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A Lopsided Economy

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Both risk and risk-aversion continue to run high, and even Alan Greenspan is silent as an anemic recovery muddles on.

Perhaps one of the more telling indications of the continuing uncertainty surrounding the economy's prospects came last Thursday when **Alan Greenspan**, in his appearance before the **House Budget Committee**, opted against testifying on the "economic outlook." Although that had been slated as the hearing topic in information put out both by the committee and **the Fed's** public affairs office, Greenspan chose instead to offer yet another take on the importance of maintaining "fiscal discipline," a perennial favorite of the fed chairman's.

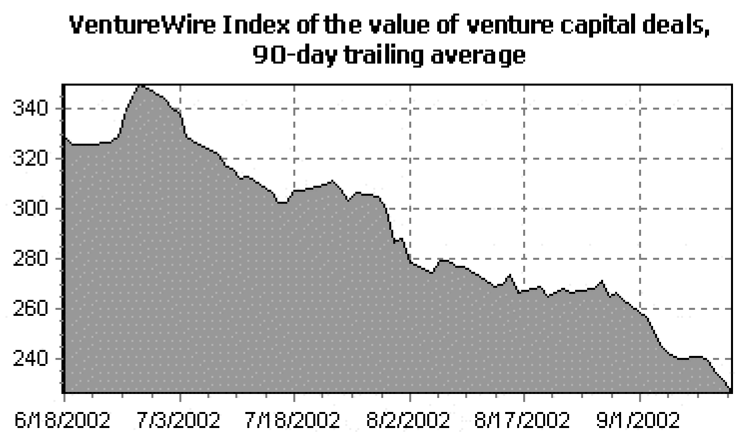
In Greenspan's conception, it seems safe to say, fiscal policy dynamics are subject to far less variability than the factors currently affecting the macroeconomy, and were thus a considerably less risk-prone topic of discussion. Immersing himself again in the budget debate was preferable to offering a detailed economic assessment even at the cost of having to acknowledge that the market has openly -- and quite spectacularly -- defied his oft-repeated warnings about the risk to long-term interest rates arising from a return to deficit financing. Needless to say, Greenspan was silent on the contribution of his own policy errors in precipitating the economic downturn which has drained tax revenues and forced the federal budget back into the red.

Timing likely played a role in Greenspan's decision to punt on the economic overview. With the September 24 **FOMC** meeting on tap, he may not have wanted to offer comments that could possibly be interpreted as foreshadowing a policy move. In the wake of last month's meeting -- which resulted in the policy panel adopting a directive biased toward weakness -- several members made public remarks suggesting that a 1.75% funds rate is low enough to support recovery, indicating further cuts are unlikely. Greenspan, though, was not among them. In fact, he has not made any public remarks about the economy since his semi-annual report to **Congress** in mid-July, when he suggested that the "fundamentals are in place for a return to sustained healthy growth." That, however, pre-dated most of the speculation that the economy was at risk of double-dip recession. At last week's hearing, the only glimpse into his thinking came when he acknowledged that the "central tendency" of FOMC members in the July report for 3½ - 3¾% GDP growth this year "would be somewhat lower" if the forecasts were now updated.

In fact, though, the greatest concern now isn't over whether or not the distorted statistical aggregates that make up the national income accounts end up showing "growth" this year of something on the order of 3%. Remember, the GDP tables gave us illusory first-quarter growth at a breakout pace of 5%, based largely on the statistical mirage of computing the rapidly decelerating pace of inventory liquidation as an addition to output ("That Was the Quarter That Was(n't)" May 28, 2002). And thanks to the widely hailed resilience of "the consumer," as seen in Friday's reported 0.8% jump in August retail sales (0.4% ex-autos), the third quarter is now on track for growth of at least 3%.

Hold the champagne. In our view, the incessant focus on consumer spending as the be-all of economic activity is hugely misplaced. Consumption is the reward, or benefit, of production. It is axiomatic that in the aggregate, it is impossible to consume that which is not produced. Indeed, in our supply-side analytical model "the consumer," as such, does not exist. Consumption is, at root, an exchange among producers of the fruits of their productive labors. Empirical studies have found that in the short-run, consumption is sensitive to expectations of future income. In other words, current consumption is lifted by expectations of rising future production. In that sense, the recovery of consumer spending carries hints that a more complete and robust expansion could be in the offing. Confusion over cause-and-effect in this phenomenon, however, is rampant, and could in itself be a risk factor in the current environment. Rising levels of production and increased wealth do not result from increased consumption. Increased consumption results when wealth creation calls forth higher levels of production.

Crucial to the wealth creation process is the risk-taking that fuels the capital formation and innovation at the heart of sustainable productivity-based expansion, and it is here that we continue to see scant foreshadowing of a significant near-term growth acceleration. Risk aversion remains the most conspicuous feature at the grassroots of entrepreneurial capitalism, and in some ways actually appears to be getting worse.



The chart at left plots venture capital investments computed on a 90-day moving average basis. The index has lost more than 75% of its value relative to a base of 1,000 keyed to the 90-day average on January 1, 2000. While that was close to the peak of the venture boom and could be considered an elevated level to serve as the index base, the critical point is that this gauge now stands at new lows, down more than 25% just since the end of the second quarter. As it was, total venture funding in the second quarter of $5 billion was about half of year-earlier levels, and down some 17% from already depressed first quarter levels.

The implications of such a financing drought for start-ups and other immature enterprises at the vanguard of technological advance are potentially ominous. The **US Patent and Trademark Office**, for example, estimates growth of new patent applications is slated to slow sharply this year. After rising at an annual rate of about 10% over the past several years, patent applications are expected to slow to a rate of just 1.3% this year. Of course, only a small percentage of the hundreds of thousands of inventions and innovations patented -- with 350,000 applications expected this year -- ever result in commercial applications that contribute to the economy's productive potential. However, the odds are certainly more favorable in a fecund environment friendly to risk than in one characterized by a scarcity of risk capital, as is currently the case.

Over the past few months we have maintained that the deflation relief indicated by the dollar's weakening in terms of foreign exchange, gold and broader commodity indices should gradually reduce risk premia and lay the foundations of sustainable recovery. Inklings of that process can be seen in various measures suggesting the beginnings of a rebound in real fixed investment activity. It's also the case, though, that the highest-risk market segments also suffered the heaviest damage and will likely be the slowest to recover. The recent intensification of various political risks -- from the possibility of war with Iraq to the corporate accounting scandals -- certainly are no help to the market's fragile risk propensity. Inasmuch as those sectors most sensitive to risk preference are also the ones with the highest growth potential, our outlook for a glacial, unimpressive pace of recovery remains intact. TM