial reporting,” says Jack Ciesielski, publisher of The Analyst’s Accounting Observer newsletter. (Published by R.G. Associates, Inc., the newsletter’s stated objective is to provide “remedial accounting’ for institutional investors who should know better.”)

“There ought to be a law in this country that before you’re allowed to buy a stock you have to be able to read its
balance sheet,” Bill Fleckenstein, a money manager at Fleckenstein Capital in Seattle, told The New York Times. Investors who bothered to do so might have spotted growing inventories, accumulating receivables, high cash-burn rates – and some of the accounting gimmicks – indicating all was not as it had been hyped.

Even close readers might have missed the extent to which tech companies enhanced cash flow with tax deductions for employee stock options (a popular form of compensation in this sector). The deductions, which are taken when employees exercise their options and reflect the difference between the exercise price and the market price at the time, don’t show up in the income statement but in the cash-flow statement – and are added to the balance sheet as part of paid-in capital. According to a Merrill Lynch study, an average of 48% of fiscal 2000 operating cash flow at 37 major technology companies surveyed came from these tax deductions. With the value of high-tech stock options deflating, options are not being exercised at the same pace, deductions are down, and another source of cash flow – albeit questionable – for tech companies is drying up.

In March of 2000, The Economist advised its readers that Wall Street was more overvalued than at any time in the past 150 years. On the eve of the stock market crash of 1929, the price-earnings ratio for the Standard & Poor’s composite index, calculated on a backward-looking 10-year moving average of earnings, reached 33. In January and again in March of 2000, the S&P price-earnings ratio soared to 44.

At the time, Robert Shiller, in his book “Irrational Exuberance,” dismissed the arguments that the new economy was invulnerable to an old-fashioned bust. Taking it as self-evident that the bubble was on the verge of bursting, he concerned himself with identifying its sources – including the advent of the Internet, demographic shifts, the declining quality of professional investment advice, and the media (among others). All these contributed, but their effects were amplified to create a self-sustaining cycle of rising investor confidence by what Shiller calls naturally occurring Ponzi processes – that’s right, as in Ponzi or pyramid scheme.

**The human factor.**

It’s somehow easier to accept that investors got caught up in a speculative frenzy ... easier than understanding what drove seasoned executives to steer established companies so far from sound business practice and competitive fundamentals.

Many of the dot-coms could trace their philosophical roots back to the freewheeling 1960s counter-culture.

“There is no revenue credibility for new services on the Internet – and that’s the fault of the west coast hippies,” said Tom Nolle of CIMI, a telecommunications consulting firm, in a keynote speech to the Vortex conference in April. The failure of so many “something for nothing” Internet business models is construed by some as an overdue repudiation of flower-power generation values (at least as they apply to commerce).

Intel’s Andy Grove offers an interesting theory (in Wired in May) – also based on generational history. Recall, he says, the 1980s, when Japanese industry overtook, then outdistanced U.S. manufacturing. Ten years later, that generation of managers, anxious not to be caught flat-footed a second time, responded quickly and aggressively when consultants and analysts started to beat the drum about the threat of dot-coms to old economy companies.

Adding to the urgency was Clay Christensen’s theory of how new technologies cause great firms to fail. The Internet
seemed to be the epitome of the disruptive technology that arises outside the commercial mainstream and ultimately overturns the old economic order. (As Christensen has pointed out, his book, “The Innovator’s Dilemma,” wasn’t about the Internet, but the PC revolution.)

Theory aside, there was the very real need for speed. Moore’s Law was in force (and will be at least through 2007, on available evidence). The Internet did achieve 30% market penetration in four years. Electronic communications does compress cycle times. The deadline for deciding how to deal with Y2K bug could not be postponed.

According to the New York Times, the CEO of one e-consulting firm coached his staff to “accentuate the fear factor” by telling clients, “You have the money, but you don’t have time.”

Finally, it has to be said, some business people recognized a speculative bubble, and decided to capitalize on it – confident they could get out in time.

**Still a bumpy ride.**

The human factor helps explain why IT didn’t smooth out some of the bumps and jolts of the business cycle as advertised.

Remember? Companies were going to be able to fine-tune their software-driven operations in real time. A wealth of information – from market intelligence to order processing status to supply chain flow – was to be immediately available in the form of digitized content to guide decision-makers. Networks would seamlessly link the business’s managers, employees, suppliers, business partners, and customers. Commerce would be conducted in “frictionless” virtual markets.

With all this in place, how could so many companies get blind-sided by the downturn in business?

The early evidence is that, to the extent they were in place, the IT systems performed largely as they were supposed to. Indeed, many (beginning with Federal Reserve Chairman, Allan Greenspan) suggest that more immediate information on sales, production and inventories has resulted in more business managers responding more quickly – and in closer alignment – than in the past. This has resulted in a sharper downturn in the economy and, it is hoped, will result in a faster recovery.

However, some companies failed to make the most effective use of their systems.

Many forget that, while the software-based systems offer a more precise, up-to-the-minute view of business operations, astute managers are still required to read, interpret and act on the information the systems serve up.

This is the view of Antonio Cordella, who teaches at the London School of Economics, and who has done case studies of enterprise resource planning – or ERP – systems. He told the Wall Street Journal: “The main reason for failures in ERP implementations was that the technology was seen as the solution, without taking into account the complex dynamic of the organization and people. It doesn’t matter in which area, whether it’s knowledge management or B-to-B. You can’t forget that organizations are made of people and technology, and both people and technology will define the success of an organization.”

Echoing Cordella, Bill Gilmour, a senior partner with PricewaterhouseCoopers, said: “A lot of people put in systems expecting the magic wand to be waved and they’ll get the benefits. They’ll find it’s not that easy.”

More immediate information on sales, production and inventories has resulted in more business managers responding more quickly – and in closer alignment – than in the past. This has resulted in a sharper downturn in the economy and, it is hoped, will result in a faster recovery.
The Industry Standard’s close look at the savings GE has realized through its e-business strategy bears out this view. The Standard found that much of cost-cutting is attributable to improved business practices adopted as an adjunct to its new, Internet-based processes.

There’s a learning curve involved in the new systems, too. AMR Research projects that manufacturers may be able to save as much as 10% on operating margins with supply chain management systems – but cautions it may take a decade to fully realize those gains.

**Information please.**

Sometimes bad data is put into an IT system and skews results.

To take just one example: Point-of-sale scanners and electronic inventory systems were supposed to revolutionize supply chains by connecting manufacturing directly to consumers. In a recent study of 35 leading retailers, Harvard Business School researchers found that bad data input routinely results in inaccurate inventories – with reductions in profits as high as 25%. Again, the human factor is at the root of much of the error, from slipshod stock clerks, to cashiers rewarded for speed rather than accuracy, to lax management.

The sheer volume of data that can now be accessed with a few clicks obscures the plain fact that much of it cannot properly be called information – accurate, timely intelligence directly relevant to decision-making.

Appraising the success of Li & Fung, a Hong Kong-headquartered manager of global supply and distribution chains for manufacturers of high-volume, time-sensitive consumer goods, The Economist comments that while the company uses the Internet, it never confuses the Internet with knowledge. Li & Fung can put together complex chains linking dozens of suppliers around the world at Internet speed. The company’s ability to do so rests on an army of 3,600 staffers in 37 countries – “a machete in one hand, a laptop in the other” – who vet quick-response manufacturers in Asia, Eastern Europe, the Mediterranean, and the Americas.

Similarly, Dun & Bradstreet, the world’s leading provider of business information and analytical tools, uses the Internet both to collect and to supply information online in real time. But the major value D&B offers its customers is the solid assurance that information obtained from its global database of more than 62 million companies (updated more than a million times a day) is accurate and complete. That assurance is achieved by D&B’s trained specialists, equipped with sophisticated software systems (the customized data entry system alone contains over 2,000 ways to validate input) gathering, verifying and analyzing information.

**Ignoring the messenger.**

Sometimes good information comes out of an IT system and is ignored.

The Industry Standard wondered why the IT industry, in particular, was caught off guard when the market for its products declined. Many of these companies had used their own operations as showcases for e-commerce, supply chain management, sales force automation, customer relationship management, and so on. And, by all accounts, the systems worked.

Still, the IT sector’s leading companies failed to react even as indicators of softening demand became apparent. D&B began clocking upticks in financial distress, credit risk, higher risk, late payments, bankruptcies and other measures of deteriorating business conditions early last year – reliable information available to any D&B subscriber that would have alerted managers to the need for a course adjustment.

By way of explanation, one high-tech CEO said: “Nobody wanted to flinch. Everybody was building for 50% market
growth. We didn’t want to miss the opportunity on the upside if business was to go for another six months.”

Comments The Standard: “In public, executives maintained their bullish outlooks. And in private, [they] were reluctant – and late – to tell suppliers to slow shipments and manufacturers to idle assembly lines. ... The forecasting failure illustrates just how much the industry still depends on human instincts and gut decisions.”

Finally, the positive effects of IT systems were muted because they are not deployed as widely as they have been publicized.

Take business-to-business commerce, for example.

This spring, the Conference Board found just 10% of small companies engaged in any meaningful degree in e-commerce. Jupiter Research reported that procurement managers “see so little advantage in moving online” that nearly half of those surveyed expected to do less than 20 percent of their procurement online for at least the next two years. A survey earlier this year by the National Association of Manufacturers found that only one-third of American manufacturers were using the Internet to sell or buy products or services.

**B2B bust?**

Back in 2000, business-to-business e-commerce was poised to be the next big thing, with online B2B sales dwarfing retail sales. The Gartner Group forecast $7.3 trillion in B2B transactions over the Internet by 2004 (that estimate was revised downward to $5.95 trillion this March).

But even a year ago – before the dot-com implosion – a Forrester Research survey of 50 e-marketplaces found that 95% were doing fewer than 10,000 transactions a month. Commented Information Week: that’s fewer than a decent-size grocery store might do in a week. Fully 63% of the marketplaces surveyed were logging 1,000 transactions a month or fewer.

Much of this commerce was to flow through e-marketplaces, or exchanges. These virtual marketplaces were supposed to bring together buyers and sellers within various industries. In theory, these exchanges had a win-win proposition: Sellers would cut the costs of marketing their products. Buyers would enjoy lower prices.

The trade never materialized – for several reasons.

Sellers stayed away because the exchanges look like buyers’ markets, driven by auctions and revolving around price. They were also discouraged by the exchanges’ very different formats for listing products.

Purchasing managers didn’t trust the new marketplaces – certainly not as they trusted suppliers of many years’ standing. “For the purchasing agents, it’s all about relationships, consistency, quality and reliability,” said John-Gabriel Henry, an analyst with Jupiter.

Even those purchasing managers enticed into the electronic exchanges had misgivings. One purchasing manager for a gene therapy company told Information Week she preferred not to buy at Chemdex because its “people are techies from Silicon Valley who don’t really know our business.” In fact, Chemdex employed a platoon of life-science PhDs – until it closed earlier this year, failing to convince investors it would ever turn a profit.

Many procurement managers were skeptical about how long the exchanges would be around. Their concerns, it turns out, were well founded. Analysts estimate that only about 200 of the 1,000 or so B2B exchanges that existed at the peak last year will be around in 2003.
No dead-ends.

This is not to say that B2B e-commerce is a dead-end. Analysts agree that the exchanges left standing after the shakeout will offer far deeper value. For instance, some e-marketplaces can now handle RFQs – requests for quotes – that specify quality, delivery, and service, as well as price.

And some companies are opening private online marketplaces. GE’s marketplace handles a bigger volume of business than all the B2B exchanges combined.

Nor should it be forgotten that, while the e-marketplaces handled $43 billion in transactions in 2000, another form of e-commerce – electronic data interchange, or EDI – handled $458 billion, according to Yankee Group estimates.

Some industry analysts suggest that EDI, as a first-generation B2B e-commerce system, can serve as a model for the newer, Internet-based versions. Adopting EDI required companies to re-engineer processes – and took years to reach critical mass. But it has undeniably reshaped the way business gets done: just-in-time inventory practices are the norm because of EDI.

And then what happened?

So there was a bubble and it has burst.

This begs the question: What happened to the new economy – the core reality that remains after the hype is stripped away?

While the press on the new economy was greatly exaggerated, there was something undeniably new about the 10-year up-cycle. What probably isn’t new is what slowed and reversed the cycle.

The Economist reports that Larry Summers, just-retired Treasury secretary, is among those who believe the current cycle is something different in the post-World War II era – not because it is new, but because it is very like the economic cycles before 1939.

The new economy seems to have stayed such traditional triggers of recession as inflation, excess inventories and over-staffing. So economic expansion was sustained for nearly a decade. But longer periods of expansion allow other imbalances – over-spending, over-investment, individual and corporate debt. The late 20th century boom has been followed by an early 21st century bust – the pattern of business cycles in the 19th and early 20th centuries.

Fed governor Laurence Meyer, who provided the narrow definition of the new economy with which we began, recounts events from his perspective: Convinced that high productivity growth would outstrip demand, and that unemployment could not continue to fall without the economy overheating and inflation rising, the Federal Open Market Committee – or FOMC – began tightening monetary policy in the middle of 1999. By mid-2000, the economy appeared to be slowing, and the Fed stopped tightening – then started loosening controls on the money supply.

Meyer acknowledges that many economists think these policies were a mistake – that it was monetary policy that stalled the new economy. His rejoinder: No one really knew for certain if new economy growth trends were sustainable. The Fed acted on the best information at hand. In December, he notes, the Blue Chip consensus was forecasting 3% growth over 2001.

The hoped-for “soft-landing” turned into a sharp downturn in the new year because of three, inter-related developments: The shock of high energy prices; the unwinding of the imbalance in tech equity values; and a collapse in consumer and business confidence (due, in part, to a collapse in lenders’ confidence in borrowers).
The correction does have a new economy flavor, according to the Fed governor. Because IT feeds sales and inventory data to business managers more quickly, they may have responded more quickly. That makes for a sharper decline in production, but may mean a shorter down-cycle.

“We could say that the new economy has suffered an old economy disease – if not a full-fledged recession, at least a close relative, a growth recession,” Meyer says.

Our new economy has no special immunity to recession; in fact, the new economy developments that raised growth may make economic performance more volatile.

In Meyer’s view, as of this June, we were still in a new economy ... but with the added benefit of having been taught – or retaught – valuable lessons: “Equity prices can go down as well as up. Firms need profits to survive. Business cycles happen.”

Lessons learned.

The 60% Nasdaq correction has – mercifully – brought about a deep discounting of hype.

Consulting firm Accenture now cautions business managers against “Internet-speak” ... in which “creative” is a euphemism for “undisciplined;” the “untried” is always “innovative;” and “the rules have changed” translates into the old “just trust me.”

Cash flow is king says McKinsey & Company. McKinsey’s Tom Koller recommends that investors try an old tool for valuing new economy companies – long-term discounted-cash-flow analysis – with some “twists” to account, conservatively, for their lack of history. “Be cautious,” he says, “about business models based on future revenue for anything that people wouldn’t pay for today.”

As for entrepreneurs, McKinsey warns that the days when acting first and thinking later were rewarded are gone for good – if they ever really existed at all. In a study of 80 Internet companies – including B2C, B2B and infrastructure providers – McKinsey found that speed to market turned out to confer an advantage on only 10%, and then only if certain conditions were right. “Some entrepreneurs made getting to market as fast as possible an end in itself, though they had to do so with insufficient information.”

McKinsey’s conclusion that speed kills is echoed far and wide. “Speed does not trump perspective,” grumps Forbes. Webmergers.com warns that the speed of modern marketplaces distorts judgment and outstrips analytical tools. It lofted Internet-based businesses, then brought them down with a crash. It’s taken optical networking here in the U.S., and wireless in Europe for the same wild ride. “We simply need to learn to deal with speed.”

Chas Evans, D&B’s Director of Commercial Litigation and Bankruptcy, notes that the need for speed is often cited as the reason to rush to judgment on extending credit or closing a deal. Perhaps that made some sense at the height of the overheated economy, when the higher rates of loss were offset by the gains in volume overall. But many of the businesses that got into the habit of jumping without looking missed the early signs that the inevitable cool-down was imminent – and paid dearly.

The irony is that due diligence can proceed at I-speed too. Not only can D&B’s experts spot the profile of a risky
business partner and the pattern of events that presages a trip to the bankruptcy court, they can share this vital intelligence with clients in a matter of seconds via the Web.

And if the worst happens? “We have someone posted in each of the 191 bankruptcy courts,” Evans says. “They each have a hand-held scanner, so bankruptcy documents are ‘read’ into our databases almost as soon as they are filed. Then we investigate – checking the named companies against our databases, doing overnight validations.

“D&B can notify its clients of a severe risk condition, such as bankruptcy – and its ripple effects – within 24 to 48 hours of a petition filing. One customer called personally to thank us for the D&B Severe Risk e-mail notification he received just as the driver turned the ignition on a truck loaded with goods bound for a newly bankrupt customer. If he hadn’t stopped that truck, he’d be joining a line of creditors in the hope of being paid 10 cents on the dollar someday.”

**New economy models …**

So the pendulum has swung. Yesterday’s media darlings, the dot-coms, are today’s object lessons in how not to run a business. The case studies now focus on established companies that took the time to study IT and figure out how to use it to enhance their operations – as The Economist remarks, they gained by avoiding both the mistakes and the huge spending of the pioneers.

Still, The Economist cautions that the gloomy view of the new economy may be every bit as unfounded as last year’s euphoria.

As already noted, the manufacturing sector has only begun to capitalize on the cost-cutting and streamlining the Internet offers. The impact of IT on business operations to date may have been overestimated; it would be a mistake to underestimate the extent to which it will redefine the way businesses are run.

The “Dell model” – direct sale to consumers of made-to-order PCs – has not only made Dell the market leader, but has reshaped the PC sector. When competitor Compaq announced its shift in focus from selling hardware to software and services, Fortune commented, “Compaq’s move says that in making PCs and other IT equipment, the Dell model wins.”

Many of the leading pioneers in e-business are very much alive and with a strong claim on a bright future. Consider eBay, Yahoo!, Amazon. The business models they invented – online auctioneer, Internet portal, and e-tailing, respectively – continue to generate revenues (and, increasingly, profits) for their originators and savvy competitors.

Even the deceased dot-coms left a legacy of good ideas that, in the hands of old-guard companies schooled in the old rules of value creation, may yield dividends yet. Thus online grocer Webvan has cashed out; but Peapod, now a unit of Royal Ahold, the world’s largest food retailer, reported its first operating profit.

B2C may not have transformed consumer markets overnight – but online sales for the 2000 holiday season were up 60%. There may be a shakeout underway among pure-play e-tailers, but almost without exception retail’s established leaders have reinvented themselves as click-and-mortar companies that use the Internet for marketing
and customer service as well as sales. (The stories of e-tailing’s demise are probably premature: The Industry Standard reported this July that half of all online retailers are still in business, and an additional 16% survive as acquisitions.)

While new economy business models are shaking up – and out – some old economy business sectors, they are revitalizing others that faced flat-growth (at best) futures.

Out-of-print book dealers were being forced to shutter their (usually leased) shops by the skyrocketing value of suddenly fashionable downtown real estate. The Internet has opened the global marketplace to these dealers, whose numbers have increased from 3,774 in 1996 to 4,308 today, according to Book Hunter Press.

As it happens, location is not the only source of appreciating real estate value. According to J.P. Morgan, 176 “e-real estate” companies have emerged to design, own and operate high-speed broadband services within residential and commercial buildings and developments. Deutsche Bank says that e-enabled real estate is the “ultimate portal” – and its owners stand to profit not merely as landlords, but as gatekeepers to new economy services and marketplaces.

... cause for rational exuberance.

Bottom line: the old economy must adapt to the new economy business models ... maybe not quite so quickly, but as inevitably as the Internet visionaries predicted. That’s where the deep cost savings, the revenue growth and – ultimately – the profits will be.

The Internet gurus were wrong about the old economy rules, though. The new economy doesn’t get a pass here.

Wired now writes approvingly of Andy Grove’s “Rational Exuberance.” Says Grove: “We are in the process of deploying another package of technology, which is just as significant as the railroads, the telephone, the telegraph, electricity, and so on – all of which were terribly significant. I just don’t think it alters the fundamentals of supply and demand.”

In Harvard Business Review, Michael Porter argues that the new economy now looks more like an old economy with access to a new technology. The Internet is a communications tool – a powerful tool, but a tool nonetheless, to be used with care in the service of sound business strategy.

Companies need information in Internet time, but from sources “on-the-ground” who take pains to ensure its accuracy. Companies need to bring their products and services to cybermarkets, but with full knowledge of the customers, suppliers and partners with whom they do business. Companies need to pioneer new Internet business models, but they don’t have to abandon marketing fundamentals, fiscal controls and due diligence.

Porter strikes a low-key but exuberant note of his own: The Internet actually provides a better technological platform for competition than previous generations of IT. The Internet is an open platform that allows companies to craft unique competitive strategies and customize value chains. Older “shrink wrapped” IT forced companies to conform to standardized systems, erasing differences.

Fast Company, a magazine launched in 1995 by two former Harvard Business Review editors to chronicle the new economy, now remarks on the “sober quality” of the current, “second round” in the development of the Internet economy: “Big established companies are discovering that their advantages of scale, their established brands, their loyal customers, and their long-standing relationship with suppliers are just as valuable online as they are offline.”

Internet-based businesses – whether they’re pure-play or clicks-and-mortar – are being subjected to new (or is it
old-fashioned?) discipline. It’s a process *Fast Company* likens to the work a turnaround specialist does with distressed companies – stripping away the soft coating to get to the hard, shiny seed of an opportunity.

That opportunity is there. It will take hard-headed, savvy managers to turn the opportunity to account, creating economic value measured the only way that makes sense – by sustained profitability.

It is a new economy, but the winners will be playing by the old economy rules.
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