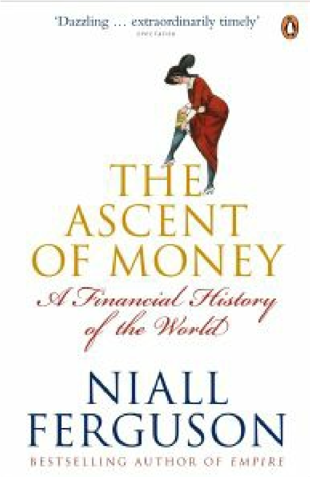

Book The Ascent of Money

A Financial History of the World

Niall Ferguson
Penguin Books, 2009
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Recommendation

Niall Ferguson offers a comprehensive collection of anecdotes and observations about the development of finance. He begins with a brief discussion of pre-money societies. Then, he carries you through the birth of banking in Renaissance Italy, the 18th-century Mississippi and South Sea bubbles, the role of Nathan Mayer Rothschild in the Napoleonic Wars, and the 20th-century transition from the gold standard to free-market derivatives and currency trading. *BooksInShort* finds Ferguson's book eminently readable, entertaining and informative. One caveat: the author's approach is more that of a journalist than a historian, so he does not advance much of a comprehensive theory to explain the events he discusses, even the ones that are still occurring, notably, the financial crisis that began in 2008. This tasty financial history thoroughly covers who, what, when, where and how, a feast of facts with not quite enough "why" for dessert.

Take-Aways

- Modern credit markets were born in Renaissance-era Italy.
- Loan sharks and debt slavery flourish in the absence of banks or credit markets.
- • Today, the bond market is a powerful force; it reflects the judgment of every government's fiscal and monetary policies.
- Financial markets inevitably have ups and downs – at best, hope that they will be gentle and gradual.
- The welfare state insures against many of life's risks, but at a steep social cost.
- The quantitative finance experts who led Long-Term Capital Management understood the neat implications of theory, but could not cope with untidy realities.
- U.S. government support of home ownership helped create the savings and loan crisis in the 1980s and the subprime mortgage crisis in the early 2000s.
- Before the subprime mortgage crisis, China and America were locked in a strange embrace, with the penurious Chinese lending to the affluent Americans.
- Human behavior is often irrational. That can make rational analysis dangerous.
- Finance is an evolutionary arena where creative destruction does useful work.

Summary

The Mountain of Money

Idealists beginning with Karl Marx have excoriated money and the "cash nexus" that they believe threatens human relationships. However, the only societies that existed without money were singularly ill-equipped to survive. Hunter-gatherer cultures lacked money and had remarkably high rates of violent deaths. The Inca Empire had no money, but Francisco Pizarro – who was very interested in money – conquered it almost single-handedly. In Bolivia, he and his men discovered a mountain of silver ore they called *Cerro Rico* ("rich hill"). They sent tens of thousands of tons of silver back to Spain, which discovered something new and strange: All this money did not make it rich. The increase in the money supply merely led to increased prices. In some ways, Spain's silver impoverished it by preventing the development of the viable industries and democratic governmental structures that could have helped it fit a changing world.

The Birth of Banking

Meanwhile, in Italy, the Medici played midwife to the distinctly modern institution of banking. There, as elsewhere, people who needed credit had to use high-interest loan sharks who encouraged repayment by cultivating a reputation for violent retaliation. The Medici were gangsters, too, but Giovanni di Bicci de' Medici set them on the road to grandeur. An astute currency trader, he recognized the benefits of using diversification to lower risk, and helped make the family business a hub of financial and political power.

> "When we withdraw banknotes from automated telling machines, or invest portions of our monthly salaries in stocks and bonds, or insure our cars...we are entering into transactions with many historical antecedents."

Using the Italian model, northern Europeans kept developing new financial institutions. The Amsterdam Exchange Bank was established in 1609 to provide a standard unit of denomination and a system of money transfers. In 1656, Sweden's Riksbank pioneered credit creation, lending most of its depositors' funds out and retaining only a small reserve against withdrawals. The Bank of England, established in 1694, eventually monopolized the issuance of bank notes.

The Bond Markets

President Bill Clinton's campaign manager, James Carville, famously quipped, "I used to think if there was reincarnation, I wanted to come back as the president or the pope or a .400 baseball hitter. But now I want to come back as the bond market. You can intimidate everybody."

> "Though the line of financial history has a saw-tooth quality, its trajectory is unquestionably upwards."

The bond market is like a daily poll in which investors and traders express how they think their nation's politicians are doing. They display a negative opinion by sending bond prices down, raising the country's borrowing costs. In extreme circumstances, politicians may have to choose between refusing to pay (thus losing access to future bond market funds), or funding the payment by cutting services and increasing taxes (thus angering voters). Like banking, the bond market has its roots in Renaissance Italy. Florence fought other city-states using money lent by its citizens, who could buy and sell "bonds" that gave them a right to repayment. Like banking, the bond market was an innovation taken up by the Dutch and the English. This innovation helped credit-worthy Holland free itself from rule by Spain, which was notorious for defaulting on debt.

> "Far from making money from Wellington's victory, the Rothschilds were very nearly ruined by it."

Finance was a critical source of British strength in the war against Napoleon Bonaparte. Nathan Mayer Rothschild was a bond market genius but, contrary to legend, Waterloo did not help him. Expecting a long war, he accumulated gold reserves, but the victory at Waterloo meant a likely drop in gold. Knowing that, Rothschild started buying British bonds, and continued until 1817, for extraordinary return. Later, during the U.S. Civil War, his family refused to back the South. The resulting financial constraints helped crush the Confederacy.

> "Only when borrowers have access to efficient credit networks can they escape from the clutches of loan sharks."

In the early 20th century, the bond market was a potent global force, and imperial powers were diligent about debt repayment. Rentiers, those who earned interest from government bonds, prospered. However, after World War I, extreme inflation eroded the value of their income stream. John Maynard Keynes once maintained that, to stimulate employment, society should institute inflationary monetary policies even at the cost of "euthanasia of the rentiers." The 20th century's subsequent history, including Argentina's disastrous inflation and financial collapse, put this proposition in a harsh light.

Big Bubbles

Almost since the development of markets, bubbles have appeared and gone through five stages:

1. **"Displacement"** – Something in the economy changes and new opportunities appear.
2. **"Euphoria"** – Prices move up rapidly. Traders buy to get future increases, which occur because of the extra buying. The results confirm predicted price increases, leading to further buying in anticipation of more price increases, and so on.
3. **"Mania"** – Naïve investors hear they can make big money and throw in new cash.
4. **"Distress"** – Savvy investors recognize that prices are too high to be sustainable, and start selling for profit while they can. Prices begin to fall.
5. **"Revulsion"** – The bubble pops. People sell; the euphoria sequence plays in reverse.

> "From a politician's point of view, the bond market is powerful partly because it passes a daily judgment on the credibility of every government's fiscal and monetary policies."

The most notorious bubble in western European history may well have been the Mississippi bubble engineered by gambler and felon John Law. A Scotsman, he managed to become the most important force in the French economy in the early 18th century. Inspired by the example of the Dutch East India Company and its relationship with the Amsterdam Exchange Bank, Law worked to establish a French central bank and a *Compagnie d'Occident*, or Company of the West. Frenchmen and foreigners could buy shares in exchange for their French debt (issued to fund the Sun King's wars). France's public debt thus became stock in a private firm. Meanwhile, the central bank expanded the money supply. Prices of Company of the West stock soared. All the phases of the bubble played out.

> "In effect, stock markets hold hourly referendums on the companies whose shares are traded there."

Note the instructive parallels between Law's bubble, and the bubble and collapse at the end of the 20th century in the U.S. In both cases, money supply expansion helped drive euphoria. The road through revulsion was rocky and painful. One great lesson of both bubbles is that central bankers' commitment to sound money can do a lot to prevent bubbles and crashes.

Risk Management

Hurricane Katrina's devastation of New Orleans in 2005 put insurers in the crosshairs of the "King of Torts," Richard F. Scruggs. He challenged insurers' claims that many policyholders in New Orleans and Mississippi were not entitled to loss compensation, because floodwater – not wind, which insurance covered – caused their losses. Scruggs seemed likely to prevail until he was indicted for trying to bribe a judge.

> "Longer life is good news for individuals, but it is bad news for the welfare state and the politicians who have to persuade voters to reform it."

The insurance industry originated in Scotland in the 18th century, when Robert Wallace, Alexander Webster and Colin Maclaurin established a fund for the widows and orphans of clergy. To compute the annual premium, they calculated the death rate of clergymen and the average number of survivors. The fund invested the premiums to buy annuities for the bereft. Insurance let people protect themselves against big losses by accepting small losses in the form of annual premiums. In the 20th century, national governments attempted to shoulder the burden of protecting the elderly against illness and other risks. Eventually, the burden became too great. Now, many nations face the dire prospect of an aging population with greater claims for pensions than their systems can satisfy. State insurance also carries perverse incentives; that is, it discourages personal responsibility and initiative.

Real Estate Investment

Real estate has an undeserved reputation as a safe, sound long-term investment. In the U.S. and the U.K., home ownership is more the rule than the exception. This was not the historical norm. Until the 19th century, most of Britain's land belonged to aristocrats, who borrowed heavily, using their estates as collateral, and eventually lost their properties to creditors. In the 20th century, widespread home ownership remained rare in the U.K. and the U.S. until the Great Depression. The New Deal's reforms included a program to expand access to mortgage financing. The Federal Housing Administration set up standardized mortgages and let a secondary market emerge. The Federal National Mortgage Association (Fannie Mae) issued securities to pay for bond purchases. Instead of a national program of public housing, the U.S. embarked on a program of owner-occupied housing, but it was inconsistent and incoherent.

> "The Nobel Prize winners had known plenty of mathematics, but not enough history. They had understood the beautiful theory of Planet Finance, but overlooked the messy past of Planet Earth."

To deal with 1970s inflation levels, monetary authorities raised interest rates, leading indirectly to the savings and loan (S&L) crisis. Higher interest rates had put S&Ls in a squeeze. Regulations required them to pay relatively low interest rates on deposits. Their long-term mortgages also returned relatively low interest rates. When depositors could get better interest elsewhere, they withdrew their S&L deposits. To help S&Ls compete, regulators lifted restrictions so they could invest in higher-returning instruments than fixed-rate mortgages. Scam artists moved in. They could easily attract depositors' money because the government guaranteed S&L deposits. They could make risky investments, keep the profits if they did well and leave the losses to taxpayers. The higher-returning investments that attracted S&Ls included junk bonds, which were based on the logic of diversification. The idea was that while investing in a single questionable bond might be unsafe, a portfolio of such bonds might provide an attractive overall risk-adjusted return.

> "Every shock to the financial system must result in casualties."

Meanwhile, on Wall Street, traders discovered that they could assemble large pools of mortgages and issue various types of securities against those pools. For example, some investors could buy the rights to the interest portion of a mortgage payment, others to the principal payment. New financial engineering permitted increasingly complex, securitized mortgages. With federal regulators' encouragement, bankers made loans – the famous subprime mortgages – to people who would never before have qualified. Wall Street securitized and sold the subprime papers. Combined with expansive monetary policy and the early 21st-century real estate bubble, securitized subprime mortgages helped bring about a global financial crisis.

> "Financial history is essentially the result of institutional mutation and natural selection."

Hedge funds were important actors in that crisis. Managing vast pools of capital with little oversight, hedge funds offered extremely generous, even insanely generous, compensation to their managers, who amplified the power of the capital invested with them by borrowing heavily. Some managers became famous or notorious. George Soros, founder of the Quantum Fund, made a highly leveraged bet against the British pound, winning head-to-head against the Bank of England. John Meriwether and his Long-Term Capital Management hedge fund colleagues nearly precipitated a global financial crisis when their highly leveraged quantitative bets went wrong.

"Chimerica"

Globalization advanced in the years prior to World War I. The trade and financial links among countries were so strong many experts thought war was economically impossible. WWI disproved that. The world did not achieve comparable integration until the late 20th century.

> "All financial institutions are at the mercy of our innate inclination to veer from euphoria to despondency; our recurrent inability to protect ourselves against 'tail risk'; our perennial failure to learn from history."

The emergence of China's market economy is one of recent history's most momentous developments. Paradoxically, credit extended by the impoverished Chinese let Americans purchase vast quantities of Chinese goods. This kept Chinese factories humming, let U.S. monetary authorities keep interest rates low and allowed U.S. companies sourcing in China to report high profits. The subprime mortgage crisis, among other things, threw that tidy arrangement into disarray. Thus, one lesson of the early 21st century is that globalization is fragile, no matter how far advanced it seems. Theoretically, the current relationship between China and America parallels the relationship between Britain and Germany in the early 20th century.

> "Financial markets are like the mirror of mankind…It is not the fault of the mirror if it reflects our blemishes as clearly as our beauty."

The ascent of money has been a long evolutionary process, neither predictable nor rational. Human behavior and psychology are surprising. Financial practices and institutions mutate in response to the surprises, regulators introduce new environments that favor even newer mutations and so the process continues.

About the Author

Niall Ferguson is Laurence A. Tisch professor of history at Harvard University, senior research fellow of Jesus College, Oxford University, and a senior fellow of the Hoover Institution, Stanford University. His books include *Paper and Iron, The House of Rothschild, The Pity of War, The Cash Nexus, Empire, Colossus* and *The War of the World.*