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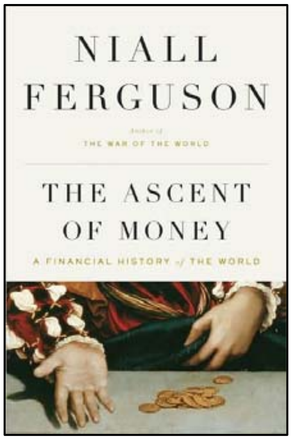


# The Ascent of Money:
**A Financial History of the World**

Author: Niall Ferguson
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**About The Author**:
Niall Ferguson is one of Britain's most renowned historians. He teaches history at both Harvard and Oxford. He is also the author of numerous bestsellers including *The War of the World*. In addition, Ferguson has brought economics and history to a wider audience through several highly-popular TV documentary series and also through his frequent newspaper and magazine articles.

**General Overview**:
Bread, cash, dough, loot: Call it what you like, it matters. To Christians, love of it is the root of all evil. To generals, it's the sinews of war. To revolutionaries, it's the chains of labor. But in *The Ascent of Money*, Niall Ferguson shows that finance is in fact the foundation of human progress. What's more, he reveals financial history as the essential backstory behind all history. The evolution of credit and debt, in his view, was as important as any technological innovation in the rise of civilization.

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## Introduction

Christians have identified the love of money as the root of all evil. Socialists and revolutionaries identify money as a form of oppression. And military men see money as the sinews of war. Money has taken many forms – shells, clay tablets, metallic coins, paper, and now bytes of information on a computer screen – but money has always mattered. Indeed, the world of finance is the foundation of human progress.

The emergence of credit and debt is as important to the rise of civilization as any technological innovation. To put it simply, financial innovations go hand in hand with human progress and finance pertains to all areas of human endeavor, especially war.

The origins of the French Revolution can be traced back to a stock market bubble. The bond market proved to be a decisive factor in the outcome of the Civil War. And the rise and fall of civilizations are inextricably entwined with sound and unsound economic practices.

Finance has proven to be an engine of human progress. Complex financial systems have made collective endeavors possible – such as the joint stock company – allowing individuals to pool their resources and achieve unprecedented goals. However, the same impulses that engender prosperity also figure in financial busts. Human beings are driven by fear and greed. These emotions are behind the bubbles and busts that have always been part of our history.

"Financial markets are like the mirror of mankind." Understanding the ascent of money and the role it plays in our lives helps us understand ourselves, our values, and the world around us. We cannot abolish money. Demonizing our financial systems will not help us solve our problems. Rather, we need to examine our financial markets closely so that we can begin to see and understand ourselves more clearly. It would be foolish to blame a mirror because it reflects our blemishes as well as our beauty. We should take the same approach towards our own financial systems, which have always magnified our imperfections and our strengths.

## Dreams of Avarice

Socialists, anarchists, and revolutionaries have frequently tried to imagine a world without money. However, few complex societies have managed to function without money. Anthropologists *have* discovered remote hunter-gatherer tribes that eke out an existence without forms of monetary exchange, but their lives are invariably wretched.

Money is a medium of exchange, which is vastly more efficient than barter. Because money acts as a storehouse for value, it facilitates economic transactions over time and distance. For centuries, durable material, particularly metals, have been used as money. In fact, by Roman times the value of metal coins depended on the scarcity of the raw material used – i.e., gold being the most valuable, followed by silver and bronze.

During the Middle Ages, the Islamic world eclipsed Europe. Because money was in demand in commercial centers, it tended to drain away from backward Europe and towards the Islamic Empire. The Crusades were as much about plundering precious metals as converting Muslims to Christianity.

By the time New World was discovered, the Spanish "piece of eight" had become the world's first global currency. Of course, crusading, plundering, and conquering far-off lands proved to be an expensive proposition. Paradoxically, Spain's wars of conquest yielded such an abundance of precious metals that their value declined. The Spaniards failed to appreciate a fundamental truth about money: "Money is worth only what someone else is willing to give you for it."

Today's money, of course, consists of promissory notes made out of paper, a material which is basically worthless. Virtual money – the electronic money we transfer place to place via computer – takes paper money a step further. That is, virtual money is intangible to the point of abstraction. From this, it follows that money is not any particular underlying substrate. Rather, "money is a matter of belief…it is trust inscribed."

The word "credit" is derived from the Latin *credo*, which means "I believe." In fact, sophisticated lending systems can be traced as far back as ancient Babylon (1750 BC). The idea of credit as we know it today was not invented in ancient Mesopotamia, however, but in Northern Italy.

Shakespeare's *The Merchant of Venice* depicts a fictional moneylender named Shylock, but the play itself accurately depicts some aspects of economic life in 14$^{th}$ century Venice. These lessons still apply to money lending in general:

1) Lenders charge exorbitant interest rates when credit markets are in their infancy.
2) Law courts are essential to resolving financial disputes that might otherwise lead to violence.
3) Creditors who are part of an ethnic minority are vulnerable to a backlash from angry or aggressive borrowers who belong to an ethnic majority.

*The Merchant of Venice* vividly highlights a perennial economic fact: creditors are rarely popular and are frequently loathed. In the case of the loan shark, of course, it is the creditor that instills fear in the borrower. To some extent, this has been a matter of necessity for loan sharks; if they weren't feared, they raised the chances of not getting paid pack. In general, creditors have dealt with their vulnerability to default "by growing big – and growing powerful."

The Medici family of Renaissance Italy illustrates creditors who managed to extend their financial and political power. Early on, there may have been an element of gangster-ism to the Medici clan, but the family emerged as the most successful and legitimate financiers of their time. The Medici found shrewd ways to make a profit on a variety of transactions, particularly bills of exchange, which allowed parties to conduct business before cash changed hands. At this time, the Catholic Church prohibited usury (the charging of interest). However, the Medici found clever ways to make profits on such transactions. The Medici did not invent the methods they used, but they employed such a variety of them, and on such a scale, that they transformed the practice of finance. In sum, the Medici imparted a lesson that still applies today: "in finance small is seldom beautiful."

The banking methods developed by the Medici in Italy would soon be adopted throughout Europe. Spain, however, would prove a notable exception (because Spain put all its stock in precious metals, it never developed a sophisticated banking system). In fact, "the idea that money was really about credit, not metal, never quite caught on in Madrid." Perhaps this explains why the Spanish Crown defaulted on its debt so frequently. In the modern world, political and economic power would accrue with creditors.

The financial revolution came before the industrial revolution, but that does not imply a simple or direct cause and effect. However, the emergence of savings banks in England during the 19th century would prove pivotal in transforming the economic landscape. Put simply, the British banking system accomplished two things of note: 1) it made usury laws obsolete, and 2) it completely expanded the scale of lending in so far as banks increasingly functioned to attract capital from depositors and that money could then be lent out at a profit to borrowers.

The British banking system became something of a model for most other advanced economies. In a nutshell, the British system consisted of a central bank, which had a monopoly on printing currency pegged to the price of gold, as well as a limited number of banks that took deposits and made loans.

The financial system in the United States evolved quite differently, however. For example, America's legislators resisted the creation of a central bank until 1913. Further, the difficulties associated with banking across state lines contributed to a plethora of small and undercapitalized banks. As a result, financial panics and bank runs have been quite common throughout American history.

"The evolution of banking was thus the essential first step in the ascent of money." Credit and debt have proven absolutely essential to creating prosperity. In fact, poverty is seldom caused by greedy financiers, but rather by a lack of banks and other credible financial institutions. Only when borrowers can tap legitimate credit networks can they escape the clutches of loan sharks that are ubiquitous in less developed economic systems. In sum, reliable financial institutions help insure that money will be channeled to productive purposes.

### Of Human Bondage

Bill Clinton's campaign manager, James Carville, once joked he'd like to be reincarnated as the bond market (because the bond market intimidated everybody). In fact, "after the creation of credit by banks, the birth of the bond market was the second great revolution in the ascent of money." Bonds, of course, are IOUs that governments and corporations use to borrow money from a wide range of individuals and institutions.

In essence, newly issued bonds are sold to the public and institutions at a specific price. Typically, a bond promises to pay a fixed interest rate for a set duration. After the bond reaches maturity, the bondholder's principle is returned. For example, a bond investor might buy a 10-year U.S. Treasury bond with a face value of $100 and a coupon rate of 3%. This instrument would pay the investor 3% for ten years, after which time the investor would also get his or her original $100 back.

Bondholders have the right to sell their bonds on the open market. The price of bonds can vary depending on the market's judgment regarding the soundness of the instrument. That is, bonds issued by a government likely to default on their obligations will move down in price, which will push up their interest rate. The converse is also true – bonds selling for more than their original face value will see their yields go down.

Today's bond markets are so huge that they set long-term interest rates overall. Not surprisingly, when bond prices plummet, interest rates soar, which hurts all borrowers. Put simply, the bond market is enormously powerful because it can pass collective judgment on a government's credibility and financial policies. No government wants to incur the wrath of the bond market, which would entail higher interest rates.

The Greek philosopher Heraclitus insisted, "War is the father of all things," and there is little doubt that war is the origin of the bond market. After all, history has shown that war is only possible if you can finance it. In fact, financing war through government debt is another invention that can be traced to the Italian Renaissance.

Bond markets have helped decide major conflicts such as the Napoleonic Wars and the American Civil War. This is hardly surprising, since war is not just a battle between armies, but also a contest between competing financial systems. For instance, it was the Confederacy's inability to finance its armies that ultimately undermined the South. The South hoped to raise cash by selling bonds in Europe, but investors generally shunned Confederate bonds because the South was viewed as a bad credit risk. In a desperate attempt to continue the war effort, the South did what most irresponsible governments do in a crisis, they printed more money. The predictable consequence was hyperinflation.

The economist Georges Maynard Keynes identified inflation as a further vulnerability creditors faced. More specifically, Keynes spoke of the "euthanasia of the *rentier*," the notion that inflation would devour the paper wealth of bondholders. However, over the last three decades, inflation has been tamed in most parts of the world.

**Blowing Bubbles**

The joint-stock company was the next step in the ascent of money. The corporation, of course, is an entity that allows multiple parties to pool their resources in the pursuit of long-term and sometimes risky ventures.

Originally, those that operated the company were supposed to be held accountable by the owners – i.e., the shareholders. In practice, however, it is the stock market itself – the arena where small slices of companies are sold as shares – that exerts discipline on businesses. "In effect, stock markets hold hourly referendums on the companies whose shares are traded there: on the quality of their management, on the appeal of their products, on the prospects of their principal markets."

Stocks have traded for roughly 400 years. Since that time, many cycles of booms and busts have occurred. Frequently, unscrupulous insiders and traders have taken advantage of credulous investors. The pattern behind financial bubbles has proven so durable that it can easily be broken down into five stages:

1) Displacement – A new economic era seems to be at hand, which offers unprecedented opportunities for profit.
2) Euphoria – A feedback process develops where expected higher profits lead to rapid increases in share prices.
3) Mania – The prospect of easy profits attracts swindlers and gullible investors.
4) Distress – Insiders and experts realize profit expectation cannot possibly be met and they begin unloading shares.
5) Revulsion – Everyone stampedes for the exit as share prices plunge and the bubble bursts.

There are some other important features of financial bubbles worth mentioning. First, insiders always have asymmetric information, which they can exploit. Second, bubbles occur more frequently when capital flows are unfettered. And thirdly, "without easy credit creation a true bubble cannot occur."

The joint-stock company and stock market are amazing innovations. However, there have always been swindlers, fraudulent companies, and irrational markets. A Scottish con artist by the name of John Law, for example, engineered a spectacular financial scheme that brought economic ruin to 18$^{th}$ century France, ultimately setting the stage for the French Revolution. And in the 21$^{st}$ century, the implosion of Enron sent shivers through America's financial world. In the case of both Law and Enron, cooked books and market manipulation created phantom profits out of thin air, which enriched the architects of the fraud, but ended up costing ordinary investors, employees, and the public.

Neither Law nor the executives at Enron could have inflated their stock prices to the extent they did without the existence of easy credit. Central bankers invariably share responsibility for creating financial bubbles. Of course, overly-tight monetary policies run the risk of exacerbating recessions. In short, "the path of financial markets can never be as smooth as we like."

### The Return of Risk

The world is unpredictable and dangerous. Humans have a natural impulse to prepare for the future, but even the best laid plans can go awry. Risk management is the attempt to hedge bets and cover, or at least mitigate, losses when disaster strikes.

Insurance is another great innovation in the ascent of money. Embryonic forms of insurance date from the beginnings of the 14th century in Italy. However, it was not until the second half of the century that insurance policies in the modern sense emerged. In essence, these early forms of insurance were contracts whereby merchants (i.e., the insurers) agreed to assume the risks "of God, of the sea, of men of war, of fire," etc, in exchange for a premium (usually 15% to 20%).

The Great Fire of London in the 17th century focused much attention on risk and insurance. Underwriters sprung up soon thereafter offering fire, life, and other forms of insurance on a pay as you go method. A remarkable series of intellectual breakthroughs involving theories of probability would transform the insurance industry. Increasingly accurate actuary information and statistical data would allow insurers to turn the calculation of risk into a science. A further innovation occurred when insurance firms invested their accumulated capital (collected from premiums) into the stock and bond markets.

Hedge funds and derivatives are the most esoteric and complex forms of financial insurance. Warren Buffet has called derivatives "financial weapons of mass destruction," but others believe these instruments help protect the world's economic system. In any event, some of the richest companies can afford to hedge against unforeseen disasters, such as hurricanes or terrorist attacks. Most Americans, however, cannot afford exotic hedges. Nevertheless, in recent times Americans have used their homes as a hedge of sorts. "As an insurance policy or a pension plan, however, this strategy has one very obvious flaw. It represents a one-way, totally unhedged bet on one market: the property market."

### Safe as Houses

Owning a home is a universal aspiration, but this aspiration is particularly pronounced in the English-speaking world. Not surprisingly, creditors prefer lending money to homeowners. After all, a borrower may default on his or her debts, but when this happens, the house can be repossessed. Concomitantly, entrepreneurs frequently leverage the equity in their homes to start new business ventures.

Homeownership is also the basis of a bold political experiment: "the creation of the world's first true property-owning democracies." However, the recent housing bubble (2000 to 2007) has raised the question: is real estate a house of cards?

When it comes to property, however, the security rests with the lender, not the borrower. The real security for homeowners and borrowers lies in having a steady income. Nevertheless, since the New Deal, homeownership has been viewed as a route to financial freedom and prosperity. To this end, the U.S. government has effectively subsidized the housing market through the popular mortgage deduction, and also through institutions like Freddie Mac and Fannie Mae. From the 1930s on, homeownership rates soared, but so has mortgage debt.

New Deal interventions helped stabilize mortgage markets during the Great Depression. The government also introduced federal deposit insurance to prevent bank runs. This program has largely succeeded. However, the mixture of federal deposit insurance and Reagan era deregulation of the banking industry helped fuel the Savings & Loan crisis that cost taxpayers billions in the 1980s. At this time, many S&L executives had used their insider status to loot their own banks, thus leaving taxpayers to foot the bill. To paraphrase one observer, the easiest way to rob a bank is to own one.

Our current decade has represented a new era in finance. The process of securitization – whereby mortgages were sliced and diced into collateralized mortgage obligations – transformed Wall Street. Once again, however, the federal government implicitly stood behind an increasing array of complex mortgage-based securities.

The subprime market (which included loans to those with poor credit) was particularly lucrative for lenders. The banks that made these loans and the financial institutions that repackaged them were content to collect their fees and pass off the risky mortgage instruments to third parties. The subprime lending phenomena fueled housing prices and home ownership. As a business model, it worked like a charm, "as long as interests rates stayed low, as long as people kept their jobs and as long as real estate prices continued to rise."

The subprime phenomena took off when interest rates were at or near-historic lows. Inevitably, the Fed's monetary policy tightened and interest rates rose, which proved devastating for subprime borrowers with adjustable rate mortgages. Not surprisingly, subprime borrowers began to default, which flooded the market and led to lower home prices. With the bursting of the real estate bubble, many homeowners found they had negative equity – i.e., their homes were now worth less than their mortgages. Many homeowners simply stopped making mortgage payments and walked away from their homes.

The crisis that began in the subprime sector has wiped out hedge funds and cost banks and other financial institutions billions. The leverage most of these institutions used compounded their losses. Further, the complexity of the mortgage instruments meant no one knew which financial institutions might be insolvent or holding toxic waste. With lenders afraid to lend, the world faced a liquidity crisis. “The subprime butterfly had flapped its wings and triggered a global hurricane.” Across the world, many came to view the United States as a subprime superpower.

**From Empire to “Chimerica”**

We are witnessing a global shift in financial power. Some estimate that China could overtake the United States as the world’s economic leader as early as 2027. In fact, China has been relatively unaffected by the credit crisis playing out in the U.S. Ironically, although the average American earns 17 times what the average Chinese earns, the Chinese have financed America’s spendthrift ways by using their immense currency reserves to buy U.S. treasuries.

China, of course, has spent billions buying U.S. bonds in order to keep its currency undervalued relative to the dollar, which has bolstered its exports. The U.S., needless to say, welcomed Chinese imports and credit because they tended to keep inflation and interest rates low. The Chinese-America partnership had something for everyone: the Chinese did the savings and the Americans did the spending. There is little doubt, however, that the “Asian savings glut,” as Fed Chairman Ben Bernanke put it, helped inflate the housing bubble.

## Conclusion

The ascent of money has never followed a smooth trajectory. Our financial institutions are only as strong as their weakest link – human nature. Human beings, in fact, are hardwired in ways that make them prone to bias and irrational reasoning.

Financial evolution is not unlike Darwinian evolution. In fact, “financial history is essentially the result of institutional mutation and natural selection.” This analogy is not perfect. However, when it comes to capitalism, a certain degree of creative destruction is inevitable.

The dramatic expansion of the financial sector over the last quarter-century may be like the Cambrian explosion (in evolutionary terms a period when existing species flourished and many new species were created). If so, then the current financial crisis can be likened to what in evolutionary terms is called the Cretaceous period (a period of mass extinctions). No doubt, the crisis marks the beginning of the end for many bond insurance companies, hedge funds, and banks. We are also likely to see strong financial firms devour the weak. As economist Joseph Schumpeter wrote, “This economic system cannot do without the *ultima ratio* of the complete destruction of those existences which are irretrievably associated with the hopelessly unadapted.”

Our financial system can trace its existence to moneylenders in ancient Mesopotamia. While there have been a great number of shocks and setbacks along the way, the trajectory *has* always been upwards.

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