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In this Issue

THEY SAID IT

Critics of capitalism typically identify it with its worst possibilities: ruthless competition, exploitation, greed, crude commercialism, social atomism, etc. These are said to be of the very essence of a free economy. In reality, the prominence of such phenomena is a sign that capitalism is operating within a society in which people lack ethical, aesthetical, and other inhibitions and strong communal ties, a society in which institutional structures do not embody civilized purposes and in which neither supply nor demand recognizes any higher standards. Critics of democracy similarly identify democracy with its worst potentialities: unchecked majoritarianism, political irresponsibility, demagoguery, rule by pandering to the lowest common denominator, etc. Here, too, the alleged essence of the phenomenon in question is how it performs in a society where civilized restraints are weak. Both points of view are unhistorical and reductionistic. In reality, capitalism and democracy have no single definition or 'essence.' They exist only in particular historical manifestations. These can be sharply different depending on the ethical and cultural health of the particular societies in which they operate. They can be compatible with the ends of the good society, in which case their institutions and practices are integral to the structures and practices of civilization. But they can also be destructive of higher values, in which case they manifest the structures and practices of the deteriorating society.

Claes Ryn, *The New Jacobinism: Can Democracy Survive?* 1991.

MIKE MAYO AND US.

As many of you may already know, Mike Mayo, the Wall Street veteran, celebrated wave maker, and current bank analyst for Credit Agricole Securities, has a new book out in which he documents the trials and travails that he encountered while attempting to tell the truth about the nation's big banks. Mayo, whose book was released two weeks ago and is titled *Exile on Wall Street: One Analyst's Fight to Save the Big Banks From Themselves*, notes, among other things, that many of the big banks have long been dogged by endemic problems ranging from "excessive risk" to "outsized compensation for bankers" to overly "aggressive lending." Despite this, he says, anyone who ever even dared to mention these problems – himself, most notably – was "yelled at, conspicuously ignored, threatened with legal action and mocked by banking executives . . ." And that's not the worst of it.

According to Mayo, his own firm, his own friends, and his clients were among those who most aggressively repudiated his desire to tell the truth about the banks – a "truth" he feels has been vindicated by the financial collapse in 2008 and the subsequent lessons learned. To wit:

It started in 1999, when I was managing director (the equivalent of partner) at Credit Suisse First Boston. At the time, what gave me the biggest concern was a sense that stocks within the banking sector were likely to turn downward.

Five years after the interstate banking law of 1994, which allowed banks to operate across state lines, the easy gains from consolidation were over. When banks couldn't maintain their growth momentum through mergers and cost cuts, they took the next logical step—they made more consumer loans. Logic dictated that this meant the quality of those loans would probably decrease, and, in turn, create a greater risk that some of them would result in losses. At the same time, executive pay was soaring, aided by stock options, which can encourage executives to take on greater risk.

For my 1,000-page report on the entire banking industry, with detailed reports of 47 banks, I wasn't just going to go negative on a few main stocks but the entire sector. This was completely the opposite of what most analysts were saying, not just about banks but about all sectors . . .

Analysts almost never said to sell specific companies, because that would alienate those firms, which then might move business for bond offerings, equity deals, acquisitions, buybacks or other activity away from the analyst's brokerage firm. Say the word "sell" enough times, and you win a long, awkward elevator ride out of the building with your soon-to-be-former boss. And here I was, ready to go negative on the entire banking sector.

At the company's morning meeting between analysts and the sales staff, I gave a short presentation on the report. "In no uncertain terms," I said, "sell bank stocks. I'm downgrading the group. Sell Bank One, sell Chase Manhattan . . . ." The message went out over the "hoot," or microphone, to more than 50 salespeople around the world. They would relay my thoughts to more than 300 money managers at some of the largest institutional investment firms in the business.

The counterattack started almost immediately. One portfolio manager said, "What's he trying to prove? Don't you know you only put a sell on a dog?" Another yelled, "I can't believe Mayo's doing this. He must be self-destructing!" One trader at a firm that owned a portfolio full of bank shares—which immediately began falling—printed out my photo and stuck it to her bulletin board with the word "WANTED" scribbled over it. I'd poked a stick into a hornets' nest.

That morning, I got a call from a client who runs a major endowment. "Check out the TV," he said. On CNBC, the commentators had picked up on the news and were now mocking me. Joe Kernen joked: "Who's Mike Mayo, and do we know whether he was turned down for a car loan?" *I even got an ominous, anonymous voice mail from someone with a strong drawl cautioning, "Be careful with what you say."* [Emphasis added]

Of course, the banks that I had downgraded were even more furious, and they let me know it. Routine meetings with management are a standard part of my work, yet when I requested these meetings after my call, several banks said

> no. Worse, a couple of big institutions in the Midwest and Southeast threatened to cut all ties with Credit Suisse—no more investment banking deals, no more fees.

Now, we don't know how any of you feel about Mike Mayo or about what he has done or what he has said or about how terribly he believes he was treated by his fellow "Wall Streeters." Some of you may love him. Some of you may hate him. Some of you may never have heard of him and may never give him another thought once you've finished this piece. All of this is fine, since what Mayo has or hasn't said about the banks isn't really our concern here. Our concern is the nature of the "the system" he tried to fight and, more specifically, the incomplete, albeit damning, picture that he paints of that system. There is, in other words, more to the story here than has been apparent from the excerpts, articles, and interviews we have seen about Mayo's book and its indictment of the capital markets.

You see, in many ways, we are Mike Mayo. Or, at the very least, we can empathize quite ardently with him. We can't say we really know the guy, since our paths crossed only briefly. And we suspect that he would have no idea whatsoever who we are. But then, there is a reason that our paths crossed only briefly, namely because we, like he, made something of a habit of annoying the proverbial "powers that be" with our own truth telling. And we, like he, paid a price for it.

Mayo mentions, among other things, "I've worked at 6 Wall Street firms. I analyzed Wall Street. I was fired from one and muzzled by another." For our part, we haven't worked at six firms, but we have worked at two of the same firms Mayo did. And indeed, we were "fired from one and muzzled by another." It is no coincidence, in our humble estimation naturally, that neither firm exists anymore. Like Mayo, we were constantly told what we could and could not say and about whom we could and could not say it. Like Mayo, we were told that if we didn't shut up – in one particular case, if we didn't stop calling the Butchers of Beijing the Butchers of Beijing – that we would hurt our firm and cost it investment banking business, which, unsurprisingly, is what brought out the aforementioned muzzle. Perhaps most interestingly of all, one of us (the senior one of us) was, like Mayo, the recipient of a "friendly" phone call warning that we should "be careful what you say."

All of that said, the differences between us and Mayo are also quite substantial – and obvious. And, moreover, they're the whole point of this piece. Whereas Mayo thought (and presumably thinks) that the big banks were corrupt and corrupting. We have always thought and said the same thing about big government. Whereas Mayo was canned from his big-time analyst job for calling out what he saw as corruption in the private sector. We were canned for noting the same about the public sector. To this end, we cite a profile of Mark published by *Barron's* and written by that publication's Washington Bureau Chief, Jim McTague, roughly nine months after said canning:

> A recurrent Melcher theme is that moral deficits have severe economic consequences in that they facilitate the spread of corruption. As such, he argued that Wall Street and its investors have a responsibility to reverse what he considers to be the leftward drift from moral norms and capitalism, not just in Washington, but in universities, the mass media and churches.
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> Such views, however, apparently displeased John Strangfeld, who took over as head of Prudential Securities in October, the same month Melcher was forced to step down. Melcher, who had been predicting a Bush win, was shown the door two weeks before the presidential election.
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> The economist won't comment on the circumstances behind his departure, citing a confidentiality agreement. Prudential Financial spokesman Bob DeFillippo also demurs, "We do not comment on the reason a person

> leaves Prudential," he says, adding curtly, "We also don't comment on rumors, especially unattributed and unsubstantiated rumors."
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> The source of this "rumor," however, is Prudential itself. A U-5 filing with state regulators discloses the reason for Melcher's forced departure. "Employee's work product exhibited difference in philosophy from that of firm management," Prudential reported.
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> The irony is that Strangfeld has been telling everyone within earshot about the firm's intention of letting its analysts "call them like they see them," without fear of alienating clients. Indeed, *Fortune* magazine last month praised Strangfeld's gambit, stating, "Investors, at last, will be served well by Wall Street research."
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> Melcher's firing coincided with the departure of long-time Prudential Securities chief executive Stanwick "Wick" Simmons, who has since been named chief executive of Nasdaq. A Melcher friend suggests that Simmons had long protected the economist from Prudential Financial's chairman, Arthur Ryan, and senior vice president, Harold Davis, who were taking heat from liberals both in- and outside the firm. Indeed, even as Melcher was blasting Clinton, Ryan was hobnobbing with the President aboard Air Force One.

And this brings us to the biggest difference between us and Mayo. Whereas Mayo feels vindicated by the events of the last several years and is, in fact, congratulated by many – including the press, his publisher, and countless others – for his prescience and vigilance, we feel no such vindication. If anything, we see the arguments that we have made for the last two decades falling more and more on deaf ears, despite the fact that they are every bit as relevant – if not more so! – as the arguments that Mayo has made.

It makes no difference whatsoever, in short, if the private banking system is cleaned up, wholly purified of its sins, and made a model of probity, transparency, decency, and fairness. If the government continues to be corrupt; if the government continues to grow and to operate as an entity unto itself rather than merely the representative of the people; if the government continues to prioritize the government's interests or the interests of a handful of individuals within government over those of the market, then the condition of the private economy is, quite simply, entirely irrelevant.

How, we wonder, does one make reasonable bets or sound investments when, upon the largest bankruptcy in the history of the nation, the government can intervene in the proceedings, pre-empt settled bankruptcy law, re-prioritize the distribution of assets, and ensure that politically connected constituencies receive preferential treatment?

How does one know what to believe or whom to trust when a securities firm goes bankrupt – one of the ten largest bankruptcies in American business history – in large part because of the recklessness of a former United States Senator and governor; and it is then discovered not only that said Senator-turned-governor-turned-fraudster failed to keep track of billions of dollars of client funds, but that the government official in charge of finding those funds, the Chairman of the Commodity Futures Trading Commission, used to work for the fraudster at the last firm he tried to bankrupt and therefore has an enormous conflict of interest?

How does one make a reasonable play in the healthcare/pharmaceuticals market when it turns out that the Obama administration has spent the last year or more pushing "aggressively" to award a no-bid contract to develop an "experimental" small-pox drug to a company owned principally by a big-time Democratic donor, despite the fact that the *Los Angeles Times* says there is considerable "uncertainty over whether [the drug] is needed or will work"?

What difference does it make how well or smoothly or transparently the banking system is functioning when we have accounts of government corruption as we described in these pages two months ago as follows?

> Enter now Ron Suskind, the Pulitzer Prize-winning journalist for the *Wall Street Journal*, who has just written a new book on the behind-the-scenes maneuverings of the Obama administration, most of which are interesting, some of which are telling, and at least one of which is damning. As an *AP* account of Suskind's retelling puts it:
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> > A new book offering an insider's account of the White House's response to the financial crisis says that U.S. Treasury Secretary Tim Geithner ignored an order from President Barack Obama calling for reconstruction of major banks . . .
> >
> > The book states Geithner and the Treasury Department ignored a March 2009 order to consider dissolving banking giant Citigroup while continuing stress tests on banks, which were burdened with toxic mortgage assets.
> >
> > In the book, Obama does not deny Suskind's account, but does not reveal what he told Geithner when he found out.
>
> Now, in case you were wondering, up until early 2009, about the same time as the alleged "slow walk" of the Citigroup matter, a Director and Senior Counselor (and briefly Chairman) of Citigroup was a man named Robert Rubin, who earned over $100 million in cash and *stock* during his stay at Citi. Oh yeah. And he was also a former co-chairman of Goldman Sachs. And a former Treasury Secretary. And one more thing: as Treasury Secretary, he was boss to a young Undersecretary of the Treasury for International Affairs named . . . say it with us! . . . Timothy Geithner!

Sadly, we could go on. And on. And on. And on. But we suppose you get the point. Since the collapse of 2008, the banks have received new scrutiny. And hooray for that, we guess. But what about the people doing the scrutinizing? It seems to us that they've pretty much done exactly as they pleased, with no repercussions, no increased scrutiny, and, frankly, no serious consideration that they might be part of the problem rather than part of the solution. Heck, the law written to keep tighter reins on the financial sector and to "reform" Wall Street – the Dodd-Frank law – is named for two of the most corrupt men ever to disgrace the United States Congress. Does anyone, anywhere actually believe that everything is going to be peachy now that we have a "reform" law thought up by, written by, lobbied for, and named for Chris Dodd and Barney Frank? Really? That strikes us a little like putting one's faith for world peace in the Al Capone Institute for Nonviolence and Diplomacy.

In one of the interviews that he did in promotion of his book, Mike Mayo told the Associated Press that he "sympathizes with the Occupy Wall Street movement," but disagrees with the protestors on the subject of capitalism. "The key difference between me and the protesters," he says, "is that I believe in capitalism — a capitalism that works." And what makes it work? "Capitalism works when rules are put in place and strictly enforced. Not when government looks the other way when rules are broken and then steps in to protect banks that cannot deal with the consequences of their bad decisions."

Oh dear.

Now, in fairness to Mayo, it may be that his views on capitalism are more complicated and more nuanced than can be expressed in a two-line sound-bite taken from an interview. It may be that his views are truly more in line with our own than is suggested by this quip. Certainly we hope so. But whatever the case of

Mayo's personal views, the notion conveyed here – that the effective administration of capitalism depends on proper regulation, proper enforcement, and proper management by government – is nevertheless the notion that is predominant among the ruling class today. And it is complete and utter garbage.

Given the examples cited above – which are but the tip of the proverbial iceberg – it should be obvious to anyone paying even the remotest attention that government and its agents cannot be trusted to oversee the fair administration of anything, including a capitalist economy. Certainly rules are necessary, and laws, regulations, and other legal restraints can be helpful. But they are, at best, secondary, artificial, and horribly inefficient restraints on human behavior. Not to be too trite here, but Acton's axiom applies to government actors every bit as much as it does to non-governmental actors. Power corrupts; absolute power corrupts absolutely, and any body of government officials given the charge of "enforcing" the "rules" to see that "capitalism works" is going to be corrupted beyond even Acton's wildest imaginings.

Anyone who believes that the key to saving capitalism is better laws or better law enforcement is going to be sorely disappointed. The law, by itself, is incapable of affecting human behavior in a manner or to a degree necessary to facilitate the functioning of an effective capitalist system. If the "rules" are all we have to rely on, then we might as well concede now that Wall Street's Occupiers are right and that "late capitalism" is indeed doomed.

If we go back, ever so briefly, to the aforementioned *Barron's* piece, you see that "A recurrent . . . theme" in our work "is that moral deficits have severe economic consequences." There is a reason for this, namely the fact that it's true and has been since modern economics and modern capitalism developed. Put simply, capitalism cannot function properly if it is regulated exclusively by law. It must also be self-regulated. Capitalism must, in other words, be conducted in a moral environment.

Adam Smith, for example, wrote repeatedly and throughout both of his major works that commercial society simply cannot thrive in a climate of moral decay. In *The Theory of Moral Sentiments*, Smith noted that "upon the tolerable Observance" of such duties as politeness, justice, trust, chastity and fidelity, "depends the very existence of human society, which would crumble into nothing if mankind were not generally impressed with a reverence for these important rules of conduct." Smith maintained that social order was not spontaneous or automatic, but was founded on institutions that promote self-control, prudence, deferral of gratification, respect for the lives and property of others, and even concern for the common good.

More recently, the German economist Wilhelm Ropke made very much the same point, putting it this way in his 1971 book *A Humane Economy*:

> Self-discipline, a sense of justice, honesty, fairness, chivalry, moderation, public spirit, respect for human dignity, firm ethical norms – all of these are things which people must posses before they go to market and compete with each other. These are the indispensable supports which preserve both market and competition from degeneration. Family, church, genuine communities, and tradition are their sources. It is also necessary that people should grow up in conditions which favor such moral convictions, conditions of a natural order, conditions promoting co-operation, respecting tradition, and giving moral support to the individual . . . It is the foundation upon which the ethics of the market economy must rest. It is an order which fosters individual independence and responsibility as much as the public spirit which connects the individual with the community and limits his greed.

Longtime readers know that another "recurrent theme" in our work is "the clash of moral codes." Newer readers may think this a little strange or obsessive on our part, but the fact of the matter is that the moral code by which society is governed is critical in determining what kind of a society it will be and specifically what kind of economy will be viable in the society.

A society in which a post-modern ethic predominates simply cannot function as a capitalist society over the long-term. When morality is capricious and determined by situation, circumstances, and power relationships, then there is no foundation upon which one might effectively invest resources over the course of many months, years, or decades. Winners and losers in such an economy are determined not by merit, by appeal to consumers, or by effective management. Rather they are determined by political connection, by appeal to the conscience of the moment, and, frankly by the whim of the ruling class.

By contrast, a society in which traditional Hellenic-Judeo-Christian morality prevails does indeed provide a foundation for effective and communally beneficial capitalism to thrive. There are constants and norms of behavior. There are universal expectations and commonly accepted standards. Individuals, obviously, may not always live up to these standards. But when they don't the society as a whole rebukes them. Return on investment is far more reflective of merit than corrupt association.

If asked, we would argue that Mike Mayo has it precisely backward with regard to banks and government and the effective operation of capitalism. It's not that we need more or more effectively enforced rules. It's that we need better capitalists, men and women who are not only versed in the expectations that society has for them, but willing to enforce the norms of the culture in order to meet those expectations.

Unfortunately, for at least the last 150 years and for the last four decades in particular, the Western intellectual apparatus has been pushing in precisely the opposite direction. Do not think for a second that this is any mere coincidence.

Since its inception – essentially with Rousseau – the modern political Left has always and everywhere made an enemy of the institutions of the establishment and most especially of the classic works of Western civilization and of the Church. The reason for this is obvious. If you can undermine the Church, then you can undermine the moral order based in large part on the Church's teachings. Likewise, if you can undermine the great texts, the classics – Sophocles, Aristotle, Augustine, Aquinas – then you can undermine the moral order derived from these texts. And if you can undermine this moral order, then the economic order which rests entirely on that moral order will, in time, collapse.

One of the greatest tragedies of the financial crisis of 2008 is the emergence and general acceptance of the narrative that posits that only government intervention managed to stave off greater destruction and devolution into economic misery. This, in turn, has spawned even greater belief in the importance of government as an agent of stability and dependability in economic matters. This is precisely the wrong lesson to have learned.

In truth, both the inflation and the popping of the asset bubble were the result of a societal ethos that was too far removed from the moral underpinnings necessary for the effective operation of a capitalist economy. But the blame cannot be assigned wholly to the bankers when their government counterparts were equally – if not more – responsible for abdication of moral responsibility. And addressing the failures of the private sector while leaving the public sector entirely unbothered simply sets the stage for a repeat of the tragedy.

Mike Mayo declares that his one regret about Wall Street's Occupiers is that they don't have faith in capitalism. Our regret is that they are not more serious and more intelligently led, which is to say that they do not represent a more legitimate threat to the current system.

The system as it exists is a fraud. As we have written many times before, it is a corporatist oligarchy with mere capitalist trappings. If capitalism is to be saved from this fraud, then people – political leaders in particular – will have to get serious about the corruption of the public sector and the corruption of societal values more generally. And something will have to push them to get serious.

Occupy Wall Street, if it were done better, could have been the threat that forced that day of reckoning. Instead, it is a joke, which we, among countless others, have laughed at repeatedly. And the leader for the Republican presidential nomination has himself expressed his sympathy for this joke, which is to say that he not only doesn't see it as a threat, but doesn't understand that the real joke is on all of us.

What this means, unfortunately, is that the devastating Bubble-Burst cycle is not over. It will be repeated. And it will be repeated no matter how many new laws are passed, how many new rules are instituted, or how well those rules are enforced. Rules alone can't save capitalism. For that, we would need a moral renaissance. And such a rennaissance seems unlikely for now – at least as long as no one in a position to do anything about it seems willing even to acknowledge, much less address the problem.