

## E-Memo

**TO:** INVESTORS/MEMBERS/PARTNERS AND FRIENDS  
**FROM:** Jon Bruss and James Bruss  
**DATE:** May 26, 2009  
**SUBJECT:** Can We Grow Again?

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As we look at our bank investments, public and private, we find many are hunkered down, focused on extricating themselves from the real estate crisis. Providing additional headwinds are the steepest recession in 70 years and the prospect of suffocating government deficits. The thought has occurred to us (and to you, we are sure): "Can we get out of this mess?" We have focused our bank investments around a theme of growth—above average market growth and organic growth opportunities created by consolidating markets. Such growth and the attendant opportunities will only happen if we succeed in pulling ourselves out of the mess.

The financial center of the U.S. and the world has shifted from New York City to Washington, D.C. That's not a good thing. The reason for this shift is the mistaken belief in what Thomas G. Donlan, in yesterday's *Barron's*, called the "one misdeed at the root of the mess." If only we would repent of this one misdeed, he muses, we "will restore the prosperity we enjoyed so much so recently."

But we all know the mess we find ourselves in was created by a multitude of sins, many of which we've examined in this forum over the past six months. Moreover, to cover this multitude we've committed much worse sins, some of which attack the very liberties and rule of law that form the basis of our country and strike at the confidence in economic stability that is necessary for long term growth.

We borrowed from the future and, as Donlan points out, the only way to pay this back is with growth. And as we think about growth, we think we are, in the words of Paul Simon, "Slip Slidin' Away". But how can that be, we ask? According to Donlan, the U. S. economy grew at an average of 1.8% per annum in the 39 years from 1973 to 2001 meaning that we'll double our income in 39 years. Thirty-nine years! It's like we are running in place, going nowhere fast.

So how do we grow? What is the solution? More government intervention into our lives? History shows that less government in our lives works best.

Donlan believes the "American economic policy should be to wait and see." In short, don't pretend the stimulus package is a solution to anything (except, of course, the problem of getting re-elected). Instead, government policy should encourage long term investment. Lowering taxes (income, capital gains, etc.) and exiting the marketplace, the government can actually provide incentives to producers of wealth.

The consequences of government meddling, it's no surprise, adversely effect all of us, including banks. Some would argue banks got us into to this mess with risky credit—the "one misdeed for which we need to repent", perhaps. Regular readers of these pages understand that banks are only partly to blame. The guilt resides, in large part, with the shadow banking system, a system that allowed Wall Street to dump billions and billions of dollars of financial assets into structured financial products and encourage the growth of debt throughout the economy. These assets were often created just to fill these structures and sate Wall Street's fee-driven culture. This system is now a mere shadow (forgive the pun) of its former self, and it will be a cold day in hell before it is reborn in the form that triggered the Bear Stearns and Lehman Brothers failures, the government takeover of AIG, and the *de facto* nationalization of the behemoth banks like Citigroup.

The media, the government and many in academia are agog at the quick success of the administration's stimulus plan. Few, if any, acknowledge the impact of last fall's monetary easing which, by all accounts takes at least six months or more to gain traction. If what we are seeing are indeed green shoots then we must acknowledge the source—the monetary easing of late 2008.

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The very government taking premature credit for the impact of the stimulus is about to take *away* from small businesses—including small banks—the fuel both need to restart their engines: capital. Small business has always been the engine of economic growth and employment in this country. But today it is stuck in neutral, caught in the risk aversion hysteria that began last fall with the failure of Lehman Brothers. Now, six months later, we find ourselves in mid-spring, looking for green shoots (grasping at green shoots is more like it). As the government removes capital from the economy with punitive incomes taxes, higher capital gains taxes will remove the very incentives needed to kick start growth beyond a paltry 1.8%. (Any protestation that taxes will not increase falls on deaf ears. There is simply no way around it given the extravagant fiscal obligations our government is now agreeing to.)

The other threat to capital is crowding out: funding our trillion dollar deficits will also steal deposits from banks (as investors seek out the increasing rates on Treasuries) and loan capacity dries up for small companies that rely on banks for funding. We may not be able to rely upon China and the petro-nations to buy our debt. Some ask where else can they put their dollars to work? With the prospect of inflation right around the corner, owning U.S. debt tied by a declining dollar is a non-starter for China and others. Recently, the Chinese were even kind enough to tell us so.

This is a mess and it will not be cleaned up by the government-centric solutions now being offered. Pro-growth solutions make far more sense:

- Enforce existing banking regulations related to safety and soundness rather than creating a new regulatory regime for banks.
- Create legislation forcing the FDIC to better manage insurance premiums, setting aside funds from good years to fund the bad years.
- Allow banks to build loan loss reserves to levels deemed prudent by bank management (and their regulators) to better survive periods of time such as this recession by getting the SEC and FASB off their backs.
- Enforce SEC regulations intended to limit the leverage of brokerage firms.
- Regulate the derivatives and structured finance sector.
- Eliminate mark-to-market accounting.
- Cut corporate tax rates to encourage investment.
- Eliminate taxation on capital gains to encourage investment in small business.

This nation needs to grow at a rate far faster than the 1.8% per annum of the period 1973 to 2001. According to Donlan, China has been growing at roughly 10% per year. That's doubling every 7-1/2 years. As incredible as it may seem, the adoption by the Chinese of certain elements of capitalism has lifted more people out of poverty than all of the foreign aid since World War II, Donlan says. If we were growing like that we'd be able to pay off all of our foreign creditors AND fund both Social Security and Medicare.

We agree that we have a mess of historic proportions. Donlan observes that it will take an unexpected technological advance of historic proportions—such as the steam engine, the telephone, the electric light bulb, or the computer revolution—to make this happen. As a nation we have been at the forefront of all of these advances. Many of these breakthroughs were created in a time when we had no federal taxation of any kind. These inventor-entrepreneurs Fulton and Edison enjoyed the fruits of their inventions (and the losses) without the intervention of government stimulus or subsidy.

These technological advances were created when banking was not dominated by a handful of huge banks designated by the government as "too big to fail". Small businesses drive innovation and invention; small banks are the best lenders when it comes to small businesses. To produce the kind of catalytic technological advance that Donlan talks about, we need a diverse and strong banking system that includes small banks. Our banking system, flawed as it may be, works best when its shareholders and

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management operate with enlightened self-interest, financing businesses in the communities and markets they serve. Banks operate most efficiently when government regulation is evenly and judiciously applied to achieve optimal economic growth. And they function best in a growth environment where they can capitalize on the growth and innovation without taking extraordinary risk. Just as banks provide the fuel for growth, they thrive in markets that are themselves growing.

We can grow again and, perhaps at a rate far in excess of 1.8%. Such growth can substantially improve the conditions for all participants in the economy, but it can only be accomplished with minimal government interference and tax rates on capital formation that are competitive throughout the world.

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