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Is There a Dime's Bit of Difference between Wall Street's "Innovation" and Gambling?

THE WISCONSIN FIVE wanted their money to beget money. Actually, they wanted *borrowed* money to do all the begetting. There is a very long and controversial history about whether or not that's a good thing.

Money seems to have sprung up about 9,000 years ago. The first currency was cows. Before we developed crops, our ancestors domesticated wild animals. A few of these species (taurine and zebu) became cattle that provided people with food, milk, and a way to carry loads.

Apparently, from the start, *Homo sapiens* has had a fondness for trading just about everything. We loved to barter. If we had a little extra of something, we wanted to trade it for stuff we didn't have. But as our societies became more complex, it became increasingly cumbersome to work out the exact terms of each barter deal. So items were measured against the value of a cow. One cow equals so many spears or concubines.

The Chinese were the first to figure out that coinlike objects might be easier to put in your purse than a cow. They started using cowry shells—those shiny porcelain-like sea shells that were easily carried and transferred. Their beauty also gave them intrinsic value. In Africa, cowry shells were also known for their magical powers and were associated with fertility.

Herodotus, the ancient Greek historian, noted that by 687 B.C., the kingdom of Lydia (in what is now western Turkey) used

minted coins. Historians believe this might have been the first society to systematically do so. In short order, decorative metals—silver and gold—became the standard means of exchange.

People were probably long familiar with loans: I will give you my extra cow now, and you will give me back a cow later. Or maybe you will give me back an armful of wheat every new moon for twelve new moons. But at some point—historians don't know exactly when—people came up with the idea of charging interest: You can have my extra cow now, but only if you give me a cow back next year plus an armful of wheat every month. (Interest may have started because animals could reproduce during the period of the loan. Who got the calf?)

Early on, our hard-working ancestors worried about the impact on society of those who received extra wealth from loans. Money lenders often were viewed as leeching off those who worked hard for their bread. Long before Christ, people were making a clear distinction between earned and unearned income. But more importantly, they worried about the consequences for the community: The indebted could become slaves to their creditors, and destabilize the social order.

The concept of interest was first codified about 4,500 years ago in Mesopotamia, as that society developed an urban civilization that relied on a division of labor. Wheat growers, fishermen, and herders in the countryside fed the urban population of craftsmen, priests, and government officials. The temple, and later the central government, took in surpluses from the countryside (taxes in the form of agricultural produce) and distributed the goods to the urban dwellers. Everyone had to pay some kind of tribute (taxes) to the temple and the state. If you couldn't pay, you borrowed either from others or from the central government to cover what you owed.

King Hammurabi (1790–52 B.C.), whose administration was the first to use writing to codify his decrees, allowed interest to be paid on loans of barley and silver. We have records of these loans. For example, "Igizi, the blacksmith" owed 720 liters of

barley. So did "Kikuli, the shepherd" and "Ur-Hamazida, the plowman."[1] There were also loans made by individuals to other individuals. The loans often were needed to cover harvest shortfalls. Sometimes they were needed to purchase bridal gifts as well. Loans seemed ubiquitous and formed the bulk of the written record. And many of these written loan agreements contained provisions for interest. The fact that so much of the early written record was dedicated to financial transactions and laws suggests that the stability of the social order required that finance be carefully controlled.

It seems that Hammurabi and his advisors—as well as his subjects—understood that loans, especially at high interest rates, could enslave the poor and make the lender excessively rich. Therefore, his codes limited interest rates: 33.3 percent if you loaned barley and 20 percent for silver loans. (This was for the life of the loan, not per year. So for short-term loans this was a very high rate.) The codes also forgave loans in case of natural disasters, literally wiping the slate clean, at least if the loan was recorded: "If anyone owes a debt for a loan, and a storm prostrates the grain, or the harvest fail, or the grain does not grow for lack of water; in that year he need not give his creditor any grain, he washes his debt-tablet in water and pays no rent for this year."[2]

The Greeks, however, were far less supportive of the idea of interest. Aristotle thought it unnatural and therefore unethical:

> The most hated sort and with the greatest reason, is usury which makes a gain out of money itself and nor from the natural object of it. For money was intended to be used in exchange but not to increase at interest. And this term interest, which means the birth of money from money is applied to the breeding of money because the offspring resembles the parent. Wherefore of all modes of getting wealth, this is the most unnatural.[3]

In his *Ethics*, Aristotle put money lenders in with a bad crowd, namely "those who ply sordid trades, pimps and all such people and those who lend sums at high rates. For all these take more than they ought, and from the wrong sources. What is common to them is evidently a sordid love of gain. . . ."[4]

Many Greek and Roman philosophers agreed. Republican Rome in 340 B.C. outlawed interest entirely.

It appears that every society and culture that has used some form of money has struggled with the notion of interest and excessive interest payments. None more so than the Jewish people. In fact, the Hebrew word for interest is *neshekh*, meaning "a bite." In the Talmud and other rabbinical texts, it was generally agreed that no interest at all should be charged to fellow Jews. But it was okay to charge interest on loans to Gentiles, because they charged *you* interest. Rabbinical scholars also were acutely aware that there were hundreds of ways to beat the system, including bringing a Gentile into the mix so that interest on a loan could be laundered through a third party. However, they were very concerned that charging interest could victimize the poor. And they were even more worried that compound interest (adding accumulated interest back to the principal so that the lender earns interest on their interest) would create more misery.

The Prophet Muhammad (in about A.D. 600) and the Koran took a harder line: No interest at all was permitted. "And what you give in interest that it may increase on (other) people's wealth, increases not with Allah . . ." (Koran 30:39).[5] (This stricture is still followed by some banks in Islamic countries.)

For nearly a thousand years the Catholic Church also weighed in heavily against all forms of interest. First the clergy were prohibited from charging interest, then the laity. In 1311, Pope Clement V declared all secular laws that allowed interest null and void.

But a much more complicated reality grew up between church and state. Kings needed someone to finance commerce and war. Who could do it? It was very risky for Catholics to loan money,

since they could be excommunicated for usury. How about the Jews? (Actually, any non-Christian minority would do.) At the height of the Middle Ages, when the church ban was strongest, sovereigns encouraged specific Jewish merchants to go into the money trade. The Jewish money traders were permitted, even encouraged, to charge high interest rates. But there was a catch: The sovereign could and did seize the wealth accumulated by the Jewish lenders either during their lives or upon their deaths. According to the Jewishencyclopedia.com, "It was for this reason indeed that the kings supported the Jews, and even objected to their becoming Christians, because in that case they could not have forced from them money won by usury. Thus both in England and in France the kings demanded to be compensated [by the Church] for every Jew converted."[6]

As commercialization accelerated, church bans on usury faded, and all manner of Catholic lenders entered the field. Nevertheless, the caricature of the Jewish money lender persisted. While the Protestant Reformation's famous "work ethic" helped fuel the rise of commerce, the man who officially launched the Reformation, Martin Luther, railed against the concept of interest. In *Trading and Usury* (1524), Luther wrote, "He who lends expecting to get back something more or something better than he has loaned, is clearly a damned usurer, since even those who lend demanding or expecting to get back just what they have lent, and taking no risk of its return, are not acting in a Christian way."[7]

John Calvin, however, pulled away from the severe Catholic and Lutheran restrictions on interest lending. As inflation of currencies became more common, Calvin apparently was among the first theologians to understand that money lent today might be paid back with money worth less in the future owing to inflation. Therefore, the lender needed interest payments just to break even. But Calvin still wanted restrictions on the practice. For example, he argued that it was morally just to lend money for commercial trading only if the risks were borne both by lender and borrower. If the ship went down both should lose, rather than

having the lender repaid regardless of outcome. This theological change corresponded with the dramatic rise of international trade as sailing ships improved and the Europeans colonized the globe.

As the commercial world became more complex so did the role of finance. Interest was here to stay. But for the sake of society's well-being, the first political economists worried about how much it should be controlled. Adam Smith, the foremost theorist of capitalism, tried to bring sound economic reason to the issue of interest. He wanted the most productive deployment of capital. It was okay, he argued, to borrow money and pay the going interest rate *if* the money was used productively. But Smith deplored the idea of aristocratic profligates securing loans to buy goodies for themselves. Instead, he wanted borrowed money to be invested in productive enterprises that would make the investor a profit, employ more citizens, and generally add to the wealth of the nation. Although Smith believed usury could pose a problem, the solution was not to forbid lenders from charging interest. That, he believed, would only drive the citizenry deeper into the arms of unsavory usurers: "This regulation, instead of preventing, has been found from experience to increase the evil of usury; the debtor being obliged to pay not only for the use of the money, but for the risk his creditor runs . . . to insure his creditor from the penalties of usury."[8]

Smith may have conjured up the idea of "the invisible hand" of the market, but he thought the government should have a hand too—at least when it came to usury. He argued that the government should cap interest rates at just above the rate that the market was charging prime borrowers (those with the best prospects of repaying because of their assets and incomes). Why so low? Because, he wrote, with high interest rates, "a great part of the capital of the country would thus be kept out of the hands which were most likely to make a profitable and advantageous use of it, and thrown into those which were most likely to waste and destroy it."[9] With a ceiling on interest rates, a lender would

not want to risk loaning money to those (subprime) wasteful aristocrats who would surely gamble and drink it away.

Karl Marx went one step further. He believed that banking, interest, and credit created an illusionary and unstable world of fantasy finance. In 1867, he observed:

> With the development of interest-bearing capital and the credit system, all capital seems to double itself, and sometimes treble itself, by the various modes in which the same capital, or perhaps even the same claim on a debt, appears in different forms in different hands. The greater portion of this "money-capital" is purely fictitious. All the deposits, with the exception of the reserve fund, are merely claims on the banker, which, however, never exist as deposits.[10]

In short, it seems that everyone everywhere in every era—from Hammurabi to Aristotle to Adam Smith to Karl Marx; from the Greeks to the Jews to the Muslims to the Christians—has understood that finance—money-making-money—poses serious difficulties for the social order. We are painfully relearning these lessons.

Does high finance still threaten the social order? The answer has little to do with individual greed or morality. Rather we need to understand how financial markets break down modern economies. The leading issue is systemic risk—losses that don't merely harm individual investors or firms, but can undermine the functioning of the entire economy.

Until very recently, too many of our economic leaders and academics believed that such risk had been drastically curtailed, if not forever eliminated. The modern financial sector could do no wrong. Policy makers and economists lavished unqualified praise on the industry's innovative new financial products, which

fueled the sector's huge growth and attracted capital from all over the world. Now these same products are commonly called "toxic waste," and the financial industry called a "casino." So—is the industry a cauldron of innovation or a superfund site? Are these new products the financial sector's equivalent of the iPod? Or lead paint and asbestos?

Consider for a moment your home. Without a financial instrument—the mortgage—very few of us could afford to purchase a home. We need credit and we need the payments spread out over many years. The same goes for those who start new enterprises or expand existing ones. In general, credit fuels economic growth and keeps enterprises moving. And what those with capital love most about the financial industry is that all these good things happen simply because the industry is looking to maximize its own returns, like any other enterprise. Money-making-money doesn't care about jobs or housing or the common good. Smith's invisible hand translates this innate selfishness into national well-being. (One evening after soccer practice I had a conversation with a private equity manager, a fellow soccer dad in my town. I was trying to get him to talk about the social utility of his work, so I asked him how his investments helped businesses expand and create jobs. He turned to me with his big, infectious smile and said, "Les, I'm in it for the money.")

But . . . if the invisible hand is doing its job, why is it so hard to identify the many wonderful new products the financial sector has created? Innovations that have improved our world, fulfilled a need? These money-making-money instruments must be playing an important economic role. If they were just props in an elaborate game of fantasy finance, surely they would not endure. Would they?

John Kay, writing in the *Financial Times*, refers to the financial sector as "a utility attached to a casino. The utility is the payments system that enables individuals and non-financial companies to go about their everyday business confident that they can make or receive payments, and lend and borrow to finance normal trans-

actions." The casino is, well, a casino where tens of thousands of very bright people try to beat the odds. [11]

Kay believes you can't have one without the other, and that the casino part is that cauldron of financial innovation. In fact he argues that it is folly to try to control or eliminate the casino since the industry will always invent new ways to work around regulations. So if you want a robust financial system, says Kay, you must accept the casino's innovation.

But if Kay is right—and we better hope he's not—what *are* those wonderful innovations, exactly?

Here's one: the pawnshop. It debuted in a monastery in China in A.D. 662—or at least that's the earliest record, thanks to a pawn book that survived the centuries. The idea was simple: You give me something of value and I give you money (originally in the form of gold or silver). When you give me the money back, I give you back the item. From the monastery, the concept spread, at first to a Chinese princess, who supplemented her income through a pawn business. About eight hundred years later the Franciscans in Italy tried the very same idea. According to historians Valerie Hansen and Ana Mata-Fink, these pawnshops had "the explicit goal of giving ordinary people an alternative to usurers . . . Like Chinese monasteries, they initially did not charge interest."[12]

It was only a small step to turn the pawnshop into a bank that would loan out money against a pledge of collateral. Add interest and the relending of deposits to the mix and you've got the makings of a very powerful and profitable institution.

An interest-bearing pawnshop loan, however, was clunky when all you could loan out was gold and silver. The Chinese fixed that problem with the next great financial invention—paper money. They figured that money didn't need to be a precious metal or a valuable cow. It didn't need to have any intrinsic value at all. In the tenth century A.D., after the Song dynasty had unified a large part of the country, the economy was humming. Gold and silver, which were used as currency, started

to disappear as external trade expanded. Soon businesses began using cheaper metals like bronze and finally abundant iron.[13] Carting all that iron to market was extremely cumbersome. So a few clever merchants came up with the paper bill. By 1024 the state stepped in and created the first official paper currency, controlling the amount and guaranteeing its value.

Really, this is quite a feat. That a worthless piece of paper serves as a means of exchange still boggles the mind. You pull this scrap of nothing out of your pocket and someone gives you a latte—all because the government says it is worth much more than the paper it is printed on. It truly is faith-based currency. (And with our current technology, electronic money will make paper money practically disappear as it is reduced to nothing more than electronic impulses.)

So far we have the financial innovations of the pawnshop (bank) and paper money. Somehow these inventions don't inspire the same awe we feel for the printing press or the light bulb. But let's not call the question just yet.

As trade evolved in Europe, a truly momentous innovation evolved with it—a functioning capital market. Here, money could be raised for all kinds of ventures, primarily through the buying and selling of financial instruments (which we'll describe below). This innovation gives our financial sector major bragging rights, because it enabled people to raise capital for ventures (including wars) that could expand economic activity and state power. Financial experts are quick to remind us that capital markets provide the venture capital that is absolutely vital for developing new products and services. No capital markets, no high-speed Internet, no laptop computers, no Prozac.

Two prior innovations came together to produce functioning capital markets. The first was government bonds. The first real public-debt bonds that could be bought and sold were issued by Italy's city-states, which had wracked up big debts in their wars with each other and other Mediterranean nations. (In fact, war has usually been the driver for government debt.) Venice,

Genoa, and Florence needed money, but they'd already taxed their citizens to the hilt. So they hit upon a much bigger and better idea—sell people bonds and pay them interest. At first the city-states made buying such bonds compulsory. Then they realized that they could attract money from their wealthiest citizens simply by issuing government-backed debt and selling it. They could spread out interest payments to only a few times a year, which made the arrangement very affordable. Large sums could be raised quickly. Creditors could buy the bonds, and, most importantly, they could resell them to each other. By the late 1400s, all three city-states were circulating some form of negotiable government debt instrument. The bonds not only raised cash for war, but literally bonded the wealthy to the state. Everyone who owned a piece of the government debt had a tangible stake in the government's well-being.

While Italy produced the first transferable government bonds, it didn't develop the other ingredient necessary to produce a fully fledged capital market: corporate shareholders. The Dutch East India Company, founded in 1602, became the first to offer shares. The corporation was organized by the Dutch state to systematize the hundreds of sailing ventures from competing Dutch port cities to the Far East. By issuing shares, the company provided a piece of the action to each of its participants. The company was controlled by a board of directors that included representatives from each of the cities involved. Amsterdam, the largest, received the most directors. At first the shares (legal documents that described the buyer's ownership) were only redeemable by the company. Later, a secondary market grew up to buy and sell shares.

This buying and selling of shares in the Dutch East India Company became the basis of the first stock market. Not only could the shares be sold, they also could be used as collateral for loans to fund other ventures. This gave rise to all manner of modern financial transactions. The company's sailing ventures were a gamble. Profits and therefore dividends were in no way guaranteed, nor was

the timing of payments. Before long, some innovative soul realized that it might make sense to exchange shares in the future based on a price agreed upon in the present.

Such a futures transaction was a hedge against uncertainty. It would lock in money for the holder of the shares, while allowing the buyer a chance to make a bit more in the future when the dividends rolled in. The practice of locking in future prices also helped protect the share price of those who had pledged their shares as loan collateral.[14]

Although this Dutch stock market thrived, the first fully fledged capital market was born in seventeenth-century England. For the next two hundred years, England was the hub of the world's financial market. England had both necessary ingredients: government debt and the shareholder corporation. The British parliament chartered the Bank of England in 1694 to raise money for accumulated debts. Bonds were sold to the public, and the debt was readily transferable. Meanwhile, investors chartered the West India Company, a shareholder-driven rival to the Dutch. Companies sprang up right and left to raise cash for new ventures—especially for dredging up wrecks that supposedly were laden with riches. Diving and dredging companies were all the rage in England. Although most of these companies failed, they helped create a flourishing capital market. At the market, investors could buy and sell existing shares and debt, and entrepreneurs could raise money (by selling new shares) for new ventures.

Government debt, the shareholder corporation, and a capital market were each world-changing inventions, the financial equivalent of electricity.

But before we get too euphoric about these breakthroughs, we need to take a look at the troublesome twins spawned by these new capital markets—the bubble and the bust. Enter systemic risk. Long before there was Wall Street, there was the bubble. Something about the financial market seems to encourage finan-

cial booms, which lead to bubbles, which lead to debilitating financial collapses. Only the blindest ideologue could ignore the historical connection between financial panics and "free" financial markets. When left to their own devices, financial markets always melt down, eventually. (Scholars have counted 148 meltdowns since 1870 where a country's economy has shrunk by 10 percent or more. They also found 87 instances where per-person consumption dropped by that amount. On average the size of the drop was 21 to 22 percent and lasted three and a half years.[15])

The first sizable bubble and bust involved the tulip-loving Dutch during the 1630s, a time of commercial success and relative peace. Thriving regional trade had enabled Dutch merchants to accumulate significant wealth and enough surplus income to indulge in conspicuous consumption. The Dutch adored rare varieties of tulips for their beauty and because they advertised the wealth of those who possessed them. According to financial historian Edward Chancellor, "In 1624, a Semper Augustus[16] fetched the handsome sum of 1,200 florins, an amount sufficient to purchase a small Amsterdam town house."[17] Soon nearly all tulip varieties were in high demand, generating a vibrant tulip-trading market. But this was not your typical floral market. Since tulips could only be grown at certain times of the year, the market developed contracts for future delivery, secured by borrowed money. As a result, "most transactions were for tulip bulbs that could never be delivered because they didn't exist and were paid for with credit notes that could never be honored because the money wasn't there."[18] This practice of leveraging (buying stuff with lots of borrowed money) drove up prices to insane levels: One Viceroy tulip bulb was supposedly worth the equivalent of "twenty-seven tons of wheat, fifty tons of rye, four fat oxen, eight fat pigs, twelve fat sheep, two hogsheads of wine, four turns of beer, two tons of butter, three tons of cheese, a bed with linen, a wardrobe of clothes and a silver beaker."[19] As prices climbed, word spread, attracting more and more of the Dutch as well as foreign investors into the market—further inflating prices. For a

short time it seemed that small and large fortunes came to those who bought and sold tulip contracts. Modest tradesmen got into the act by taking out loans against their homes and other assets. The casino was open for almost a year and it seemed that everyone came away a winner.

No one is sure why the crash came on that day, February 3, 1637. Prices plummeted so catastrophically that a year later a government commission had to unwind the tulip contracts altogether, declaring that each could be annulled on payment of only 3.5 percent of the agreed price. Although the Dutch economy did not collapse, a great many players were badly burned. The Dutch love of tulips turned to disgust.

We've had nearly four hundred years to absorb the lesson of this market bubble. And yet we haven't. Obviously, we are prone to get-rich schemes. We move like a herd when the chase is on for items of apparent value. The more others move, the more we want in on the action. As share prices rocket upward, we want to get our piece, further driving up the price. When the gap between the intrinsic worth of the item and its bubble price stretches to the breaking point, the herd stampedes in the other direction. Prices reverse, leading to more selling, and an even more swooping decline. Because so much of the upside is fueled by borrowed money, the downside accelerates when the collateral for the loans—the shares that were bought—declines in value. Shares then must be sold to pay off the loans and a death spiral follows: declining share prices leads to more sales to repay loans, which leads to more declining prices. Nearly four centuries later, then Federal Reserve chairman Alan Greenspan called the upside "irrational exuberance."[20]

The Dutch Tulip Bubble was harmless compared to the bubbles that followed. England's South Sea Bubble of 1720 more accurately foretold our financial future.

The South Sea Corporation was founded to conduct trade and to market much of the English national debt, which was until then held by wealthy citizens in the form of annuities.[21] The

corporation encouraged these rich annuity holders to convert their holdings into South Sea Corporation shares, which would pay dividends. In the process, the government's debt would disappear, and a new secondary market would be created that would allow the wealthy annuity holders to unload their assets more readily. The new company cut a careful deal with the Bank of England: The higher the price of the shares, the higher the profits for the investors. In fact, higher share prices benefited the government by making it more tempting for annuity holders to convert their claims on the government into corporate shares. To grease the skids, many members of Parliament were given stock, as were various cabinet ministers. The stock soon became wildly popular, and the bubble began to expand. In only six months the stock's value increased eight times its original price. The euphoria spread throughout the growing English capital market, leading to a profusion of new bubble companies seeking—and finding—investors for fraudulent ventures.

The South Sea corporate directors didn't like all these imitators entering the frothing market in search of sterling and suckers. They wanted the government to tamp down the proliferation of these competing bubble companies by requiring all new shareholder corporations to get a government charter. The "Bubble Act" barred "the establishment of companies without parliamentary permission and prevented existing companies from carrying on activities not specified by their charters."[22] When this failed to suppress the bubble companies, the South Sea directors asked the attorney general to prosecute. They also increased the company's guaranteed dividend to a whopping 50 percent per year for the next twelve years to get the attention of investors who were chasing after high returns in the boom market. The combination of government regulation plus the exorbitant dividend was supposed to further drive up stocks. Instead, the euphoric stock market crashed, taking down the South Sea enterprise with it. In four weeks the value of South Sea's stock fell by 75 percent.

In the decades and centuries to come, such bubbles would form and burst again and again—from South American mines, to railroads, to the stock market bubble of the 1920s, to the crash of the Internet and housing bubbles in the early twenty-first century. Investors can't help themselves, nor can the financial system as a whole. The key players always find ways to profit wildly by building the momentum and pumping up prices well past any reasonable value. The process of borrowing to buy more assets and the inflation of those asset prices reinforce each other. At some point, the gap between fantasy finance and reality stretches to the snapping point. And then comes the collapse. Sometimes, the underlying economy is strong and the impact is contained. At other times, the collapse sets off a deep depression that threatens the entire economy.

We've examined some important financial inventions: government bonds, shareholders, capital markets, with their inevitable bubbles and busts. But we've missed the financial market's greatest invention of all: *political leverage*. Big investors and other major financial players have become so strong that they are almost impossible to control effectively by government policies. Put more bluntly, high finance reigns, or at least has exorbitant veto power over economic and political life. (Note how today's politicians respond to the gyrations of the stock market.)

Take the South Sea Bubble. After the bubble burst, government investigators discovered that many members of Parliament had been bought off with valuable shares. Several were expelled from their seats. In fact, Parliament went so far as to pass a bill to confiscate all the profits made by the South Sea Company directors during 1720. It never was implemented. Remarkably, in the 1820s, the Bubble Act was actually removed from the books after yet another finance bubble. This time the bubble concerned fantasy gold and silver mines in South America. British investors believed that South America, which recently

had liberated itself from Spanish rule, would benefit greatly from English know-how and commerce. Surely once the English got involved with these South American mines, money would flow to the investors. British publications touted the humongous gold nuggets that were just lying on the ground, waiting to be processed by British companies. All those companies—and the emerging South American governments—needed were some wise English investors. The binge was on. Company after company floated shares. Markets and prices were effectively manipulated, spurious investment reports were circulated, and government ministers were turned into cheerleaders with free shares. Prices took off . . . and then crashed.

By this time some English observers had already seen enough to question the fundamental value of the financial markets and those who made them tick (and manipulated them). These observers had noticed how these markets resembled a casino. One banking family scion, Alexander Baring, said that he "saw no difference between the gambling of the nobleman in the halls of St. James's Street, and the gambling of the merchant on the Royal Exchange; except that the latter kept earlier hours and more respectable company than the former."[23]

Even though the financial markets were rife with fraudulent manipulation, the English government refused to act. Why? Enter the innovation of financial political leverage and power. By this time the financial markets had become inexorably attached to the ideology of the "free market," a horse they would ride to riches for the next two hundred years. They had convinced political rulers that unregulated financial markets, though messy, were the heartbeat of capitalism. And these markets could not—and should not—be constrained or even seriously controlled. In essence, financiers argued that it was impossible to draw a line between healthy speculation and venal overspeculation without killing the market. You could not really differentiate a bubble from legitimate investment until after the fact. Alexander Baring put it well in 1820:

> The evil [of speculators] was certainly one which deserved to be checked; though he hardly knew how the check could be applied. The remedy would be worse than the disease, if in putting a stop to this evil, they put a stop to the spirit of enterprise. That spirit was productive of so much benefit to the community, that he should be sorry to see any person drawing a line, discriminating between fair enterprise and extravagant speculation.[24]

This argument has been trotted out for nearly two centuries to protect the financial markets from effective regulations, and to condone "irrational exuberance." When major financial players fear a government policy or regulation, they threaten calamity. Nearly always, politicians of all stripes back them up. Political leaders live in fear of how the "markets" will respond to their statements and policies. A strong market decline after a policy pronouncement is nearly the equivalent of a parliamentary vote of no-confidence.

Or as President Bill Clinton put it: "You mean to tell me that the success of the economic program and my re-election hinges on the Federal Reserve and a bunch of fucking bond traders?"[25]