FINANCIAL TIMES

September 30, 2011 12:01 am

The Ideas Column: the return of get rich slow

By James Mackintosh

In the late 1990s, as the dotcom bubble made it cheap and easy to raise funds, anyone who followed the money was becoming an entrepreneur. Even within companies, the place to be was the dotcom division. Chief executives were throwing money at the new technology.

With an almost perfect lack of foresight, I moved out of dotcommery and into traditional newspaper journalism. That gave me a great vantage point from which to observe my friends, and some former colleagues, become entrepreneurs.

Whether they made money or not came down to timing: if they sold before March 2000, they became obscenely rich. If not, they went back to the corporate world or consultancy. Only one of them built a sustainable online business.

In academic speak, the bubble reduced, or eliminated, financial frictions while it lasted. Translated, that means that someone wanting to start a business did not have to waste months begging cash from friends and family or filling in small-business plans for bank computer systems to reject.

The credit bubble that ended in 2007 was less extreme, and focused on debt rather than equity, but had much the same effect: it made it easier to raise money. In both cases investors turned off their risk radar and frittered away untold billions of dollars.

But while the good times rolled, the economy did well. As Alberto Martin and Jaume Ventura of Barcelona's Centre for Research in International Economics point out*, cutting financial frictions in the credit bubble meant more efficient deployment of investment, expanding the economy.

It was based on pulling value forward from the future, acting just as a pyramid scheme does. People who got rich were, in effect, seizing the value of future savings.

Intriguingly, Martin and Ventura created a model for government intervention designed to prolong the bubble in order to avoid the pain of a bust. Their policy prescription suggested government subsidies, funded via sovereign debt, would make a profit for taxpayers, while keeping the economy on track.

In other words, some version of the Bush/Obama stimulus was the right thing to do. This works right up to the point where government debt itself hits crisis, as it already has in the eurozone's weaker countries.

Markets reflected the success of the bubble-extension project, but the problem now is that governments are no longer extending the bubble, and the private sector is in no mood to do so.

Hedge funds have cut their borrowings sharply, reducing the amount of liquidity being provided to the financial system. Proprietary trading desks at investment banks (in-house hedge funds) have been shut down. New rules designed to stop the excesses of the 2000s are pushing banks away from riskier lending – again making it harder to raise money in the real economy.

The default by Greece and the US austerity programme – whether or not it is implemented – both demonstrated that governments lack the will to continue subsidies.

That means the bubble will finally be allowed to deflate. As it does, the reappearance of financial frictions sucks out capital from the least creditworthy areas of the world. Greece may find it impossible to borrow money except from (increasingly less) friendly governments, but even banks in solvent countries are being hit with tougher terms. These are passed on to their borrowers.

Many governments are still gesturing towards the idea of stimulus, even if they can no longer afford it directly.

Efforts are under way to ensure governments can borrow cheaply, known as “financial repression”. They may not spend the money on stimulus, but the less they spend on interest, the fewer cuts they have to make.

Banks have to hold more government bonds, helping keep borrowing costs down. Insurers are being pushed in a similar direction, and pension funds have been moving into bonds for several years. European governments have announced a clampdown on using derivatives to bet against sovereign debt.

All this ensures financial frictions are low for governments. Unfortunately for would-be entrepreneurs – and the rest of us – it is unlikely to do anything to oil the wheels of the private sector.

** Theoretical Notes on Bubbles and the Current Crisis, European Central Bank working paper 1348, June 2011*