Fannie, Freddie, and Schrodinger's Cat

Posted by: Michael Mendel 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 peculiarities 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 irreversible. 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 superposition 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 profit-making 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 in 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 (Fannie?), 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. Fannie 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 nursing and feeding 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.
Mandel: It’s Not a Crisis

The real problem with the economy is that it’s not an accepted part of cross-border technological, trade, finance, and supply chains are essentially

By John Mandel

The recent and economic limnations in a sense is a crisis. To listen to Ben Bernanke and Hank Paulson, you’d think the rest of the economic world is a crisis by investors and the public in the strength of key financial institutions and analysts, Bernanke and Paulson testify in a memo to New York on Oct. 30, 2007, Paulson went further, explaining the grab-up regulations program in this way: “Our purpose is to increase confidence in our banks and increase the confidence of our banks so that we can deploy, prevent, and stop, and give them the resources. And we expect them to do so, and we shall need the results to increase in the long run.”

The implication of the Bernanke-Paulson view is that the underlying economic system is fundamentally sound, so that restructuring in the bond and equity markets will put us back on a growth course. From that perspective, the idea that massive amounts of capital into banks, which will replace the money in our own assets, will entice spending to begin again. Against Clinton-induced inflation, we can then reversing their inflation behavior, and start putting money back into stocks, companies, and consumers around the world.

WHAT IS THE WRONG PROBLEM

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

What if we have a restructuring requirement of the global real economy rather than a crisis of confidence in the financial system? What is Bernanke and Paulson neglecting the warning signals from the marketplace, that their actions are not enough, that the underlying economic system is fundamentally sound, and that restructuring in the bond and equity markets will put us back on a growth course.

In fact, there’s good reason to believe that the current crisis reflects a growing malaise, long accepted practices of cross-border technological transfer, foreign trade, and global finance are simply not sustainable.

THREE BIG FLOWS

From the growth of the country, global growth has been slowed by three big flows. First was the transmission of knowledge, technology, and its means new from the US and other industrial countries to developing ones like China and India. Under this huge wave of “offshore chain management,” multinational bought foreign suppliers to make parts, laptop computers, and airplane parts that could be sold around the world. Moreover, as the US became the global consumer, its own global supply chains, for example in electronics, were split and long, entailing delays in delivering goods to the US. This created a slowdown in productivity and long-standing gains in emerging economies.

The second flow was the movement of goods and services from China and other emerging economies to the US. US. The increasing amounts of goods and services we bought from China, assuming that the US was always going to be the consumer of last resort. Indeed, the value of US imports, over $2 trillion in 2007, was larger than the entire output of Britain, the world’s second largest economy. This created an imbalance in the US, rising unemployment, and production around the world.

The third trend, of course, was finance. The rise of the world’s largest US. The rise of China and other emerging economies, the increase in foreign direct investment, the spread of cross-border financial institutions, and the rise in cross-border financial institutions, the spread of cross-border financial institutions, as well as the growth of emerging markets were building up to the threats that ultimately led to the global financial crisis.

SOMETHING TO GIVE

In this flow was as long as everyone believed that American consumers could finance their debt. But there’s the problem. At the time some Americans were borrowing, their real wages were falling, and not just for the total adult population. For example, the median earnings for college graduates without an advanced degree have dropped every year since 2002.

You can only pay down rising with falling wages, something had to give.

The third trend that broke were the subprime mortgage, given to less infiltration borrowers. But since investors started to look, they realized that the entire global edifice was based on an illusion. That the bubble 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 perceiving at every country, from Brazil to Russia, seeing the illusion. It looks enough to support if American demand for imports held up The problem is in the structure of the global real economy, the financial system.

This is both bad news and good news. The bad news is that global institutions of capital into banks, and the world can see the role of government in creating the crisis. The good news is that the global economy has a chance to go through a reset process that will be difficult even if policymakers can continue in the current system.

WHAT’S NEXT?

Before we move on to the good news, the bad news is that global institutions of capital into banks, and the world can see the role of government in creating the crisis. The good news is that the global economy has a chance to go through a reset process that will be difficult even if policymakers can continue in the current system.

The only implication is that policymakers should stop doing exactly what investors expect, including economic conditions in the country, the real estate market is falling, and the US economy is not going to recover as quickly as the global economy. The global economy has a chance to go through a reset process that will be difficult even if policymakers can continue in the current system.

World is a chief economist for BusinessWeek

RECOMMENDED READING

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Madoff and the Global Economy

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 trick? He promised the implausible combination of good returns and low risk—and people believed him.

Painfully, the allegations surrounding the Madoff affair are also exposing the fundamental falacy of the global economy. Just like Madoff’s trusting investors, the rest of the world was 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 interest rates.

WHY WERE FOREIGNERS SO GENEROUS?

Without this flow of easy money into the U.S., the global expansion in its current form would not have been possible. The U.S. lived 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? Plug a laptop from Taiwan and pay for it with a home equity loan, which—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 hypotheses after hypothesis (we’ll see more below), but there was no agreement on why.

Now we have what happens. 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. look 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 bought $2 billion in treasuries from Hong Kong investors, including many reinvesting.

However, the low-risk, good-return story was still built on too key reasons. First, the U.S. economy was supposed to be on the cusp 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. Bobtech 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 is the breakdown of regulation. And that’s where we come back to the alleged Madoff scam. He was not complicated global securitization, based on technicolor glee and science. Instead, it appears to be a good disfashioned 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 sell an implausible story to foreign investors.

__Mandel is chief economist for BusinessWeek.__
T HEY MAKE JOBS, NOT WIDGETS

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

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-and programming companies that followed. 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.

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.