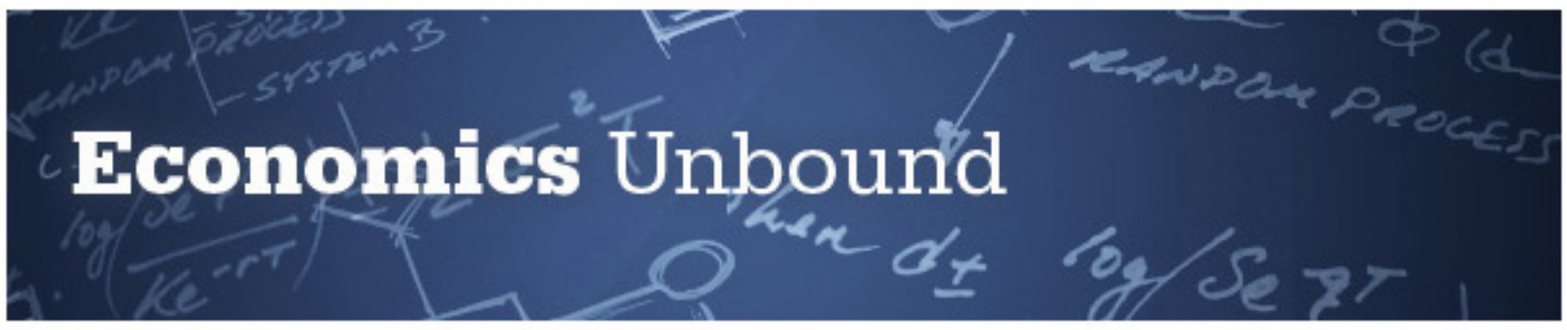

Fannie, Freddie, and Schrodinger's Cat

Posted by: Michael Mandel on September 07

You know, when I think about the fate of Fannie and Freddie, I am reminded of the fate of Schrodinger's cat. Erwin Schrodinger was an Austrian physicist in the 1930s who proposed a thought experiment to illustrate the pecularities of quantum mechanics. Imagine a cat in a sealed box with a flask of poison. You cannot observe whether the cat has drunk the poison. Is the cat alive or dead? (Don't worry, no cats were harmed—a 'thought experiment' means that it was never actually done)

According to most interpretations of quantum mechanics, as long as the box is sealed, that's not the right question. Until we open the box, the best we can say is that there's a certain probability that the cat is dead and a certain probability that it's alive. In some sense, the states of "cat alive" and "cat dead" exist at the same time.

But once the box is unsealed and we observe the cat, the two states collapse down to one. The cat is either alive and bouncing, or unfortunately passed on. And the process is not reversible. If you put the dead cat back into the box again, it will still be dead, no matter how many times you close and open the lid.

What does this have to do with Fannie and Freddie? For many years, Fannie and Freddie have occupied two states simultaneously. On the one hand, they have been operating as private profit-making enterprises, just like any other company. On the other hand, they have been operating with the implicit full faith and backing of the federal government, allowing them to raise money at a lower price than anyone else.

This superimposition of states worked, as long as no one looked in the box. Fannie and Freddie could make lots of money, investors could feel safe, and the government didn't have to decide whether Fannie and Freddie were really protected or not.

But guess what? The box has been opened, and it turns out that Fannie and Freddie really have been government agencies all the time (you can decide for yourself whether this means the cat is alive or dead). What's more, once we know they are government agencies, there is no putting them back into the box and pretending that we don't know. In fact, no matter what Paulson and his friends do, Fannie and Freddie are now permanently wards of the state.

So where do we go from here? First, Fannie and Freddie are not profit-making entities. Their only reason for existence is to protect the housing market against crashes, not to take more risks and make them worse.

The right structure is probably something like the FDIC, which protects bank accounts up to a certain limited amount. The FDIC is funded by an insurance premium paid by banks, with the federal government as the ultimate backstop. In other words, deposit insurance is both limited and costs something.

In the case of mortgages, Fannie and Freddie should be merged into one government agency (Frannie?), which packages and sells mortgage-backed securities. The mortgages would be prime mortgages, up to a certain amount, just like now. The difference is that Fannie and Freddie would charge a fee for the service, which would be required to go into a reserve fund, to be held in case of future problems.

Over time, the reserve fund would grow. By law it would be invested only in low-risk treasury securities. Frannie would not make any profits, would not pay out any dividends, and would not make any other investments. It would just serve as a passive insurance fund. In theory, subprime and altA mortgages could be handled as well, with a higher insurance premium.

It's going to take a lot of fussing and feuding to get to that common sense outcome. But Paulson is about to find out what physicists learned long ago: You can't put Schrodinger's cat back into the box again.

ABOUT

Michael Mandel, BW's award-winning chief economist, provides his unique perspective on the hot economic issues of the day. From globalization to the future of work to the ups and downs of the financial markets, Mandel-named 2006 economic journalist of the year by the World Leadership Forum-offers cutting edge analysis and commentary.

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VIEWPOINT October 28, 2008, 12:01AM EST

text size: T | T

Mandel: It's Not a Crisis of Confidence

The real problem with the economy is that long accepted patterns of cross-border technology transfer, trade, and finance are simply unsustainable

By Michael Mandel

Is the market and economic turmoil nothing more than a crisis of confidence? To listen to Ben Bernanke and Hank Paulson, you might think so. "At the root of the problem is a loss of confidence by investors and the public in the strength of key financial institutions and markets," Bernanke told the Economic Club of New York on Oct. 15.

On Oct. 20, Paulson went further, explaining the bank recapitalization program this way: "Our purpose is to increase confidence in our banks and increase the confidence of our banks so that they will deploy, not hoard, their capital. And we expect them to do so, as increased confidence will lead to increased lending."

The implication of the Bernanke-Paulson view is that the underlying economic system is fundamentally sound, so that restoring trust in the financial system will put us back on a growth course. From that perspective, the infusion of massive amounts of capital into banks, which replaces the money lost in bad mortgages, will enable lending to begin again. Once investors see that all is well, then they will cease their irrational behavior, and start putting money back into stock markets and companies around the world.

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TREATING THE WRONG PROBLEM?

But what if the Bernanke-Paulson view is wrong? What if financial stress is a symptom, not a cause?

What if we face a wrenching readjustment of the global real economy rather than a crisis of confidence rooted in the financial system? What if Bernanke and Paulson are treating the wrong problem? What if investors, realizing that their long held assumptions about the global economy are wrong, are rationally bailing out of stock markets in almost every country, at least for now?

In fact, there's good reason to believe that the current crisis reflects a growing realization: Long accepted patterns of cross-border technological transfer, foreign trade, and global finance are simply not sustainable.

THREE BIG FLOWS

For the past 10 years, global growth has been driven by three big flows. The first flow was the transmission of knowledge, technology, and business know-how from the U.S. and other industrialized countries to low-wage emerging economies such as China and India. Under the neutral name of "supply chain management," multinationals taught local suppliers to make shirts, laptop computers, and airplane rudders that could be sold around the world. Moreover, U.S. and European companies gave suppliers access to enough information that they could develop their own cell phones, software, and other tech products. The result: a massive improvement in productivity and living standards in emerging economies.

The second flow was the movement of goods and services from China and other emerging economies to the U.S. Massive amounts of production capacity was built around the world, assuming that the U.S. was always going to be the consumer of last resort. Indeed, the value of U.S. imports—over $2.3 trillion in 2007—was larger than the entire output of Britain, the sixth-largest economy in the world. The result: Rising living standards in the U.S., rising employment, and production around the world.

The final flow, of course, was financial. The rest of the world lent U.S. consumers trillions of dollars to finance the trade deficit. The money flowed into the country in all sorts of ways, including cheap mortgages and cheap credit for cars and televisions that were made overseas. At the same time, companies in emerging markets were borrowing heavily to build the factories that were going to supply the developed world.

SOMETHING HAD TO GIVE

This tri-flow worked as long as everyone believed that American consumers could finance their debt. But here's the problem: At the same time Americans were borrowing, their real wages were falling—and not just for the least educated. By *BusinessWeek*'s calculations, real weekly earnings for college grads without an advanced degree have dropped every year since 2002.

You can't pay back rising debt with falling wages; something had to give.

The first thing that broke were subprime mortgages, given to less creditworthy borrowers. But once investors started to look, they realized that the entire global edifice was built on an impossibility. The tri-flow that had built global prosperity could not be sustained.

GOOD NEWS AND BAD NEWS

That's why the financial crisis has spread across the globe. Investors are peering at every country, from Kuwait to Korea, asking the question: Is it sound enough to survive if American demand for imports falls? The problem is in the structure of the global real economy, not the financial system.

This is both bad news and good news. The bad news is that government injections of capital into banks around the world can slow the damage, but they cannot fix the basic problem. The global economy has to go through a readjustment process that will be difficult even if policymakers can restore confidence in the financial system.

The good news is twofold. First, the productivity gains in the emerging economies are real. Sooner rather than later, their growth will resume. Second, we do have a tool for easing the adjustment, and that's fiscal stimulus. With private demand for credit weak, governments can judiciously borrow and spend to help pump up growth and employment.

The final implication: Policymakers should stop talking about investor confidence as if it exists in a vacuum. Instead, they should focus on the real goal of stimulating the creation of innovative new goods and services that the U.S. can produce and sell on global markets. That would reduce the amount of borrowing the country has to do, and help create a sustainable global economy. This crisis is not any fun. But if it shakes up companies and government, and forces them to focus on innovation, the end result will be stronger, more solid economic growth.

Mandel is chief economist for BusinessWeek.

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text size: T | T

Madoff and the Global Economy

The world was told the U.S. was a low-risk, high-return investment. But like the Wall Street trader's victims, we are learning the truth

By Michael Mandel

For years, Bernie Madoff, all-around nice guy, pulled billions of dollars of foreign and domestic money into his investment fund. His lure? He promised the implausible combination of good returns and low risk—and people believed him.

Painfully, the allegations of fraud surrounding the Madoff affair are also exposing the fundamental fallacy of the global economy. Like Madoff's trusting investors, the rest of the world was willing to assume that the U.S. economy as a whole was a low-risk, good-return investment. This belief drove the entire structure of global trade and finance for the past 10 years. And when the subprime crisis showed this assumption of low risk to be false, the financial crisis resulted.

Consider this: Since the Asian financial crisis of 1997-98, the rest of the world has been willing to lend money to finance the U.S.'s huge and growing trade deficit. Not just small amounts of cash either: over the past decade, the U.S. borrowed a cumulative total of $5 trillion from foreigners at relatively low interest rates.

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WHY WERE FOREIGNERS SO GENEROUS?

Without this flow of easy money into the U.S., globalization in its current form would not have been possible. The U.S. was the consumer of last resort, absorbing cars from Germany and Japan, electronics from Taiwan and Korea, and clothes and furniture from China. The earth was flat, and why not? Pluck a laptop from Taiwan and pay for it with a home equity loan, which—if you trace back the connections—was at least partly funded with foreign money, too.

The big unanswered question, for years, was why this money flow persisted. Why the heck were foreign investors willing to lend the U.S. such large amounts of money on such good terms? Economists and journalists spun out hypothesis after hypothesis (we'll see more below), but there was no agreement on why.

Now we see what happened. Wall Street firms—big operators like Lehman and relatively small fish like Madoff—told foreign investors they could put their money into the U.S.—the world's safest economy—and still make decent returns. Madoff, of course, appears to have lied. He allegedly ran an investment scam that has resulted in billions of dollars of losses reported around the world, including $4 billion in Switzerland and $3 billion in Spain.

EXPORTING 'LOW RISK' DERIVATIVES

But it wasn't simply Madoff. The Wall Street boom of recent years was built, as far as I can figure out, on selling the low-risk story to foreign investors. In fact, most of the financial innovations of recent years were about making investments in the U.S. 'safer' for foreign investors. The enormous growth of foreign exchange derivatives enabled those abroad to protect their U.S. investments from exchange-rate fluctuations. The sudden increase in credit default swaps could be used to protect foreign bond investors from problems with individual countries. And collateralized debt obligations, which could be divided into high-risk and low-risk pieces, increased the supply of low-risk investments to be sold outside the U.S.

This low-risk, good-return story attracted investors from around the world. One example: Lehman sold $2 billion in 'mini-bonds' to Hong Kong investors, including many retirees.

However, the low-risk, good-return story simply wasn't true, for two key reasons: First, the U.S. economy was supposed to be on the cutting edge of innovation. Innovation through technological change, by nature, is a very risky activity. Sometimes it pays off and sometimes it doesn't. If the investment in innovation pays off, the economy booms, as it did during the second half of the 1990s.

U.S. REGULATION FAILED

But innovation has fallen short in recent years. Biotech and nanotech still have not come to fruition, and alternative energy is moving slowly. As a result, the U.S. economy has fallen short of expectations. The income isn't there, and the debt just piles up.

The second reason why the low-risk, good-return story wasn't true: the breakdown of regulation. And that's where we come back to the alleged Madoff scam. His was no complicated global securitization, based on black-box rocket science. Instead, it appears to be a good old-fashioned Ponzi scheme, enabled by a lack of government supervision.

What comes next? The fallacy is punctured. Globalization will be seen as what it is—a game with risks that can't be wished away. And U.S. prosperity will depend on the success or failure of its ability to innovate—not its ability to tell an implausible story to foreign investors.

Mandel is chief economist for BusinessWeek.

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THEY MAKE JOBS, NOT WIDGETS

Health care, education, and other "intangible" industries are on the rise even as the rest of the economy craters

MANDEL ON ECONOMICS

By Michael Mandel

The war between the tangible and intangible sectors of the U.S. economy is over, and intangibles have won.

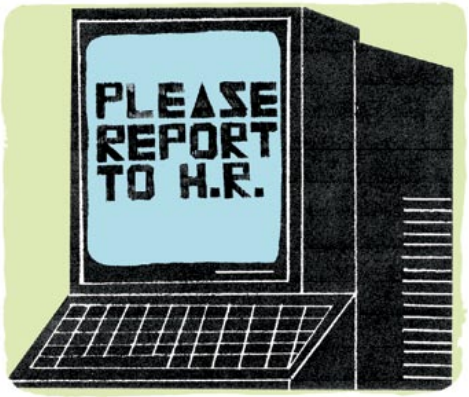
Since the economy went into recession in December 2007, the industries producing or distributing physical goods—such as construction, manufacturing, retail trade, and transportation—have lost 1.8 million jobs. That includes a decline of 260,000 positions in the much beleaguered auto industry and its dealer network.

Meanwhile, the intangible sector, including such industries as education and health care, has received far less attention than autos and housing. Nevertheless, intangible-producing industries have gained about 500,000 jobs since the recession began.

These figures may be telling us something about the nature of the jobs recovery, when it comes. In past downturns the industries that continued to add jobs during the recession often became leaders in the next expansion. During the recession of 1990-91, employment at software and programming companies rose, foreshadowing the surge of computer-related jobs later in the decade. Similarly, banks, mortgage brokers, and real estate agencies kept adding jobs during the recession of 2001, a sign of the housing boom that followed.

Today's troubles in autos and housing reflect a long-term shift: The U.S. economy—because of globalization and the nature of knowledge-based growth—is increasingly reliant on investments with long-lasting effects but no solid form. One such intangible, produced mainly by schools, is human capital—another term for the enduring value of education. Another important intangible is intellectual capital, which is the accumulation of scientific knowledge and business knowhow. Finally, the U.S. is spending heavily on building up "health capital," a dollar value of a person's lifetime health.

These intangibles are not well-measured by the gross domestic product figures produced by the government. Yet intangibles do produce jobs. Consider the last business cycle, which ran from March 2001 to December 2007: During that stretch, health and education alone contributed 3.5 million added jobs, roughly 63% of all net new positions. Altogether, the intangible sector accounted for about 75% of job growth. By comparison, the tangible sector, led by manufacturing, lost some 1.8 million jobs over that time.



WHERE THE JOBS ARE

	CHANGE IN JOBS DEC. 2007-NOV. 2008 (Thousands)
Tangible sector*	-1,791
Intangible sector**	515
Other services***	-635
TOTAL	-1,911

*Includes manufacturing, construction, wholesale and retail trade, transportation and warehousing, natural resources, and real estate
**Includes public and private education and health care, publishing, computer-systems design, finance and insurance, scientific research, and other intangible-producing services
***All other services, including temporary-help agencies
Data: Bureau of Labor Statistics, *BusinessWeek*

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THE JOB CRISIS

OBAMA'S DILEMMA

Of course, drawing the line between the tangible and intangible sectors is a bit messy in practice. Some manufacturing companies, such as Intel and Merck, are huge producers of intangibles in the form of research and technological knowledge.

At the same time, the intangible sector is not immune to the downturn. Publishing is losing jobs as newspapers, magazines, and book companies wrestle with the shift to digital formats. Finance is experiencing big job losses, which will accelerate in the coming months. And spending on education and health care is tied to state and local budgets, which could crater without federal aid.

For President-elect Barack Obama's Administration, the question is whether the shift to intangible production is a sustainable economic strategy over the long run. Better education, improved health, and more research are clearly necessary to be globally competitive. But it's not clear that the U.S. can afford to let all of its tangible industries shift offshore. That's why Washington is wrestling with the knotty problem of spending billions to save the domestic automakers.

Americans who want jobs have no such dilemma. For them, intangible is the way to go. | BW |

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