FORGET ADAM SMITH WHATEVER WORKS

Washington's partial nationalization of banks marks a fundamental shift in thinking about the relationship of the public and private sectors

By Pete Engardio

THE FUTURE OF KAPITALISM

On Oct. 11, amid a week of astonishing developments in the global stock and credit markets, Federal Reserve Bank of Dallas President Richard W. Fisher addressed the high and mighty of global finance in Washington during pivotal meetings of the Group of Seven and the International Monetary Fund. The gravity and complexity of the 15-month-old credit crisis called for action that transcended familiar ideological categories, he hinted, such as free markets vs. state intervention. Fisher even borrowed a Chinese proverb popularized by the late Chinese leader Deng Xiaoping: "No matter if it is a white cat or a black cat, as long as it can catch mice, it is a good cat."

Back in the late 19805, Deng meant that China needed to abandon basic tenets of socialist orthodoxy that stood in the way of prosperity. In these tough times, the proverb resonates in another way. The Bush Administration, by committing $250 billion to buy equity stakes in a huge swath of the U.S. banking system and extending all manner of financial guarantees to depositors and money-market investors, has just violated some enshrined principles of American-style, free-market capitalism.

You might dismiss all this as extreme measures for extreme times, a pragmatic adjustment that will be quickly undone once order is restored. But the significance, not to mention irony, of a Republican Administration partially nationalizing the U.S. banking system cannot be overstated. It could well go down as an important turning point in postwar American economic history, the beginning of a fundamental rethink of the proper boundaries between the public and private sectors. "The pendulum between the state and markets is swinging back before our eyes" says Daniel Yergin, co-author of the 1998 book *The Commanding Heights*, which chronicled the triumph of market capitalism over state-led economics since World War II. "And it is happening a lot faster than anyone expected."

As America struggles to recover from the deep recession that likely lies ahead, a new economic model could take shape that would involve a great deal more than direct government involvement in the world of Wall Street. It could mean

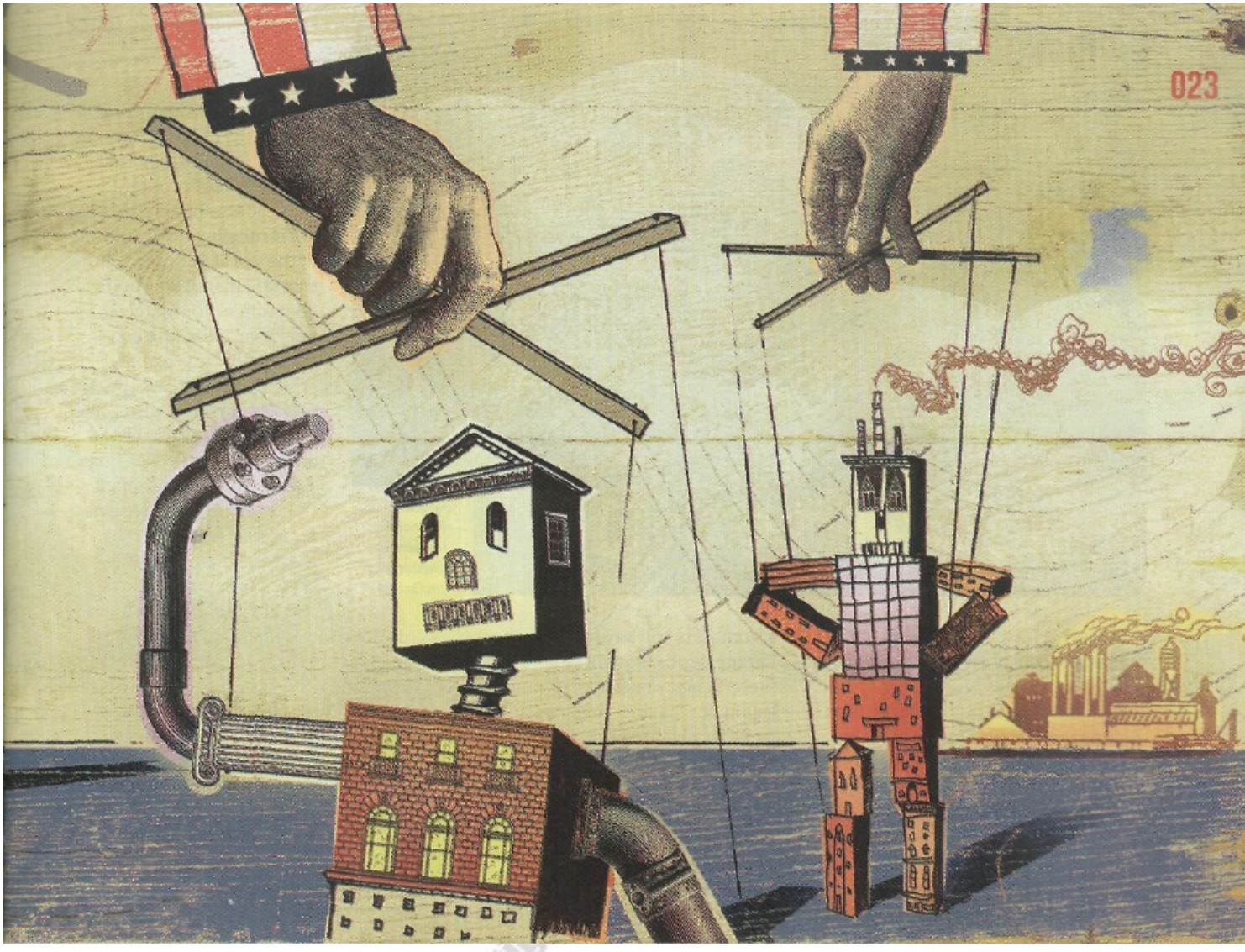
A BIGGER ROLE

How public policy and tax dollars could affect private industry

REGULATION
In exchange for funds, banks face higher capital requirements and oversight of subprime lending. A new Congress could toughen rules on telecom, energy, and health care

INDUSTRIAL POLICY
Federal bailouts will give Washington more say over Detroit's investment in fuel-efficient vehicles. Washington also could bankroll more investment in green technologies

ACTIVE STATES
New York, Pennsylvania, Oregon, and New Mexico are already investing in targeted industries such as semiconductors, renewable energies, and biotechnology



greater support of such industries as autos, nanotech, and renewable energies, which face fierce global competition. And it certainly spells a return of heavier regulation. It is far too early to predict that the U. S. is headed down the road of Asia - style industrial policy or the kinds of interventions imposed during the Great Depression, when bureaucrats seized and micromanaged entire industries. The U.S. won't have voting rights on the preferred shares it bought in Bank of America, Citigroup, JPMorgan Chase, and others. And analysts doubt Washington will dictate lending. But as Yergin notes: "The political process has not even begun to get ahold of this." If Barack Obama wins the Presidency, possibly with a filibuster-proof majority in the Senate, the next Administration could have a mandate for sweeping change.

Unlike many other recessions, this one wasn't caused by a downturn in a few specific industries. It started with a housing bust and then metastasized into a full-blown credit crisis that eventually destabilized the entire U.S. financial system. As previous financial crashes in nations such as Japan and Mexico have shown, recovery can take years. "We will see de-leveraging on such a scale that we are in uncharted waters," says economist Hung Tran of the Institute of International Finance, a Washington think tank.

Government involvement may go far beyond the financial sector to include support for struggling industries

In fact, the crisis has been so devastating that once - cherished assumptions about the superiority of the U.S. economic model are now in doubt. Take the notion that the American economy could keep flying high as its manufacturing base withered. The idea presumed that innovation and productivity alone would create the wealth and high-paying jobs needed to boost U.S. living standards. The credit boom masked a troubling trend: Over the past decade, strong U.S. productivity growth has coincided with declining real incomes for most Americans (story, p. 34),

Nor has the faith in financial engineering proved justified. Through lightly regulated derivatives markets, banks could repackage toxic loans and send them into an ocean of investors ranging from pension funds to Chinese banks. And both households and companies went wild on debt. The IIF

Global financial leaders in Washington on Oct. 11

estimates at least 30% of the $1.3 trillion in U.S. consumer debt, most of it on credit cards, is bad. Nor has the system sorted through the $1.7 trillion in high-yield corporate debt.

The new American reality will first manifest itself in greater regulation of finance. "The financial landscape is being redefined in fundamental ways," says Mohamedel-Erian, co-CEO of PIMCO, which is managing commercial paper assets the government has assumed. "There is no reset button." El-Erian is convinced the government, even under an Obama Administration, will not intrude in nitty-gritty management or loan decisions. He thinks lasting intervention will come in the form of higher capital reserve requirements and curbs on subprime lending and complex derivatives.

This financial reckoning will focus minds on rebuilding the U.S. manufacturing base. Here, too, government could play a huge role. That $25 billion bailout Congress has promised General Motors, Ford, and Chrysler likely will come with strings. The subsidies give Washington considerable leverage over Detroit on strategic matters. U.S. automakers will have to convince the Energy Dept. they will be able to boost fuel efficiency to at least 35 miles per gallon, for instance, by investing in facilities to make electric cars. Obama supports giving another $25 billion to Detroit. On top of that, he promises $150 billion in new spending on clean-energy technologies.

SUSTAINABLE INDUSTRIES

Yet skip Washington for a second. Go instead to states such as New York, Oregon, Pennsylvania, and Texas, where governors, business leaders, and university deans have been leading efforts for the past decade to nurture new industries. States aren't just rolling out tax breaks and offering cheap land. They are adapting strategies from nations known for generous industrial subsidies, such as Singapore, Germany, China, and Finland.

A good illustration is Advanced Micro Devices, which on Oct. 7 decided to spin off its manufacturing operations into a new company in which the government of Abu Dhabi will own a 50% stake. The venture will build a $4.5 billion silicon wafer plant in Albany, N.Y. The state of New York, which already has invested more than $1 billion in nanotech research and development, worker training, and a state-of-the-art clean room in Albany, will kick in $1.2 billion in tax benefits and outright cash rebates to cover construction and equipment costs. For struggling AMD, one of the last U.S. chipmakers that still manufactures its own wafers, the financial help from New York and Abu Dhabi "was incredibly important," says AMD CEO Hector de J. Ruiz. Few private investors in the U.S. are willing to risk such huge sums on a high-tech plant that won't produce returns for at least five years. "In a large economy like the U.S., it is impossible to be successful and thrive if you do not make something, especially in industries in line with your core strengths. The government will have to realize it must play a role," says Ruiz.

Call it industrial policy, or use the euphemism of "public-private partnership." But as America emerges from the rubble of the credit bubble and soberly confronts the task of building a strong, sustainable economy, the new credo will likely be "whatever works." IBW'

Washington's subsidies for automakers will give it considerable leverage over Detroit on strategic matters

Business Exchange

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The Housing Bust and Jobs

IMF researcher Prakash Loungani crunched some numbers and found that unemployment typically increases by 1.5 percentage points in the 12 months following the onset of a recession. But in recessions accompanied by a housing slump, the increase amounts to 3 percentage points. His findings aren't relevant just to the U.S. Britain, Denmark, New Zealand, and Spain all experienced much bigger declines in home prices in the first half of this year than those the U.S. witnessed.

To read Loungani's article, go to **http://bx.businessweek.com/housing-market/reference**

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