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The American philosopher Santayana is responsible for the now famous dictum, "Those who do not heed the lessons of history are condemned to repeat them". It is clear that all who are in positions of power should theoretically have a Masters degree in that discipline. I would include a large group of people from politicians and top civil servants to most people who have a fiduciary responsibility towards others, including corporate directors, chief executive officers, lawyers, accountants, including bankers and investment types like myself. Having studied history at Chicago and continuously through reading all my life, I feel certain, especially today, that a disconnect with the past largely explains the disaster we face these days. For good measure I would also plug philosophy, sociology and psychology. All of these are required to understand human nature as well as the fact that common sense is uncommon, as it is based on reason, knowledge and experience and not on emotion - greed and fear should never overwhelm it.

But greed and fear are all too human and like so many times in history greed, if allowed to rule too long, becomes exponential and has ever led to similar results.

Unfortunately in our days of computers and instant information bombardment, we have let technology teaching overwhelm that of the humanities. When recently in Alberta and British Columbia, I was amazed how little attention the Universities give to liberal arts. Engineering, medicine, and business administration have been showered with funds, while liberal arts are being neglected. How can the University of Alberta be the largest university in the province and neglect the experience of history? Where is the Harvard to balance MIT? Similarly, UBC has had a quasi total technology direction (the Stanford of B.C., but not the University of California). Funds are flowing to technology and Chairs in humanities are rare.

The present generation coming to power seems to have major disconnects from history and philosophy. World War I is antiquity and World War II is passé. "Come into the 21<sup>st</sup> Century", my adult (36-39) children tell me.

The 8 years with George W. Bush are a perfect illustration of this disconnect. George W. went to Yale and the Harvard Business School. How he got into either is a miracle, but I suspect he had some 'pull'. He may have had good teachers, but no one can learn for another, and it shows! He is a perfect example of that fact. I don't place all the blame on George W. His advisors must share some of it. Also, to be a Republican in the USA is not only a political choice, but it means joining the elite, and sometimes I think that in some way also a religion.

Let's look at September 11 - the terrorist attack George W. used to consolidate his dubious election victory. To become a 'war president' made him legitimate. He declared the War on Terror and told all and sundry he would "smoke out Osama Bin Laden". We still require more smoke as the mythical Al Qaida is still on the loose. Billions were spent on US security and in seven years we have not seen a single terrorist act coming from Al Qaida in the USA. Still the indignities practiced at airports continue, when you could probably kill more people at the security gate than by blowing up an airliner. We have no security on trains, despite attacks in Europe! Fear is being fanned, as it has been so many times in history, by pointing at an elusive permanent "foe"! The fact is that terrorism has always existed and always will. The greatest act of terrorism has been in the economy - the recent destruction of our financial system created by a lack of proper regulation based on a "business knows best" philosophy. Business never did know best without regulation. Add to this exponential greed fostered by normal human nature, aided and abetted (this time) by the Federal Reserve Bank and Board of Director stupidity.

Let's now go to the historical disconnect in Afghanistan and Iraq. Afghanistan's history is reasonably well known. It is a nation of diverse tribes, each occupying and ruling parts of the Country. Life is hard and there is little wealth. The war today is centered largely in one area, along the border with Pakistan and especially in the South, South of Kandahar,

the City named after Alexander the Great, possibly the only one who occupied it for some brief years in his brief life. The fact is that, not unlike the Kurds who live in Iraq and Turkey, borders were again badly drawn, dividing the Pashgar tribe in two. They might also like to be reunited. Who drew the borders? – Western treaties. My reading indicates that the war is as much tribal as it is a revival of the Taliban. Kabul reigns over but a small part of the Country. Elsewhere tribal leaders are quasi independent. Why was the Taliban so easily dislodged at the beginning? Quite simply because the other tribes hated them, just like the Aztecs were laid low by Cortez, aided by those who hated the Aztecs, or why Pissaro could conquer the Inca. Will the West ever really win in Afghanistan? I doubt it. Life as said is difficult and the main crop is ‘poppies’, the source of Opium. Even today it is still the principal export. Why are we still in Afghanistan? Beats me! Rather, I will go back to history. Dwight Eisenhower and John Foster Dulles quite rightly upheld a theory which said that, so as not to have a major war, it is incumbent to make sure that borders do not change. The Soviets could live in their earthly Communist Paradise any way they wanted, as long as they did not change borders. In time internal forces broke up Communist power and the Satellites became free once more. The Dulles philosophy worked for many decades, however horrible some of the Governments were.

George W. and crew had other ideas. Since the terrorist logic did not hold water as there were no new terrorist acts in the USA, he, like Hitler or Napoleon and other braves, needed a diversion to stay in power as a ‘war president’. Being a ‘war president’ is important for it calls on nationalism, patriotism and a “we must support our troops” mentality. So, George W. needed another war. It was Iraq’s turn. Not unlike Dr. Goebbels, he resorted to the ‘big lie’, one of his few lessons from history. He declared, without having any facts, that Iraq had “weapons of Mass Destruction” – no different from Hitler’s slogans before he invaded the Saar, Danzig, Austria, Czechoslovakia or Poland – he had to free “oppressed” Germans. Of course no weapons were found. The CIA was embarrassed and had to admit failure. In order to stay in Iraq, it was then pointed out that Saddam Hussein was evil, and so the USA was bringing hope to Iraqis by way of Democracy. The US Army, victorious militarily, has now spent longer than World War II lasted in Iraq, suffering casualties. However, far more of the

dead are Iraqis as tribal war developed between arch enemies – Kurds, Shia Moslems and Sunni Muslims. Just like in Yugoslavia, these tribes had been brought into one country by the 1919 Peace Treaty. In both Iraq and Yugoslavia the border lines had been drawn by politicians who had no clue of the history of the regions. There was yet another reason to stay in Iraq – oil – one of the richest basins in the World, and certainly a Texan could understand that! Has Iraq been subdued and become democratic like us? Not yet. A thousand years of a culture do not disappear easily, especially when Iraq is really 3 small countries.

Let's now turn to Economics.

In economics history can also be of help. All you have to know is that human nature has not changed since the first writing of (I believe) the Sumerians. China wasn't far behind, nor was Egypt. Human nature has ever oscillated between greed and fear, as these are as basic human traits as you can find. In Vancouver four weeks ago I harked back to Old Egypt in a speech and discoursed about the time that Joseph lived there. He witnessed "seven fat years" followed by "seven lean years". I mentioned that the same has happened often throughout history, and not least in the period 1922-1929 followed by 1930-1936. Oddly enough, 2001-2008 was another up-period. Like in 1929, trouble started in the Fall, this Fall. All hell broke loose. Why seven years you may ask? Looking back to history, seven good years is not normal. Recessions should come every three to four years, as they did in most of the post World War II period, with a 1949 recession following the end of the war in 1945. The lesson of history is simple. To keep fear and greed within limits, good and bad times have to succeed each other every three to four years, otherwise greed becomes geometric or fear becomes excessive. It is fear which balances greed, something the police have learned as have politicians. Aristotle said that taking a social drink is a pleasant experience, while getting drunk or alcoholic is not. The mean is opposed to both extremes.

History has also taught us that human beings need laws and regulations. All religions use God and the prophets to underline this. Well, again my pal George W. and his henchmen, including one Allan Greenspan, felt that you could "trust the market forces", i.e. greed to not be greedy! Having

lived the hi-tech “new economy” madness, Allen decided to replace that bubble (when it popped) by an even more destructive one - housing, the largest single investment of the average man. He had learned nothing from the first bubble, never mind history. When that could no longer be sustained, why not commodities? All good things come in threes. The last two bubbles have now popped almost simultaneously. The latest regulations dating from the 1930’s were scrapped just some 16 months ago, when you could again sell stocks short anytime, no longer only after the shares had a 1/8<sup>th</sup> uptick. Also, so-called “naked” shorts were allowed - no longer did you need to borrow shares to sell short! Some of us feel naked indeed these days.

We can go back to ancient Rome to look at the “consumer” society and its results, when you need save no more as ‘this is a New World’. Consumerism is, or rather it was until recently, the fastest growing religion in the World, with more missionaries than ever inspired by all other religions. Moreover, to give Americans and Canadians a real chance to consume, we lowered the price for good by sending our orders to low-wage China, thus closing our own manufacturing. This way you could consume twice as much for the same price. Like in Rome, we built up a whole class of our brightest people who did little constructive to amass enormous wealth. CEO’s became paid like the best gladiators in the Coliseum. When they failed, there was no “thumbs down” as in Rome - no, they received enormous terminal bonuses to leave, which was arranged beforehand. CEOs of companies come from outside more and more often (stars) rather than following the logical internal succession. Boards no longer build cultures of loyalty to the corporation. The companies were looted by these “condottiere” who could earn four years salary plus bonus by selling the company after one year in office to create a “change of control”. Worse yet the smartest people, after a degree from a prominent school in business administration - specialty finance, went to work for hedge funds, mutual funds, private equity funds or investment dealer organizations, creating little that was productive, but they could walk away with up to \$1 billion a year (the record to-date) with no risk to themselves (hedge funds did best, charging 2% per year plus 20% of the profit). Whenever they lost their shirt, like these days, they just closed up shop and returned a pittance to the clients, who if they stayed indefinitely

with such a fund were bound to lose all they had gained and then some. For the managers it was a free lunch! You see there is a free lunch! Meanwhile they lived high on the hog in New York, London, Toronto and a few other cities. One even bought a \$12 million stuffed shark, parading it as art.

New financial products were invented without being tested, unlike every drug in the USA and other advanced nations. Derivatives were invented for everything, just like compensation consultants invented new plans allowing even a CEO to get a supplementary pension when his/her annual salary was \$20 million per year. No wonder most of these derivatives, like bad drugs, proved toxic. Swaps were invented and leveraged buyouts were disguised as private equity. Many swaps were nothing but disguised dubious insurance products.

Now let's look at a specific historic lesson. How fast can the price of housing rise without it reaching the point where no one can afford to own a house? Well, historically the answer is simple. You start with a fair value from which, if it rises, still leaves housing affordable. Well, I say that housing long-term can only rise (on average) by inflation plus the productivity of a country. So let's assume that seven years ago housing was fairly priced. Since that time inflation plus productivity must be added. Assume 2% annual inflation for the period and 1 1/2% productivity. Housing today should then be some 27% higher than the value seven years ago! However, in that period in Canada and in the US, housing prices doubled, and at their peak stood 100% higher than in 2001. In Canada (coast to coast) the inflation and productivity figures look very similar. Thus, if 2001 represented fair value, then today's house is 36.5% overpriced. It is hard to see why on average any early 2008 lender would have even granted a mortgage at 70% of market value. This calculation is so simple that you can make your own history book. Still in Canada lenders sell mortgages at 95% of market value and grant 35 years to repay the principal. Banks are proud if they have 70% mortgages. But even more stupid are those who were ready to agree to mortgage swaps at a time when housing prices well exceeded the fair value line. The history of housing has always been the same - a long boom and a rapid bust. Western Canada, where prices went up the furthest from the trend line, has

had the worst experience in housing crashes. In Alberta, like in California, you cannot even exact a personal guaranty from a mortgage holder. So when houses return to the trend line, or even lower, why wouldn't people be expected to walk away? In the case of swaps, they would all be hit pretty much at the same time. It spelled death for the World's largest insurer - American International Group!

Why were all these crazy, new, untested products allowed so easily (unlike drugs where there is stricter control)? The answer is that the front-end fees were huge and these were what mattered for reaping high annual "profits" to feed the felons on commissions or provide the fat bonuses to the executives. Also, if your earnings would continue to rise, your options (given at no initial cost to the fortunate executive) would gain in value and so would be more valuable in the year of vesting! Where were the Boards of Directors who granted this destructive, toxic compensation? Where were the risk committees of banks, insurance companies, etc? But all of this had happened in different ways before and lead us back to greed!

What happens after the binge of seven years? Presumably a lengthy, call it whatever you want, period of fear and distress! Will it lead to tight regulation? Yes! Will we see the same that happened after 1929 - new forms of Government à la Germany, à la Italy, à la China and Russia? Hopefully not because history has seen many of these new false religions.

We enter a very difficult period. We must unwind the mess created by the new "financially engineered" derivative products, as we now know that all banks in one way or another are counterparties for most of these derivatives and swaps. The failure of Lehman was a catastrophic error on the part of the Bush administration and the Federal Reserve Bank. It set in motion a domino effect sweeping through the banking system, and for insurance companies, aggravated the effect of the bursting housing bubble. The stock market crash reduced the value of their equity holdings. Mortgages were defaulting and there is still no effective bond market anymore, except in Treasuries to which people fled in droves. Banks have little money to lend and cannot retract loans or investments fast enough and also need to avoid a run on a bank draining its equity. Only a complete government guaranty of all deposits can now stem runs on the

banks. Wachovia Bank, when rumors over its Golden State mortgage defaults spread, saw \$20 billion of cash disappear in two days, even though personal deposits were largely guaranteed, except ones over \$100,000 (now raised to \$250,000 per person per bank). Only Governments, which can print money, now can keep the banks whole. This was not fully understood, which I also find hard to believe. Banks are now increasing interest spreads to rebuild balance sheets and they must find new equity money to return to lending. But we are not finished. We have faced the derivative poison to some extent, but with a recession deepening and a population (consumers) owing some 60% more in relation to disposable income than 15 years ago, credit card and personal loan default is just starting to hit the lenders. To bring debt back to the level of 15 years ago, we will need to reverse some 6 years of almost no personal savings in North America. Many leveraged investment funds are collapsing, and with a 40% stock market crash, investor-forced mutual fund and hedge fund selling induces an ever more conservative buyer into waiting until “the freight train has stopped” to make “robbing” it easier. Bids fade while funds must sell to meet payment deadlines and so have no choice. We are going to see the lowest valuations in stocks since the depression and many leveraged businesses will fold as the consumer retrenches everything to address debt. Santayana’s dictum applies! Laconically modern communications and computerization should have made the lessons of history readily available before the horrible new lessons of what is happening today hit home. Will it change human beings as to human nature? No! Maybe now history and philosophy will be taught seriously once again! I hope so!



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