Memo to: Oaktree Clients

From: Howard Marks

Re: What Worries Me

Especially in times like these, people often ask what keeps me up at night. Well I'll tell you a few things it's not: that Oaktree will suddenly depart from its investment philosophy; that some of our accounts will trail their benchmark for a year; or that the markets will be so weak that we can't earn returns (or so strong that there aren't any bargains). And it's certainly not that I'll meet up with that bus I hear so much about.

My real worries concern the big picture and the long term. Most of them have to do with America's future and the world in which my children and grandchildren will live. In this regard, I think there's a lot to worry about. I'm not going to spend this memo discussing things as mundane as investment cycles, or as cosmic as environmental deterioration, global warming or terrorism. There's enough to talk about in terms of largely economic issues without going into areas like those. And having covered them below, I promise to go back to my day job thinking about investments.

I hope this memo will be well received. I fear some may think it's un-American or unpatriotic, but I assure you I'm neither. It'll certainly seem negative and dreary; I admit up front that I see the problems more clearly than the solutions. But I hope this memo will raise some questions in readers' minds and contribute to constructive debate.

Further, I hope it'll be of interest to Oaktree's clients outside the U.S. While you may not be exposed to these issues to the degree we are at home, (a) you may want to know what I think the U.S. is up against, and (b) at bottom, we're all in this together – all nations are intertwined. And who knows: you might be looking for farsighted help with your countries' long-term problems, just like I am.

The American Century

The truth is that it's great to live in America. Ours isn't the only wonderful country, or the only good place to live, but we've benefited from:

- 230 years of stable democratic government;
- 140 years without civil war;
- the generally peaceful co-existence of a highly heterogeneous population;
- very high levels of personal freedom and opportunity;
- a highly functioning free-market economy;
- great educational institutions;
- vast land mass and natural resources; and
- a highly productive, inventive and entrepreneurial citizenry.

No one alive today has experienced anything other than American preeminence. In fact, the twentieth century has been called "The American Century." But there's no reason why the twenty-first century necessarily will be another.

National preeminence – like most other things – is cyclical, not permanent. Given time, leading nations overextend themselves, lose their energy or squander their advantages. They get fat and happy, and they relax. Underdogs try harder and rise from a lower base. Perhaps they study the leaders and learn how to emulate them. And perhaps they begin to make better use of untapped resources and underutilized labor forces. They may even benefit as the leaders share the wealth (such as the U.S. did through the Marshall Plan after World War II). Regardless of the reasons, just as the U.S. supplanted colonial powers like England, France, Spain and Portugal that had held sway earlier, countries like China, India, Russia and Brazil now seem likely to grow faster than the U.S. in the twenty-first century, narrow the gap and enjoy their time in the sun.

In Praise of the Melting Pot

One of the greatest sources of America's growth and preeminence has been the bounty of immigration. With the exception of the Native American Indians, there was no one here 500 years ago. We're a country of immigrants. We've benefited as waves of foreigners moved to the U.S. to escape mistreatment or seek opportunity. I never forget that my grandparents weren't born here, and how far I've been able to progress nonetheless.

When I was a kid in the 1950s, a joke asked why we were ahead of the Russians in technology. The answer: our German scientists were better than theirs. **This country attracted people from all over the world, gave them unprecedented opportunity, and permitted the most talented to rise to the top. What a great recipe for success.**

But today the outlook isn't the same:

- The stick isn't as strong as it used to be: economies and living conditions in other countries have gotten better and continue to do so.
- The carrot isn't as strong, either: we're no longer the only country offering opportunity.
- The barriers to entry threaten to rise, as some Americans consider immigration one of our biggest problems. And 9/11 has made visas, including those for students, much harder to obtain.

My involvement as a university trustee has exposed me to a developing trend. It used to be that foreign students were eager to come to the U.S. to gain a higher education and then stay to pursue their fortunes. They still want to come for the education, but today many want to return to participate in economic booms in their native countries. This makes me wonder whether there'll come a day when the opportunity for a first-class U.S. education isn't as much of a draw, because other countries will have developed comparable educational institutions of their own. That day seems far off – institutions like these don't arise in an instant – but it isn't an impossibility.

Many newcomers to the U.S. have found success in engineering, where their technical skills could be put to good use and language skills may have been less critical. Now, however, we hear from Silicon Valley that engineers are harder to attract and retain because of the trends described above. I'm told that in certain fields (like aerospace), U.S. engineers are declining in number and their average age is rising.

America's preeminence depends in part on continuing to attract the world's best and brightest, but the outlook for doing so is not all it was in the past.

Standard of Living

In many ways, including materially, Americans have enjoyed a wonderful standard of living over the last hundred years. Considering creature comforts such as housing, food, sanitation, healthcare, leisure and luxuries, ours may have been the highest standard of living in the world. That raises three questions:

1. Why should we continue to enjoy the highest standard of living?
2. Why should it continue to improve?
3. And why should the rate of improvement outpace that of the rest of the world?

We often see poll results showing that increasing numbers of Americans doubt their children will live better than they do. We'd like them to, but why should they? Other than technological improvements which doubtless will continue to make life better for everyone, why should our standard of living improve monotonically? And improve relative to the rest of the world? Certainly the advantage in this regard can shift to other countries, just as it shifted to us in the past.

The World's Highest Earners

One of the reasons for our high standard of living is the fact that Americans have been paid more for doing a given job than everyone else. This was fine as long as (a) the U.S. enjoyed the benefits listed on page one, and (b) significant barriers protected the status quo. But why should this go on? How can it go on?

Think about two cities. City A has more jobs than people, and city B has more people than jobs. Initially, people in city A – where labor is relatively scarce – will be paid more for doing a given job than people in city B. **The key to their continuing to earn more is the existence of barriers that prevent people from moving to city A.** Otherwise, people will move from city B to city A until the ratio of people to jobs is the same in both cities and so are the wages. **Among other things, geographic inequalities are dependent on the immobility of resources.**

For much of the last century, barriers kept our pay high. Other countries' output wasn't as good as ours. Some lacked investment capital, and some were decimated by war from time to time. Perhaps they didn't possess our ability to generate technological advancements or our managerial skills. High transportation costs, tariffs, prejudices (when I was a kid, "Japanese transistor radio" was synonymous with "low quality") or legal restrictions (e.g., keeping foreign airlines from competing freely in our markets) may have protected American wages. International trade wasn't what it is today. But all of these things can change over time, and it's hard to see how the earnings supremacy of U.S. workers will be sustainable.

Among other things, our legacy airlines became weighted down with high-cost labor contracts and all have gone through bankruptcy to shed them. Likewise, high healthcare costs added to the cost of every car built in the U.S. to an extent that hurt our competitiveness. Thus the U.S. auto industry lost domestic market share, sent production overseas, and consists of three companies of uncertain creditworthiness.

Protectionism favors the erection of trade barriers, but it's usually resisted based on the totality of its effects. **In international trade, just as in local markets, the only real way to maintain and grow market share – and thus to protect earnings power – is to offer the best combination of price and value. Regulations and tariffs won't make us competitive in the long run, and without offering a superior bargain, the supremacy of our standard of living will not be preserved in a world of lower barriers.**

<u>What Do You Make?</u>

We're all familiar with the pattern: as communications improve and barriers and transportation costs come down, jobs move from the U.S. to China, India or some other low-cost country, spurred by producers' desire to increase profits or just remain competitive. There's even a word for it: outsourcing. As a result, with each passing year, the U.S. manufactures less of its needs and the world's.

I looked at myself on the way to work this morning. Everything I had on was made outside the U.S.: suit, shirt, tie, shoes, eyeglasses, even underwear. My car, TV and stereo are imports. So's my computer. I bought some of these things from American companies, but they were made elsewhere. (I don't think I'm unpatriotic in buying these things: I'm just pursuing high-quality goods at the best ratio of value to price.)

There's no way around it: we don't make much anymore. What does that mean? I have to admit I don't know. I'm not enough of an economist to have the answer. But I wonder a lot about how an economy can function if it doesn't make much.

Joe does Ed's legal work, and Ed keeps Joe's books. Sarah cuts Bob's hair, and Bob cooks in the restaurant where Sarah eats. Rich drives the bus that takes Sue to the bank, and Sue handles Rich's loan application. And, of course, someone like me manages investments for all of them. But how does an economy function if nobody actually makes anything – and if we have to buy all of our stuff from other countries? I'm exaggerating for impact, but you get my meaning. We make less and less each year – and we consume more.

Can an economy be successful if it consists of nothing but service providers, government workers and retailers? (Think about the unions you hear the most about in connection with the upcoming presidential election: the Service Employees International and the American Federation of State, County and Municipal Employees – no longer the Teamsters and Auto Workers.) Can a nation prosper without producing goods? I just don't know the answer.

And then there's the question of where we'll get our stuff from. Of course, we'll buy it from other countries. **But that leads to other questions: To what extent will rising inflation in cheap-labor countries raise the cost of the imports on which we depend so thoroughly? What will we sell to the rest of the world in order to get currency with which to buy their stuff? And for how long will they buy it from us?**

Certainly American goods have become less price-competitive, and other countries have learned to produce for themselves. Think about what we export. Movies? Computer software? Other countries are increasingly making their own. Financial products? Now there's an area where we're still exporting. But given the results with subprime and CDOs, might we have damaged that franchise? (Here's a piece of trivia for you: what's our biggest export by volume? This trick question hinges on the inclusion of the words "by volume," and the answer is waste paper for recycling. Certainly this doesn't indicate a manufacturing advantage on our part, or value we're adding to the global economy.)

Increasingly, we're reduced to designing products, styles, software and media content for production elsewhere. What's the long-term outlook in that regard? How long will others need us in that role? It's been said we're becoming a nation of burger flippers. An exaggeration, certainly, but how much of one? And what are the ramifications? One last thing (and don't tell my friends I said this): **What does it mean when investment bankers and money managers – who add relatively little to economic output – are among a society's highest paid members?**

Earning and Spending

When I meet with people in other countries, here's how I describe the typical American (again, exaggerating for effect): $1,000 in the bank and $10,000 owed on the credit card; makes $20,000 a year after taxes and spends $22,000. That may not be strictly accurate, and I haven't checked my facts. But I think it presents the general picture.

Many people have little if anything saved up – we often read about people being bankrupted by a bout of sick leave – and the savings rate has fallen to roughly zero.

People probably think of their pension plans, IRAs and home ownership as eliminating the need for savings. But certainly recent events have shown the holes in that approach.

U.S. consumers increase their debt continually, seemingly without ever thinking about paying off the balance or of how they might accomplish that (short of winning the lottery). It doesn't seem to trouble people when they spend more than they earn, whether through the use of credit cards or by taking out loans, including borrowing and spending the equity in their homes. In all of these regards, the American consumer doesn't seem to give any thought to how this movie will end (I last raised this in "Hindsight First, Please" in October 2005). **It's just a matter of people wanting to consume more than their income supports. Saying "I want it, but I can't afford it" seems hopelessly old-fashioned in the America of today.**

<u>Who Else?</u>

I wish only consumers acted this way. Go back three paragraphs, though, and ask whether my description of the typical American doesn't also relate equally to our government: constant deficit spending and continually increasing debt.

Our fiscal deficit and national debt aren't enormous relative to other developed nations and to our GDP. And I don't make a value judgment that it's wrong to run deficits from time to time. The traditional view of fiscal policy is that deficit spending should be used counter-cyclically, expanding it in weak times to stimulate the economy, and contracting it (perhaps paying down debt) to throw on some cold water when the economy becomes heated. **But I wonder whether constant deficits, and a national debt that always grows faster than GDP, can be right in the long run**.

Right now, the U.S. Treasury has to borrow to cover our fiscal deficit. As the debt grows, the interest bill rises – and in connection with the rescue of Fannie Mae and Freddie Mac, Congress just approved an increase in the national debt ceiling from $9.8 trillion to $10.6 trillion. Pretty soon, we may have to borrow just to pay the interest.

Might we ever pay off our debt? How? More importantly, what are its ramifications? Dependence on foreign lenders puts us in quite a box:

- To attract foreign capital, it's better to pay high interest rates. But the need to keep them high could complicate the job of stimulating our economy when it slows.
- The fact that our negative balance of payments pumps excess dollars into circulation abroad can put downward pressure on the value of the dollar.
- Weakness in the dollar can make foreigners reluctant to hold reserves in dollars, and to buy Treasury debt that will be repaid later in dollars that buy fewer goods. What happens when we pump out so many dollars – and they depreciate so much – that foreigners refuse to accept our promises of payment? How then will we fund our deficits?

This debate has gone on for years. Our politicians want to borrow so they can continue to spend more than comes in via taxes. But shouldn't we ask what amount of debt is right to leave for future generations? As the federal deficit grows relative to GDP, so will the national debt, and future generations will be saddled with an increased interest burden (even if there's never a need to repay).

Again, I'm not enough of an economist to know the answers. (And even economists disagree about the significance of national deficits and debt.) **But I wonder whether it's prudent for a country to spend more than it makes in both good times and bad**.

Affording Retirement

In college macroeconomics, I learned that Social Security was one of the important components of the "safety net" preventing a recurrence of the Depression. With help from their personal savings and the private pension system, Americans would be able to afford retirement, rather than end up on the streets in their old age.

Now I worry about the outlook for my fellow Americans in this regard. Many have little saved, as I mentioned above. According to Tom Friedman, writing in *The New York Times* on June 29, "[Since 2000,] our national savings have gone from 6 percent of gross domestic product to 1 percent . . ."

The defined benefit pension system is shrinking, especially with regard to new enrollments. Defined contribution plans and IRAs replace it somewhat, but their voluntary nature leaves big holes in the safety net. (I admire the wisdom of mandatory pension plan participation in countries like Australia, Denmark and the Netherlands; people can find it hard to save rather than spend, so it's a good idea to give them "encouragement" in that regard.)

Finally, the impending shortages in the Social Security System have been very well documented, and the best the optimists can say is "it won't be a problem anytime soon." Add in more years spent in retirement by people living longer and a declining ratio of workers paying into Social Security to retirees drawing out, and the outlook is very problematic.

Will large numbers of Americans be unable to afford retirement? Will they experience deprivation? Will they become a burden on the community and the nation? I see no easy or pleasant answers to these questions.

The Healthcare Dilemma

Healthcare is another example of a problem crying out for a solution, but the stumbling blocks are many.

- Healthcare is expensive, and the cost rises all the time, in part because costly new medicines and procedures are developed.
- Americans are living far longer, so there are more years in which sickness is high and costs are elevated. In the modern era, few people (understandably) are content to slip into decline and death without a fight.
- Remarkably in our advanced society, nutrition and health awareness seem to be going in the wrong direction, along with the level of exercise for large portions of the population. Obesity has become an epidemic, bringing with it serious health problems.
- Patients want the best care, and doctors want to provide it. How can society respond to this demand when many patients can't afford the care, or even a reasonable co-payment? I once read a *Wall Street Journal* op-ed piece on healthcare with a title something like, "If You're Paying, I'll Have Steak." That's the inevitable outcome when third parties foot much of the bill.
- It's hard to effect triage: who'll tell an 80- or 90-year-old that he shouldn't get a joint replacement or costly drug therapy? If a hospital or the insurance company wants to say "no," all hell breaks loose.
- The economics of medical care have become somewhat anti-social. Doctors face declining pay and status, and systems designed to control healthcare costs stick healthcare professionals with very distasteful administrative burdens.
- Amazingly for such a rich nation, statistics rank American healthcare low in the developed world. (I'd guess, however, that this is the result of averaging a lot of people enjoying very good treatment with the less fortunate who fare much worse than their counterparts in countries with broader government-sponsored programs.)
- One answer is some form of socialized or universal healthcare, but by nature such a system is likely to be costly, bureaucratic and/or ineffective. Other countries have national health systems, but it's hard to get appointments, and I imagine everyone gets care that's okay but not great.
- If there's a collective scheme, can the healthiest and wealthiest be forced to participate? If not, how will it function if they opt out of it, pulling away healthcare resources for "concierge" medical service and draining low-burden members from the pool of insureds?

Taken together, these points suggest possible compromises but no ideal answer. **The bottom line is that we can't afford to give the best possible medical care to every citizen. No country can, and anyone who says we can is probably running for office.** We can either (a) give moderate care to everyone or (b) retain a system under which the results are all over the map and the less fortunate get very little. Neither of those is perfect, but I think they're the choices.

<u>Growing Inequality</u>

The capitalist system produces gains because of a Darwinian process in which participants are spurred on by economic incentives and the most successful enjoy great rewards. The system runs on the ability of those who are more talented and/or work harder to do better than others. Inevitably the better life also goes to some who are undeserving and just lucky or born into wealth; that's undesirable but inescapable. But it's not good if the margin by which some do better than others is too big.

I think it was in the '70s that I came across a great explanation for America's economic success:

> When the English factory worker sees the boss drive out in his Rolls Royce, he says, "I'd like to put a bomb under that car." But when the American worker sees the boss drive out in his Cadillac, he says, "I'm going to own a car like that some day."

That's one of those little stories containing a great deal of truth. **Economic motivation and a feeling of opportunity are great positive forces, while class resentment is equally negative. We want America to remain a meritocracy where all citizens believe in their ability to get ahead.** Too much of a disparity could eat into the belief in our system.

Pay at the top has exploded relative to all else. At Citibank in the mid-1980s if my memory's correct, CEO Walter Wriston, the world's top banker, made about $250,000 a year. Twenty-five years later, the CEO of a money-center bank or large corporation makes 50 to 100 times that . . . and 400 times in a year when options pay off big. What other segment of our workforce has done as well? We're in a period of general income stagnation, when lots of Americans haven't made strides like the executive class . . . or any strides at all.

I don't expect executives to indulge in self-restraint, since people rarely do things against their own short-term interests. But I'd like to see boards take the position that huge incomes should come only with great benefits for the companies' owners. And that a single great year might not merit enormous compensation that year. Entrepreneurial rewards can be appropriate for successful executives, but they should come only for long-term success and should be at risk in the event of failure.

I believe thoroughly in the free market system, and that the worst thing imaginable would be government regulation of salaries or incomes. But I also worry about the consequences when the benefits to the fortunate few are perceived by everyone else to be unfairly disproportionate and unrelated to achievement.

In the past, in addition to the fact that incomes weren't so enormous at the top, the income gap was narrowed by the fact that people could do pretty well at the bottom. Millions of menial and blue-collar jobs were created as our economy expanded. Even without much education, people could enjoy the good things in life, including cars, TVs and vacations, along with good public school educations for their kids and the possibility that most of those kids would have better jobs than their parents. Which of those elements is equally true today?

In the "Information Age," the lack of a college degree or computer literacy is a much greater handicap than it used to be. With non-information jobs increasingly moving overseas, what jobs will our less-educated citizens occupy? You might say education holds the answer, but (a) our public education system is in decline, and (b) how, especially given these jobs' greater productivity, can there be enough tech-based jobs to keep our entire population gainfully employed?

The Energy Problem

When I began to drive in 1964, oil was $4 a barrel and gasoline was 29 cents a gallon. Then, in 1973, OPEC put an embargo on oil exports. We saw lines around the block at gas stations, and we were permitted to fill up just every other day. The price of oil jumped to $35 by 1980 or so, and then it subsided. It spent the period from 1986 to 2001 between $10 and $30 before going on to hit $92 in 2007 and $148 earlier this year.

The bottom line, however, is that from about 1880 until a few years ago, we were in an environment of cheap energy. **For over a hundred years, the price of oil didn't rise, meaning it got dramatically cheaper in inflation-adjusted terms. This encouraged exactly the behavior one would expect: rapidly growing oil consumption, lagging increases in supply, little attention to the development of alternative energy sources, insufficient investment in mass transit, and weak efforts at conservation.**

We're guilty of profligate energy consumption. Americans use SUVs or pickups capable of carrying eight people or huge payloads to do their grocery shopping. And they feel free to live 50 to 75 miles from work and to drive there alone in their behemoths. We just haven't had incentives to use energy thoughtfully.

Maybe you have your favorite example of energy waste; mine is supermarkets' removal of doors from their freezer displays. Can you imagine what future archaeologists will say about the decision to cool a whole store just to make it easier to buy some frozen food?

It's not a coincidence that with oil much more expensive, Europe uses far less energy per unit of GDP than we do. Because of high taxes, gasoline traditionally has cost 2 to 4 times as much in Europe as it has in the U.S. Today it's about $9 per gallon, and yet I don't hear Europeans complain much. That's because they drive smaller, more fuel-efficient cars, live closer to their jobs, and make major use of mass transit. They even ride bicycles to work.

The most important element in responding to the energy problem is expensive oil. Low prices have encouraged high demand and discouraged additions to supply. The opposite will be the case only if prices are high. Politicians' attempts to play to the crowd by artificially reducing the price of oil – through releases from the government's Strategic Petroleum Reserve, banning "speculation" or providing a holiday from gas taxes, as was suggested in the spring by would-be presidential candidates from both parties – will do nothing but add to demand and depress supply.

In the future, pre-industrial societies will become industrialized, and millions of newcomers to the middle class worldwide will want cars. **We need an energy policy that is constructive for the long run, encouraging us to use less oil and find more.** Everyone's squawking about gas prices and looking for culprits. **But as long as gasoline costs much less than Snapple or Evian water, resources will be misallocated and we won't see real progress.**

We also would benefit from regulations that mandate fuel efficiency, encourage alternatives and penalize high oil use (or at least don't motivate the opposite). Business use of SUVs has been abetted over the years by tax rules giving them the superior depreciation treatment accorded trucks, based on weight. No doubt this was a result of lobbying on the part of auto companies enjoying the high profitability of SUVs. Thus it's been cheaper for businesses to use a $30,000 SUV than a $30,000 car. We and our government have to make more responsible decisions.

Finally, in order to make a genuine difference, we must invest on a vast scale in mass transit, energy efficiency and non-petroleum-based energy. This will have short term consequences: some combination of higher taxes, slower growth, reduced government spending in other areas, higher deficits and/or lower consumption levels. We can't spend to solve the energy problem and simultaneously avoid all of these effects. **Does the will exist to do these things in advance of the day we have no alternative?**

Rather than tap the Strategic Petroleum Reserve (which is designated for emergencies, and high prices aren't an emergency), we could add to it. **We could say, "Let's use less than all the oil that's available – and that we can afford – so as to leave some for future generations." But that requires selflessness and farsightedness that's far from in fashion.**

<u>Who'll Own the World?</u>

In addition to the practical and geopolitical ramifications of the energy situation, we'd better consider the financial ones. When the price of oil gapped up in the 1970s, vastly increasing numbers of dollars started to move offshore in exchange for oil. The process of bringing them back came to be called "recycling petrodollars." There are both benefits and risks in this process.

Earlier this month it was reported that our trade deficit declined in June because of rising foreign purchases of our products. That's one of the positive effects of the piling up of dollars abroad, and also of the fact that our goods priced in dollars look cheap to those outside the U.S. In short, we like having buyers for the things we have to sell.

But sometimes we resent their presence. It doesn't take much for xenophobia to rear its ugly head. In the 1980s, there was fear that Japan's economic juggernaut would lead to a wholesale takeover of U.S. assets by Japanese buyers. A couple of years ago, proposed investments by China and Dubai in our oil and port industries were rebuffed, and last fall (before it was clear how desperately we needed more capital), people were grumbling about sovereign wealth funds' growing influence over our financial institutions.

Well, what do you expect to happen? If we spend more than we bring in, and thus send dollars overseas to pay our tab, isn't it reasonable to expect that some will be brought back and spent here? Clearly, the oil producers will have the ability to buy our assets. And some, like Qatar and Abu Dhabi, are far too small for the amounts involved to be invested or spent in those countries without making their inflation worse than it already is.

We're already seeing the effects. Financial institutions ran to sovereign wealth funds when they needed to add to their capital; who else is there? Room rates in hotels around the world are soaring in dollar terms. Powered by foreign buying, prices in the contemporary art market are moving out of sight, and so are high-end real estate prices in London and other cities of choice. Last month it was reported that a villa in the south of France had been sold to a Russian for $750 million: **a great outcome for the seller, but also a sign that eventually we may be priced out of our own assets.**

With dollars moving abroad and exchange rates going against us, Americans are likely to find it harder to afford the goods and the standard of living they're used to, enjoy holidays overseas, and hold on to assets rather than succumbing to bids.

The numbers involved are very substantial. On July 10, *The New York Times* wrote:

> With oil hovering near $140 a barrel, analysts expect countries in the [Persian] gulf to generate yearly cash surpluses of $300 billion . . . with sovereign funds in this area forecast to reach a size of $15 trillion by 2020.

And of course, the numbers will do nothing but increase with time. The other day I was given a shorthand way to think about the situation: for every $1 in the price of a barrel of oil at a point in time, approximately $1 trillion will move from oil consumers to oil producers over the subsequent hundred years. **Oil at $120 means the producers will reap about $120 trillion. To put this into perspective, the total value of the world's stock markets currently stands at about $47 trillion. So it's not much of an exaggeration to say the oil producers could own the world.**

You might argue that more fuel-efficient cars, electric cars, atomic cars, hydrogen power and cold fusion will alter the equation and prevent this massive shift of wealth. And we know for sure that high oil prices will reduce demand, encourage exploration and make invention and substitution economic. **But I think it's smarter to think about the issue than just count on things to work out.**

We’re From the Government and We’re Here to Help

Last month, in “Doesn’t Make Sense,” I labeled the obsession with the short term the worst thing about American business. But short-termism is far from limited to business. The process under which we’re governed is even worse.

In 2004, the *Los Angeles Times* asked me to write a review of Pete Peterson’s excellent book on the looming fiscal crisis, “Running on Empty.” One of his messages was that politicians are increasingly loath to take on the big issues of the future. Why should they? The prospects are unpleasant, and any solutions will entail pain. **What politician would trade away votes today to solve problems that are likely to come to a head long after he or she has retired?** As Peterson put it:

> . . . while our problems are not yet intractable, both political parties are increasingly incorrigible. They are not facing our problems, they are running from them. They are locked into a politics of denial, distraction, and self-indulgence that can only be overcome if readers like you take back this country from the ideologues and spin doctors of both the left and the right. . . .
>
> With faith-driven catechisms that are largely impervious to analysis or evidence, and that seem removed from any kind of serious political morality, both political parties have formed an unholy alliance – an undeclared war on the future. An undeclared war, that is, on our children. **From neither party do we hear anything about sacrificing today for a better tomorrow. In some ways, our most formidable challenge may be our leaders’ baffling indifference to our fiscal metastasis**. As former Treasury Secretary Larry Summers puts it, “The only thing we have to fear is the lack of fear itself.” (Emphasis added)

It doesn’t require higher math to see that we face serious problems in areas such as Federal deficits, the balance of payments, international competitiveness, energy, Social Security, Medicare and education. Certainly those problems won’t solve themselves. But when did you last hear of any serious debate on them?

Take the Social Security system. There are only four possibilities: (1) higher taxes, (2) lower benefits, (3) privatization, or (4) dealing with the system’s insolvency when it occurs. But the first two are unpopular, and the third is politically contentious, given that it’s inherently less egalitarian than the current system and could result in the government being on the hook as the payer of last resort. So that leaves the fourth . . . which is where we stay. **This just is not an acceptable approach to problem solving**.

Likewise, everyone knows the tax code is overly complex, indecipherable and larded with provisions benefiting special interests. It desperately needs reworking from the ground up, but no one considers that politically doable.

As *The Wall Street Journal* pointed out on June 24:

> When President Clinton tried to overhaul the health-care system, he couldn't get even a committee vote on his plan in a Congress his party controlled. When President George W. Bush tried to revamp Social Security, he couldn't get even a committee vote on his plan in a Congress his party controlled.

Washington's failure to solve the big problems really gets me going, calling to mind a great quote from Will Rogers: "The more you observe politics, the more you've got to admit that each party is worse than the other."

Condemnation of politicians needn't be universal. There actually are some I like. More than anything else, they're marked by a spirit of bipartisanship. Rather than consider politics a blood sport in which the only important goals are to embarrass the other side and win elections, they want to solve our nation's problems. I just think they're few in number, and much fewer than I recall from my youth.

I confess that I feel the deck is stacked against government getting better. Less attention paid to newspapers and TV news, declining interest in national and international affairs, the rising role of the sound bite, generally shorter attention spans, a vanishing spirit of self-sacrifice, rising me-first-ism . . . where would optimism come from in this regard? We can hope, but I'm not that hopeful. The truth is that most people vote for the candidate who looks and sounds best in TV ads, who says what they want to hear, and who they think will put money in their pocketbooks today and brighten their lives tomorrow.

Imagine two candidates for president. One says, "I'm going to give you eight years of discipline and denial – of higher taxes and lower spending – but I'll leave the country in better shape." The other says, "I have a secret plan that will solve all of our problems without requiring any sacrifice on your part." Who do you think would win?

<u>What Won't Work</u>

There are no simple solutions to these issues. But that's not going to keep simple solutions from being demanded. Two areas where we're likely to see them tried are tax progressiveness and global trade.

A lot of populist rhetoric is coming from certain candidates for office this season, and if they're elected, they might try to redress the income disparity through tax increases at the top. As usual, they'll say, "We're not out to 'soak the rich.' We're just trying to make them pay their fair share." I don't know where the populists will go for their definition of a "fair share," but I'm pretty sure it'll turn out to be just a synonym for "more."

The result would be tax increases on people who – not according to value judgments, but in sheer economic terms – are our most productive citizens. Such increases aren't the answer, and they can affect the economy negatively. Back in Britain's low days in the 1970s, the top income tax rate was in the mid-90s (as was ours when I was a boy), and I read about a banker taking a week off from work to paint his house. The calculus was simple: it was cheaper for him to give up a week of after-tax salary than to pay the painter's bill.

Taxation creates incentives: to work less, to hide income and, ultimately, to relocate income to avoid taxes. When a professional finds it economically attractive to forgo his pay to perform a physical task, the net result is a loss for the aggregate economy. **This isn't the kind of incentive we should be presenting.** What supply-siders did in the 1980s was convince lawmakers of the effect of tax decisions on the operation of the macro economy. Their lesson mustn't be forgotten.

Likewise, trade barriers sound like an easy solution but don't work.

- Operating freely, global trade causes each good to be produced where it can be done cheapest and best. In this way, aggregate efficiency is maximized, and thus so is aggregate societal welfare. Actions that interfere with efficiency and the free-market allocation of resources invariably will have a negative overall effect.
- It's highly unlikely that we can raise barriers and tariffs against others without causing them to retaliate.
- A protectionist decision is just a choice among potential beneficiaries. A ban on imports of cheap clothing, for example, would protect the incomes of Americans working in the garment and textile industries but cause all Americans to pay more for what they wear.

As the last bullet point suggests, taxes and tariffs don't add value or make society better off; they merely represent decisions about how some elements in society are to be treated via-à-vis others. However, by interfering with the free-market allocation of resources, they're highly likely to detract from the overall economy. Bottom line: handle with care.

* * *

The more I think about solving problems, the more I believe one of the crucial choices is with regard to time frame. Short-term answers are very different from long-term answers. **America's problems are long-term in nature and require long-term solutions. There are things that can help in the short term but be counterproductive in the long term, and we mustn't let them get in the way.**

Take the earlier discussion of oil prices. We know high prices discourage consumption and encourage conservation, fuel efficiency, exploration and the development of alternatives, and that low prices do the opposite. When people complain about high prices, vote-hungry politicians rush forward with short-term palliatives. **But quick fixes will do nothing but exacerbate the long-term problem, while short-term pain is probably an essential part of its solution.** In order to bring down oil prices in the long run, we need high oil prices in the short run.

Because gasoline prices were up, Americans drove 12.2 billion (or 5%) fewer miles in June than they did a year earlier. That was the eighth down month in a row. In other words, high prices made people treat energy like the finite and valuable commodity it is. High prices aren't pleasant, but eventually they could help get us to the desired result. **It's not for nothing that they say "no pain, no gain."** (And for this reason, the 20% decline in oil prices over the last six weeks shouldn't be viewed as an unmitigated boon.)

The short-term pleasure principle that seemingly governs today will make it challenging to implement disciplined and possibly painful solutions to the problems enumerated above, but they're the only way forward.

*   *   *

I hope you'll consider this memo constructive, and that it'll inform or inspire debate. The solutions to the problems I raise aren't obvious and won't come easily. But that's why these things must be tackled by skilled, apolitical problem solvers in and out of government. We need boldness, hard work and resolve from our leaders. **And we need officeholders capable of imagining outcomes worse than losing an election.** I can think of several.

We tend to lurch from crisis to crisis. In difficult times like today, we're too busy putting out fires to pay attention to long-term problems. And then, when the crises recede, people celebrate the return of prosperity and forget about the distant future and the big picture. **We'd all like to not have to face the problems I list. Indeed, we wish they didn't exist. But they do exist, and we must deal with them. And there can't be a better time than the present.**

August 28, 2008

P.s.: I always circulate my memos for comment before they're published, and this time I got a good one from Richard Masson. He's a very thoughtful guy, especially on bigger-picture matters – a bit of a libertarian, but also impossible to pigeonhole. I want you to have the benefit of his response:

> The best thing about our country is the resourcefulness of our citizenry and the flexibility of our institutions and laws. Creative destruction and a functioning market economy assure change toward the best solution over time. I generally agree with all your observations and concerns, but I have faith in our ability to create (rather than impose or legislate) solutions over time. Perhaps America will enjoy a manufacturing renaissance, or the cost of oil will force communities back together and facilitate greater interdependence between neighbors? Perhaps a slowing economy will slow immigration and create job opportunities for our less educated citizens (and youngsters). Perhaps our best and brightest will gravitate toward engineering and science rather than finance. In many ways, the next generation could enjoy a higher quality of life even at a measurably lower standard of living.

I'd love it if Richard turned out to be right.