Politics et Cetera
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In this Issue

THEY SAID IT

If honest capitalism cannot be sustained in the United States, with its long history of respect for moral and ethical behavior and the rule of law, then it will disappear from the world. And, therefore, it is incumbent on all Americans, but most especially the nation's business community and its politicians, to be scrupulously honest in their dealings, both here and abroad.

--Mark Melcher and Steve Soukup, in their first article written for Lehman Brothers' *Washington Weekly* after joining the now-defunct firm, which they did a few months after having been fired from the now-defunct Prudential Securities. The piece was entitled "Challenges Ahead For Capitalism," and dated April 16, 2001.

OF BEZZLES AND BAILOUTS.

Twelve years ago today, on September 16, 1996, the partnership that today constitutes The Political Forum was born at the old Washington Research offices of Prudential Securities in Arlington, Virginia. Prior to forming TPF in 2002, we, the principles, Mark and Steve, worked together for nearly five years at Pru and for a couple more at Lehman Brothers. And while our partnership has endured, the same cannot be said for either of the big-shot Wall Street firms that employed us. We like to think that neither could manage to keep clients and partners interested in their products and services after our departure, though we suppose that there may have been other contributing factors.

In any case, the collapse of the latter of our two common former employers has roiled both Wall Street and Washington, and while there is no shortage of reports, insights, and comments on this event, we thought we would add our two cents this week, concentrating not on the specific details of Lehman's demise but on the broader, more general causes, which have been apparent for years to anyone willing to look, and on some of the implications that go far beyond the fate of one now-defunct investment bank.

As regular readers know, throughout the twelve years of our partnership, one of the overriding themes of our work has been that of corruption, which we have consistently described as one of the most pernicious and persistent threats to the financial markets and to the global economy in general. Indeed, as noted in the above "They Said It," section, we discussed that theme and our interest in it in our introductory piece as new analysts at said defunct investment bank some seven-plus year ago. Indeed, while we hate to say "we told you so," we sincerely believe that if our former employer had paid any attention whatsoever to us and to what we wrote in those long-past days, it might not be in the situation in which it currently finds itself.

Does this mean that we believe that our former employer was corrupt or engaged in corrupt practices? No, not necessarily. What we can say for certain, though, is that if Lehman management had been more attuned to and repulsed by the corrupt practices of others, it might have avoided engaging with them in activities that reeked of dishonesty and fraud.

In his classic economic history, *The Great Crash, 1929*, the late John Kenneth Galbraith described the mechanism whereby corruption and theft tend to develop during good times, thereby setting the scene for the inevitable bad times and, eventually, more good times:

> In good times people are relaxed, trusting, and money is plentiful. But even though money is plentiful, there are always many people who need more. Under these circumstances the rate of embezzlement grows, the rate of discovery falls off, and the bezzle [described as "the inventory of undiscovered embezzlement"] increases rapidly. In depression all this is reversed. Money is watched with a narrow, suspicious eye. The man who handles it is assumed to be dishonest until he proves himself otherwise. Audits are penetrating and meticulous. Commercial morality is enormously improved. The bezzle shrinks.

The good times, of course, ended abruptly just over a year ago, when the U.S. housing market began to wobble under the weight of "subprime" mortgage losses tied, at least in part, to the resetting of interest rates and the subsequent related mortgage defaults. Money had been easy and plentiful. And mortgages had been easy to get. Housing prices rose. And money became even more available. Similarly, mortgage-backed securities generated big profits, and money became more plentiful still. The bezzle grew – in politics, on Wall Street, and on Main Street. And then it all stopped.

We won't pretend even for a second to be experts on the financial practices and the financial instruments that are specifically at fault here. But we do know that when people borrow money they can't possibly pay back, when political entities encourage people to borrow money they can't possibly pay back, when the same political entities induce would-be overseers to look the other way and to pretend not to see people borrowing money they can't possibly pay back, and when other, private entities decide to take advantage of cheap credit to leverage themselves unwisely in the hope of making even greater profits off the money lent to those who can't possibly pay it back, things are likely to end poorly.

The world officially learned last week what nearly everyone in Washington and on Wall Street had known for years, namely that the mortgage racket was a joke, a big, rotten, stinking joke played on the American markets and on the American taxpayers. The world also learned that the biggest players in the mortgage business are and long have been monumentally corrupt. And by last week, no one could pretend otherwise.

Last Monday, our friend, economist, and market strategist Ed Yardeni, commenting on Treasury's takeover of Fannie and Freddie, wrote:

> A few weeks ago, Morgan Stanley was hired by the US Treasury to do some due diligence on Fan and Fred. The auditors concluded that the two have been cooking their books to postpone inevitable disaster. In the past, I was critical of Fannie's loans to delinquent borrowers to help them make their mortgage payments. That was just the tip of the iceberg. Freddie Mac, in particular, failed to properly mark down the value of its riskiest mortgage securities to reflect market prices. Both have inflated their assets with deferred-tax credits, which can't be sold and only have some value if a company has profits. Both have been too slow to provision for loan losses.

The question we have now is whether it is possible for one iceberg to be the tip of another, much larger iceberg? Or to put it less sloppily: Ed is right, but that may not be the half of it.

Fannie and Freddie have for years been playing the Washington game better than anyone, gelding their purported regulators and buying off their Congressional overseers. They were untouchable and did whatever they wished to do. The mortgage market, which has caused so much consternation and so much pain for Wall Street, was a sucker's bet. Sure, the money was easy and profits were potentially unlimited. But the future-felons running the game were less honest and less honorable than the old mafia bosses who ran the original casinos in Vegas. And they were more powerful to boot. The following is just a taste of a *Washington Post* exposé on Fannie and Freddie published over the weekend:

> Fannie Mae and Freddie Mac enjoyed the nearest thing to a license to print money. The companies borrowed money at below-market interest rates based on the perception that the government guaranteed repayment, and then they used the money to buy mortgages that paid market interest rates. Federal Reserve Chairman Alan Greenspan called the difference between the interest rates a "big, fat gap." The budget office study found that it was worth $3.9 billion in 1995. By 2004, the office would estimate it was worth $20 billion.
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> As a result, the great risk to the profitability of Fannie Mae and Freddie Mac was not the movement of interest rates or defaults by borrowers, the concerns of a normal financial institution. Fannie Mae's risk was political, the concern that the government would end its special status.
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> So the companies increasingly used their windfall for a massive campaign to protect that status.
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> "We manage our political risk with the same intensity that we manage our credit and interest rate risks," Fannie Mae chief executive Franklin Raines said in a 1999 meeting with investors.
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> Fannie Mae, and to a lesser extent Freddie Mac, became enmeshed in the fabric of political Washington. They were places former government officials went to get wealthy – and to wait for new federal appointments. At Fannie Mae, chief executives had clauses written into their contracts spelling out the severance benefits they would receive if they left for a government post.
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> The companies also donated generously to the campaigns of favored politicians. The companies' political action committees and employees have donated $4.8 million to members of Congress since 1989, according to the Center for Responsive Politics.
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> But Fannie Mae wasn't just buying influence. It was selling government officials on an idea by making its brand synonymous with homeownership. The company spent tens of millions of dollars each year on advertising.
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> Even Greenspan, who shared the concerns of Treasury officials about the unrestrained growth of Fannie Mae and Freddie Mac, refrained for years from using his bully pulpit to urge action. He too wanted a hot housing market.
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> In tying itself to politicians and wrapping itself in the American flag, Fannie Mae went out of its way to share credit with politicians for investments in their communities.

> "They have always done everything in their power to massage Congress," [former Iowa Congressman Jim] Leach said.
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> And when they couldn't massage, they intimidated. In 2003, Richard H. Baker (R-La.), chairman of the House Financial Services subcommittee with oversight over Fannie Mae and Freddie Mac, got information from OFHEO on the salaries paid to executives at both companies. Fannie Mae threatened to sue Baker if he released it, he recalled. Fearing the expense of a court battle, he kept the data secret for a year.
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> Baker, who left office in February, said he had never received a comparable threat from another company in 21 years in Congress. "The political arrogance exhibited in their heyday, there has never been before or since a private entity that exerted that kind of political power," he said.

In a recent interview with CSpan, former Reagan administration official and author Peter Wallison noted Fannie and Freddie's willingness to retaliate against anyone in Washington who dared to question their authority or their benevolence, Wallison included. According to Wallison, Fannie threatened to end all dealings with the Mortgage Guarantee Insurance Corporation (MGIC) because, they claimed, they couldn't in good conscience do business with any company that would have Wallison sit on its board. You see, Wallison was a prominent and outspoken critic of the GSEs. And he had to be punished. Needless to say, he was. Wallison resigned from MGIC's board immediately – for the good of the company.

Of course, in addition to sticks, Fannie and Freddie also used proverbial carrots, buying off everyone and anyone who had any stake in their oversight. In addition to the aforementioned donations made to political campaigns, Fannie and Freddie maintain "foundations," which are, essentially, stockholder-funded slush funds designed to meet the every wish and need of their purported Congressional masters. Consider for example the following, from a *Wall Street Journal* editorial on Fannie and Freddie's "patron saint," House Financial Services Chairman Barney Frank:

> In January of last year, Mr. Frank also noted one reason he liked Fannie and Freddie so much: They were subject to his political direction. Contrasting Fan and Fred with private-sector mortgage financers, he noted, "I can ask Fannie Mae and Freddie Mac to show forbearance" in a housing crisis. That is to say, because Fannie and Freddie are political creatures, Mr. Frank believed they would do his bidding.
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> And this is exactly what Mr. Frank attempted to prove when the housing market started to go south. He encouraged the companies to guarantee more "affordable" mortgages, thus abetting their disastrous plunge into subprime and Alt-A loans. He also pushed for, and got, an increase in the conforming-loan limits to allow Fan and Fred to securitize and guarantee larger mortgages. And he pressured regulators to ease up on their capital requirements – which now means taxpayers will have to make up that capital shortfall.
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> But the biggest payoff for Mr. Frank is the "affordable housing" trust fund he managed to push through as one political price for the recent Fannie reform bill. This fund siphons off a portion of Fannie and Freddie profits -- as much as $500 million a year each -- to a fund that politicians can then disburse to their favorite special interests.

> This is also why Mr. Frank won't tolerate cutting the companies' MBS portfolios. He knows those portfolios (bought with debt borrowed at taxpayer-subsidized rates) were a main source of Fannie's profits before the housing crash, and he figures that once this crisis passes they can do it again. And this time, his fund will get part of the loot.

We could go on. And perhaps we should go on. But we won't. As we noted, we couldn't possibly hope to do justice to the corruption involved here in the time and space we have.

Now, we don't know anything at all about the reasons that investment banks – or former investment banks – like Bear or Lehman became so heavily involved in the mortgage mess that has always been the province of quasi-government entities bound by no rules. Perhaps they were naïve and were simply bamboozled. Perhaps they were greedy and looking to make some big money. Perhaps they were just as crooked as Fannie and Freddie and thus unaffected by the stench that encircled the two. We can't say. But the moral of the story is that if you get involved in a business that is driven by political entities dedicated to political goals and unencumbered by traditional business restraints, you'd better be prepared to deal with consequences, up to and including losing everything.

Well, actually, that's only one of the morals of the story. The other moral, perhaps the most important one, is that no one should expect any of this to change.

Above, we quoted John Kenneth Galbraith as saying that "In depression all this is reversed. Money is watched with a narrow, suspicious eye. The man who handles it is assumed to be dishonest until he proves himself otherwise. Audits are penetrating and meticulous. Commercial morality is enormously improved. The bezzle shrinks." Or in other words, when the money runs out, the corruption is not only discovered but remedied as well. That's the way the cycle is supposed to work.

The problem with this explanation is that in this case, it has no bearing whatsoever on the corrupt entities involved. Fannie and Freddie are now under federal conservatorship, and they are, therefore, officially backed by the U.S. taxpayers. And tax money NEVER runs out. Yes, Congress has passed tough new regulatory legislation and it promises to do a better job of overseeing these monstrosities. But what incentive is there for that?

Fannie and Freddie can still give campaign cash to those who call the shots and, as per Barney Frank's personal intervention, they can still maintain their foundation slush funds that facilitate the transfer of funds to legislators' cronies and pet projects. Nothing has changed, in other words, except that now Fannie and Freddie have the explicit backing of the full faith and credit of the United States government. The bezzle isn't going to shrink any, and anyone who thinks it will is likely to meet the fate of our former employers.

The fix is in. And real people are suffering for it. This is more than a financial crisis. This is a moral crisis. Corruption has thrown the financial markets into turmoil and by some accounts threatens the broader economy. We can't say we're a bit surprised, though we can say we are disappointed and troubled. For the country. For the markets. And for our friends and former co-workers who, through no fault of their own, are the real victims here.

THE CLASH OVER "STUFF."

It seems like only yesterday, but 19 years have passed since Francis Fukuyama became an instant celebrity among the nation's intellectual elite via the publication of an essay entitled "The End of History," in which he laid out the theory that "What we may be witnessing is not just the end of the Cold war, or the passing of a particular period of post-war history, but the end of history as such: that is the end point of mankind's ideological evolution and the universalization of Western liberal democracy as the final form of human government." Three years later, in 1992, Fukuyama expanded on this thesis in a best-selling book entitled *The End of History and the Last Man*.

The following year, Samuel Huntington formally entered into the intense discussion of the future, which Fukuyama's essay and book had sparked, with an article in *Foreign Affairs* entitled "The Clash of Civilizations." In 1996, he expanded this essay in a best selling book entitled *The Clash of Civilizations and the Remaking of the World Order*. Huntington's thesis, simply stated, went as follows: "It is my hypothesis that the fundamental source of conflict in this new world will not be primarily ideological or primarily economic. The great divisions among humankind and the dominating source of conflict will be cultural. Nation states will remain the most powerful actors in world affairs, but the principal conflicts of global politics will occur between nations and groups of different civilizations. The clash of civilizations will dominate global politics. The fault lines between civilizations will be the battle lines of the future."

With the benefit of hindsight, we can now say that while each of these efforts to peer into the future provided some valuable observations concerning the human condition and a useful framework from which to consider where the post-Cold War world was headed, neither proved to be all that prophetic, which is not surprising, given the inherent impossibility of accurate soothsaying.

But keeping in mind the expression "fools rush in, etc., etc.," we have decided to take up where they left off so many years ago. Our effort will be much briefer and significantly less intellectually supported than theirs, not because we prefer it that way but because we write in basement offices, neither of us having ever seen, much less sat in an ivory tower. Which is to say that we do not present our thesis under the pretense of it being more prescient than theirs, but as a vehicle, like theirs turned out to be, for examining the present and a platform from which to make some educated guesses as to what may lie ahead.

Our working thesis, which is modeled on, but quite different from the predictions mentioned above, is that "statism," for lack of a better term, is much more likely to become "the end point of mankind's ideological evolution" than is democracy, and that economic competition is more likely than cultural differences to become the "fundamental source of conflict in this new world."

Statism, in case you are wondering, is defined by the poor man's most popular intellectual reference source, Wikapedia, as "a form of government or economic system that involves significant state intervention in personal, social, or economic matters." We won't dwell on the details of this prediction because we have discussed it in these pages so many times over the past couple of decades and, even more importantly, because all of us in the investment business watched it in action and in living color yesterday as the Lehman, Merrill, AIG mess unfolded.

We will simply offer a 170-year-old quote from Tocqueville that states the case as well as can be stated, and a more recent quote from Russell Kirk, commenting directly on the Tocqueville's observation. Both are, we think, worth keeping in mind as the financial drama mentioned above continues to unfold. Here's Tocqueville.

> I seek to trace the novel features under which despotism may appear in the world. The first thing that strikes the observation is an innumerable multitude of men, all equal and all alike incessantly endeavoring to procure the petty and paltry pleasures with which they glut their lives. Each of them, living apart, is as a stranger to the fate of all the rest; his children and his private friends constitute to him the whole of mankind. As for the rest of his fellow citizens, he is close to them, but he does not see them; he touches them, but he does not feel them; he exits only in himself and for himself alone; and if his kindred still remain to him, he may be said at any rate to have lost his country.
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> Above this race of men stands an immense and tutelary power, which takes upon itself alone to secure their gratifications and to watch over their fate. That power is absolute, minute, regular, provident, and mild. It

> would be like the authority of a parent if, like that authority, its object was to prepare men for manhood; but it seeks, on the contrary, to keep them in perpetual childhood; it is well content that the people should rejoice, provided that they think of nothing but rejoicing. For their happiness such a government willingly labors, but it chooses to be the sole agent and the only arbiter of their necessities, facilitates their pleasures, manages their principal concerns, directs their industry, regulates the descent of property, and subdivides their inheritances; what remains, but to spare them all the care of thinking and all the trouble of living?
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> Thus it every day renders the exercise of the free agency of man less useful and less frequent; it circumscribes the will within a narrower range and gradually robs a man of all the uses of himself. The principle of equality has prepared men for these things; it has predisposed them to endure them and often to look on them as benefits.

And here's Kirk.

> The omnicompetent, paternalistic state, guiding all the affairs of mankind, satisfying all individuals' wants, is the ideal of twentieth-century social planners. This arrangement is intended to gratify the material demands of humanity, and twentieth-century social aspiration, so saturated with the ideas of Bentham and of Marx, scarcely conceives of wants that are not material. That men are kept in perpetual childhood--that, in spirit, they never become full human beings--seems no great loss to a generation of thinkers accustomed to compulsory schooling, compulsory insurance, compulsory military service, and even compulsory voting. A world of uniform compulsion is death to variety and the life of the mind; knowing this, Tocqueville felt that the materialism which democracy encourages may so far obsess the public consciousness as to stifle, in all but a few independent souls, the ideas of freedom and variety.

As for the second part of our above-stated thesis, we would note that the kind of "economic competition" of which we speak is as mundane as the statism that Tocqueville describes. By this we mean that we are not predicting vicious trade and currency wars. We are not predicting imperialistic land grabs as a means of controlling natural resources. We are not hawking the dangers of the emergence of a war of mercantilists states. We are simply saying that, to borrow a phrase from Huntington, the "primary axis of conflict" among the great powers, in the near future at least, will not be along cultural and religious lines as he claimed, but will be largely confined to good old fashioned economic rivalry.

Now, the obvious argument against this thesis is that feuds and fights over commerce and wealth are nothing more than proxy battles in wars over the same things that men have fought over since the beginning of time, i.e., culture, religion, ideology, honor, real estate, race, personal grievances, etc. There is some truth to that, of course, as in the old saw "the more things change, the more they stay the same." But the fact is that there is something different going on in the world today, something quite new.

For starters, advances in communications and travel, along with an extraordinary burst in world wide consumer advertising, has created a global demand for "stuff" unlike anything the world has seen since Marco Polo wowed medieval Europe with stories of the treasures and wonders available in the Orient.

From the barren plains of Siberia to the small villages of India and China, to the slums of Rio de Janeiro and Cairo, to the deserts of Arabia, and to the squalid huts in Nairobi where Barack Obama's brother lives, people all over the world, from all economic classes, are demanding a better life. They want finer food, better transportation, cleaner water, modern health care, and all of the wonderful trinkets and baubles that are now, as a result of the wonders of globalazation, as available in the stores and marketplaces near them as they are to the citizens of New York, London, and Paris.

Moreover, these people expect their government to do whatever is necessary to make these wonders attainable to them. And this too is new. How new we can't say, but somewhere along the line in the last half century or so governments throughout the world, democracies and communist states alike, big and small, have assumed the role of Godhead, or "Big Brother" if you will, in the eyes of their citizens.

It's not just Americans who think their government has an obligation to right every wrong and to scratch every itch. Across the globe, people are demanding not "freedom" or "democracy," as President Bush maintains, but a higher standard of living, or to put this in another way, "stuff." From Iraq to China, from Russia to Europe, and from Latin America to the United States, people are happily submitting to the rule of the omnicompetent, paternalistic state in exchange for the trinkets and baubles of modernity. And lo, on the other side of this process, government leaders all over the world are discovering the wisdom of Tocqueville's observation that being responsive to these material demands is a cheaper and more convenient means of subjecting the masses to servitude than is the lash.

China's leaders were among the first of the totalitarians to absorb this lesson into their ideology. They still imprison and kill a large number of citizens who obstinately cling to the archaic notion of freedom. But the tactic of choice for keeping the masses at bay is to provide them with a steadily increasing standard of living. And the preferred means for doing this is head to head competition with the United States in the global marketplace, not to get involved in a "clash of civilizations" as Sam Huntington thought they would.

Russia's political leaders haven't yet come to the same realization. They have decided instead to try to convince their citizens that a renewal of Russia's status as a widely feared superpower and international bully is a suitable substitute for the acquisition of "stuff." Time will tell whether the Russian population will agree to this trade-off for very long, but we have our doubts.

The Islamic states are having the most trouble dealing with this new materialistic reality. Most would greatly prefer the Huntington model. But they are finding, to their great and continuing dismay, that the charms of a medieval religion are not competing well with the allure of the global Casbah.

In any case, there is good news and bad news in all of this. On the good side, the possibility of a bloody "clash of civilizations" appears to have been greatly mitigated by the expansion of global trade. In fact, as we said in these pages almost a year ago, this globalization process has created a new phenomenon that we call "mutually assured economic destruction," which is a variation of the old Cold War deterrent to nuclear war.

In this new version, any serious harm to the economic health of one of the world's major trading partners can quickly spread to the others. This not only has a deterring affect on the urge by any one country to grossly manipulate the currency and capital markets, but more importantly, has a restraining influence on the trigger fingers of the generals.

The negative side of this scenario is the growth in the power, size, and global reach of the governments of large nations, and the tendency for these governments to move away from the Western liberal democracy model that Fukuyama believed would be the prototype of the future and toward a highly centralized form of statism, as we described it earlier, and which, in the long term, will eventually lead us back to the Huntington scenario.