



# MONEY, GREED, AND RISK

Why Financial Crises and  
Crashes Happen

Charles R. Morris



A CENTURY FOUNDATION BOOK

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**CHARLES R. MORRIS**

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**T I M E S   B U S I N E S S**



R A N D O M   H O U S E

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## FOREWORD

Part of Communism's intellectual appeal may well have been its promise to resolve one of man's oldest quests—the search for a way to relieve the relentless tension produced by economic risk and uncertainty. In this sense, the Soviet Union's traditional five-year economic plans—with their detailed production targets, price controls, and promises of growth—represent an almost touching fairy tale, a dream based on the assumption that humans have the power to control their economic destiny. Now, with that illusion swept into the dustbin of history, societies everywhere are converging in a belief that high rates of economic growth and long-term prosperity are possible only with free markets. But they also are continuing to learn and relearn lessons about the risks that accompany free enterprise.

Charles Morris, public manager, investment banker, and author, has written on a wide range of topics from the social policy innovations of the sixties to arms control during the cold war, from the Catholic Church to international economics. In fact, only someone who combines his broad perspective with a sharp and restless intellect could have pulled together the story he tells in this volume. The historical development of finance in the United States has seldom been explained with more economy and good sense. And few authors could effectively use the example of boom and bust in early America to help illuminate the recent events in South Asia and Russia—in the process making us more realistic about what to expect during the early stages of capitalism and market development anywhere. Most of the names in this book are famil-

iar—Carnegie, Morgan, Rockefeller—and so are some of the events, but in each case, Morris enlarges our comprehension. Even recent crises, such as the savings and loan debacle and the junk bond crash, are more sharply defined.

Tolstoy wrote that while happy families are all alike, every unhappy family is unhappy in its own way. Many have a parallel belief about markets: all booms and bull markets have a certain similarity, but each economic bust or bear market is triggered by a special set of events. Maybe. But one message of this book is that this observation is only superficially true. In fact, there seem to be significant common elements and historical resonance among most cases of boom and bust, excess and correction. Change, innovation, personality, and circumstance may shape the exact situations in which a Jay Gould or a Michael Milken operate, but as *Money, Greed, and Risk* makes clear, the reasons that financial crashes and crises happen most often derive from fundamental and recurring characteristics of any financial system.

Perhaps Morris's most valuable contribution is to help us understand the implications of the vast and ever-increasing array of exotic and new financial instruments, some of them forged out of such homely old standbys as simple fixed-rate, thirty-year, government-guaranteed mortgages. This complexity matters because it can hinder understanding and mask risk. Morris calls finance the plumbing that makes capitalism run, and in this metaphor he surely captures an essential truth about economics. As he puts it, "Therefore, [it is] with good reason that finance is among the most regulated of all businesses." And indeed, the framework that we have created is the most extensive in the world, going well beyond the federal and state government regulatory agencies. We depend, as well, on an expensive and elaborate legal system to help police contention among parties in the system; we rely on commercial credit guardians and an immense accounting profession; and we delegate important powers to self-regulatory private organizations such as exchanges. Paradoxically, America may have one of the world's freest financial markets only because it also has the world's most complex regulatory framework in place—a framework designed to keep the system from careening

from one crash to another. And, we apparently have a never-ending need to update this extraordinary oversight apparatus.

Morris reminds us of an important reality: Fixed ideas about how to improve and modernize regulation are seldom decisively convincing or lasting. In the first place, given the pace of financial innovation, set regulatory regimes tend to be obsolescent by the time they are introduced because of the increased complexity of instruments, markets, and risks. This fact of financial life means that there are no easy—let alone permanent—answers. Here, as in many categories of democratic capitalism, the advantage of “muddling through” rather than seeking universal truths remains appealing. Indeed, the permanence of uncertainty and the prevalence of change in modern markets may make such an approach inevitable.

This necessity for ad hoc policy also means that the financial community and its regulators will be engaged in constant conflict about just how much rulemaking and oversight is enough. Of course, it is the American way to recognize the right of every business, including financial firms, to argue for special public policies or public dispensations, and to do so with a straight face. At the same time, it tests our tolerance when the same industry, in time of trouble, rushes to Congress or the White House or the Federal Reserve bank to plead for help to save, say, a “Long-Term Capital Management” or some other firm that’s “too big to fail.” But these contradictions, too, are inevitable. Public policy in this area must serve several, sometimes conflicting, missions: facilitating open and competitive markets, preventing fraud and other abuses, but also ensuring that we avoid financial panics because of short-term crises, especially those involving the overall liquidity of the system. Moreover, while the unforgiving “discipline of the market” makes great theory, it may be bad policy when there are potentially grave consequences for working people and communities.

Morris advocates a bias in regulation toward focusing more on types of financial instruments than on types of institutions, strengthening protections for the little guys, and emphasizing that risk takers must have the wherewithal (capital) to deal with inevitable crisis. The rub, as Morris stresses, is that the hard thing

about this approach is staying the course—being willing to let the market be the market and allowing failures to occur that might even have negative short-term consequences for the system as a whole.

In the end, of course, there is no magic formula that will sweep away all the issues raised by the uncertainties of capitalism. Perhaps because so much chance is hard-wired into the human condition, most adults, despite the rush that may accompany high-stakes activity, understand that it is foolish to take unnecessary risks with regard to personal safety or economic well-being. In fact, economists have thoroughly documented the pervasiveness of risk-averse behavior: The average individual, according to this research, actually takes fewer risks than he or she should (should, that is, according to economists). Still, it seems true that Americans tolerate a greater degree of market risk than do many other wealthy societies. They do so not because they are exceptionally reckless, but rather because they place a high value on the positive results of a relatively unfettered free market. Given that reality about our nation, the importance of a better understanding of how financial crises happen is obvious.

Simply put, Charles Morris is a polymath. He is that rarest of all intellectuals—one who understands and can make us understand not simply one area, but many. Indeed, given the previous range of his writings and the frequently unexpected turns of his interest, one can know neither the limits of his curiosity nor the ultimate boundaries of his understanding of how things work. *Money, Greed, and Risk* is only the latest proof of how exceptional he is. On behalf of the Trustees of The Century Foundation/Twentieth Century Fund and of two decades of readers, I thank him for helping us to understand yet another part of our world.

—Richard C. Leone, president, The Century Foundation (formerly the Twentieth Century Fund)  
January 1999

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## **MONEY, GREED, AND RISK**



# INTRODUCTION

The world is awash in financial crises as this book is going to press. Japan's banking system is wallowing in \$1 trillion of bad loans; the currencies of the erstwhile East Asian "Tiger" economies are barely worth their weight in wallpaper; Russia is disappearing down a black hole; and most of Latin America—Mexico, Brazil, Argentina, even straitlaced Chile—is teetering on the brink. The United States has so far escaped the worst of the crises, but fiascos like the collapse of Long Term Capital Management have kept its financial markets frazzled and jumpy.

It is usually easy to understand why a business gets in trouble—its cars or computers cost too much or aren't as good as the competition's. But financial crises seem to arise out of nowhere, driven by mysterious forces and agencies—"globalization," "derivatives," "junk bonds," "foreign speculators." In the 1960s, it was the "gnomes of Zurich," while in most other eras, and still today in the mind of the Prime Minister of Malaysia, it was always "the Jews."

Finance operates in the murky depths of the economy. Like a plumbing system, it is invisible when it is working well, but a broken pipe can be a disaster. Occasionally, a catchy name impels some aspect of finance into the public imagination. Jay Leno fans all knew there was a junk-bond crisis in the late 1980s, but few people heard of the CMO crash about five years later, although it was much bigger. Home buyers certainly knew that mortgage rates were rising sharply, but few would have understood why.

Although the jargon changes, one generation's financial crisis is often much like the next's. "Globalization" is the buzzword for

the 1990s, but nineteenth-century investing was at least as global, and the currency crises in late-nineteenth-century America followed courses broadly similar to the recent ones in Mexico and East Asia. Investors also reacted about as quickly then as they do now, although it took longer to execute instructions—you couldn't ship bullion at the flick of a computer mouse. In both the 1870s and the 1890s, however, the reversal of capital flows from Europe to America was still brutally abrupt. The complexity of financing the railroads after the Civil War matches any that investment bankers solve today. Michael Milken didn't invent any financial instruments that Jay Gould hadn't already thought of, and Gould could also have given lessons to Indonesia's President Suharto in fleecing overseas investors. When J. P. Morgan stepped into the American crisis of the 1890s, his prescriptions were a lot like those of today's IMF.

Finance is a relatively late arrival in economic history. The Amsterdam Exchange of the early seventeenth century is probably the first recognizably modern financial market, with trading in company shares, government bonds, and a wide range of futures and options. Hard on the heels of proto-modern markets came John Law's Mississippi Company fiasco in Paris, and the South Sea Bubble in London, both of which cast shadows over national financial practice for a century or more. The link between financial innovation and crisis was there from the start.

Almost all primitive societies used some kind of money. The active trading culture of the Indians of the Great Plains and Rocky Mountains, for example, was mostly conducted by barter, but was often facilitated by the use of colored beads, or wampum, as an intertribal currency. In practice, taking beads for something as valuable as a steel ax would have been very risky, for as Lewis and Clark found to their chagrin, different tribes had quite different notions of the value of wampum, and many scorned it as a substitute for really valuable goods, like rifles and powder.

The path from money to finance is one of successive abstraction. The European analogue to bead wampum was gold and silver, the so-called precious metals, which were used to facilitate trade from the very earliest times. Over the course of several mil-

lennia, people became so accustomed to denominating traded goods in precious metals that the metal equivalent gradually became the measure of the value of the goods, rather than the other way around—which Indians would have found odd. Deciding that real wealth consists in inert metals, rather than in the goods they may temporarily represent, is an extremely useful trick, for then the metals can act as a long-term store of value in a way that perishable goods cannot. Money as a store of value is but a step away from the notion of money as capital, which is where finance begins.

Even in the high Middle Ages, the notion of money as finance capital was radical enough to earn the condemnation of the church. In the thirteenth century, Thomas Aquinas proved, citing Aristotle, that the natural purpose of money was as a medium of exchange, not as a store of value, from which it followed that the lending of money at interest, or usury, was unnatural and sinful. Aquinas was not a stupid man, and seen through his eyes, the conclusion is not so bizarre. The primary enterprises of medieval Europe were military adventure and religious display, and the primary forms of wealth were labor and land. The whole feudal system of vassal and liege was a vast machinery for putting manpower and land directly at the disposal of the nobility and the clergy to build castles and cathedrals and to wage war and stage ceremonies. Feudalism, in effect, was a comprehensive, but non-monetary, capital assemblage system. Money was needed mostly for the purposes of exchange in international trade, more or less as Aquinas said. Even in Augustan Rome, which was a much more sophisticated society, money seems similarly to have been used mostly for trade. The capital required to build aqueducts and roads was simply dragooned.

Modern finance capitalism is a creature of the vast expansion of trade in the fifteenth and sixteenth century. Trade was highly profitable, and a merchant could obviously get richer if he could put more ships to sea than his private means would allow. The logical step was to borrow the money to finance more cargoes. Usury laws were still in effect, so almost all lenders were Jews; and to assuage a Christian merchant's conscience, the loans were often couched as the purchase of a partnership, or as insurance. It was

common for a lender to advance the funds for a cargo at a high rate of interest, but if the ship was lost, the loss fell on the lender. (The same classification cat-and-mouse game goes on today, but to minimize taxes rather than the risk of damnation.) Usury laws gradually fell into desuetude, and richer merchants went into the lending business themselves. As feudal obligations were replaced by monetary contracts, it was an easy step from financing cargoes to financing kings. Kings now often had to rely on foreign troops, and they insisted on being paid in cash.

Financing a cargo with a trade credit—paying with a mere promise instead of with hard money—was a conceptual leap almost as important as the original substitution of money for actual goods. The Italian city-states of the Renaissance, and later the burghers of Amsterdam, gradually transmuted the system of trade credits into a highly polished financial machine—certificates of credit were traded freely, as if it were the certificate that was the item of value. In principle, however, all credits were still a claim on some goods, or later, as credits were extended to sovereigns, on the king's taxing power.

The magic of credit is that a thought (*credere*, “to believe”) creates wealth. Before the system of paper credits, trade was transacted in coin, which is heavy and easily stolen or clipped, or more frequently by barter. Barter voyages could stretch to ten years or more, as merchants plied from port to port, seeking just the right goods. The expansion of trade enabled by paper credit underpinned regional and national specialization, commodity agriculture, the growth of manufacturing centers, the industrial revolution.

Financing American railroads required another huge leap of abstraction. Instead of a claim on a cargo of cotton, investors received a vaguely defined share in the future success of a private enterprise. To wags, it looked like a repeat of the eighteenth-century South Sea Bubble fiasco. As enterprise became more complex, the nature of the claim, and the rights of various classes of claimants, became ever more problematic, the more so since the business corporation was itself a legal anomaly well into the nineteenth century.

Sorting through these myriad issues in America was largely ac-

completed in the three or four decades following the Civil War, when the financial industry assumed more or less the same contours and divisions of labor that define it today. Jay Gould, whose name has become synonymous with rapaciousness, gets too little credit for shaping it. But it was J. P. Morgan who set the stage for the vast American industrial expansion of the late nineteenth and early twentieth century when he took railroad financing into his own capable hands and created the rules that made private-company investing safe for the wealthy classes.

By the time of the Great War, the entire economy was monetizing. Hired labor on a family farm could be paid mostly in kind, but industrial workers received cash wages, and the monetary holdings of a new, broadly based middle class gradually became the primary source of finance capital. Transmuting millions of small pools of household savings into usable capital for commercial, industrial, and consumer finance became the primary task of financial services and opened boundless opportunities to fleece the unwary. Stock jobbers gleefully worked over the middle classes, until the New Deal reform government developed the regulatory, accounting, and disclosure apparatus to make investing safe for the proverbial prudent man or woman.

The story of finance is therefore one of innovation, crisis, and consolidation. Industrial, commercial, or technological change calls forth an innovation—paper trade credits, private-company stocks and bonds, retail stock markets, junk bonds, collateralized mortgage obligations, derivative instruments. In every case, the innovation solves an immediate problem—expanding trade, financing railroads, restructuring companies, stabilizing pension portfolios—and also triggers a period of greatly increased risk and instability, until institutions catch up. The cycles are as apparent today as they were two hundred years ago. Even many of the instruments are the same.

The first three chapters illustrate the cycle of innovation, crisis, and consolidation in America from the early nineteenth century through the market crash of 1929. The remainder of the book traces the operation of the same cycle in modern markets through