Why Are We in a Broadband Recession?

by Thomas W. Hazlett

JULY 28, 2001 - For five years--1995 through 1999--returns were phenomenal. The S&P 500 rose 26 percent annually while the Nasdaq vaulted over 40 percent per year. Two big things ignited market enthusiasm. The first was Windows 95, which brought pockets of resistance to the PC revolution to unconditional surrender. This event, whose importance was missed by traditionalists who slept through it and techies who laughed at it, boldly lifted consumer interest in computers and corporate information technology spending to where they had never gone before.

And then came big event No. 2: the browser war. The bloody software combat made some gawkers--including those at the U.S. Department of Justice's Antitrust Division--see red. But the struggle between Netscape's Navigator and Microsoft's Internet Explorer created hundreds of millions of web surfers. In 1993, only early adopters of the Web had browsers. In 1996 you couldn't buy a PC without one. A mass market for e-commerce materialized, fueling investor enthusiasm for applications, services and "arms merchants" supplying the gold rush.

An expansion unleashed by innovative technologies carries the seeds of its own demise. Investors chase new business plans, knowing that blue-sky returns--early shares in the rising Sun, the forming eBay--are temporarily available. The window will shut, but stopping too soon is as dangerous as investing too long. Millions brave injury to spin this wheel of fortune.

Despite Alan Greenspan's concern about the inflationary aspects of the "wealth effect," Fed policy fed the cycle. Pouring liquidity into the banking system in late 1999 to smooth possible Y2K glitches, it pumped up capital markets just as tech enthusiasm was reaching its zenith. Once the millennium clock struck midnight, monetary policy began to tighten. By March 2000, markets started to clench. Tech stocks went into a free fall with the collapse of settlement talks in the Microsoft antitrust case. On April 3 to April 4, 2000, as the market absorbed a tough anti-Microsoft verdict, the Nasdaq dropped an astounding 20 percent over a day and a half of trading.

Bubbly talk about buying opportunities turned to anxiety over regulatory risk and dot-com burn rates. While telecom infrastructure today leads the market down, this sector withstood the severe tech share shocks early last year. The Nasdaq topped off on March 10, 2000, but Nortel and JDS Uniphase hit all-time highs late last July. Fiber-optics suppliers saw big-time rallies last summer. As if in suspended animation, telecom infrastructure continued to climb a mountain that was already crumbling beneath it.

Waiting for Broadband

Investors were holding on for the consensus on the next big thing--broadband. Internet video looks like tomorrow's "killer app." Demand for high-speed connections has been robust, as customers have lined up to pay $40 a month to get 300 to 500kbps Internet hookups from cable or telephone companies.

Yet in late 2000, hopes that broadband would sustain the tech bull-run faded fast and furiously. Regulation of cable modems was threatened by "open access" rules giving outside service providers the right to re-sell high-speed cable lines. While recommended as a policy to advance network development, shares of Internet content and infrastructure providers have not responded positively to news that "open access" rules were moving forward.

Meanwhile, DSL (digital subscriber line) provided by local telecommunications companies and regulated

with a far-reaching form of “open access”--hit a financial market air pocket. The modular market structure, forced by regulators to allow independent companies to supply service using monopoly phone lines, produces an uncoordinated, no-one-in-charge service. The top four independent DSL providers each lost over 97 percent of their market capitalization in 2000.

Wrong Policy Prescriptions

Policy makers can help settle markets. The Fed is easing, and the Microsoft antitrust case is melting under the glare of the Circuit Court of Appeals.

But broadband regulation is alive and making investors queasy. In every high-speed platform--cable modem service, digital subscriber lines, fixed wireless and satellite--regulatory risk plagues deployment.

Cable “open access” rules miss their target while inflicting painful collateral damage. Cable systems do enjoy local monopolies, and parsimoniously devote just one video channel to Internet access while reserving 100 or more for plain old cable service.

But “open access” rules do not gain any additional bandwidth for Internet users. And if regulators do attempt to seize system capacity, they will simply succeed in chasing the investors currently sinking $31 billion to upgrade cable systems for high-speed access. FCC rejection of “forced access” would lower regulatory risk and hasten creation of broadband networks.

Despite early projections that DSL’s “open” platform would trounce “closed” cable modems, cable had 4.7 million subscribers in Dec. 2000 to just 1.7 million for DSL. With multiple companies required to service each customer, an artifact of “unbundling” regulation, network build-out moves slowly.

Moreover, boiling mad DSL customers may soon be classified as a public health problem. Congress should end micromanagement of DSL in favor of simple telephone system interconnection rules already in place.

WorldCom and Sprint are unveiling wireless broadband access in several U.S. markets. But now policy makers are talking about yanking the spectrum, re-marking it “3G Wireless” (third generation) as proposed by international regulators. U.S. regulators need to emphatically reject this economic vandalism, and instead liberalize spectrum use generally. “Fixed” wireless ought to be mobile if market competitors find it efficient. Unlocking under-utilized bands--including those hogged by off-air TV for fewer and fewer viewers (over 90 percent of U.S. TV households are projected to subscribe to cable or satellite by 2005)--could empower innovative Internet applications including high-speed broadband.

An entrepreneurial start-up called Northpoint Technologies has spent seven years trying to get FCC permission to operate a third direct broadcast satellite (DBS) system. It re-uses the radio waves now employed by DirecTV and EchoStar. Yet the FCC is moving at a snail’s pace. My economic analysis, filed with the FCC (at the request of Northpoint) in March, argued that regulators should move swiftly to license the new service. The company offers more competition in video and broadband Internet connections, while requiring no new allocation of airwaves. What’s not to like?

No single factor propelled the Nasdaq skyward, and multiple reversals have sent it reeling. But broadband deployment, central to the health of myriad communications networks, can be stimulated by public policies that would be wise even if broadband were a sleepy sector only marginally related to our macroeconomic health. And if sensible reforms in this industry do ignite a flame under tech sector investment that leads to a hot resurgence in overall capital spending by business--burn, baby, burn.

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