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Why No Outrage?

Through history, outrageous financial behavior has been met with outrage. But today Wall Street's damaging recklessness has been met with near-silence, from a too-tolerant populace, argues James Grant

By JAMES GRANT
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"Raise less corn and more hell," Mary Elizabeth Lease harangued Kansas farmers during America's Populist era, but no such voice cries out today. America's 21st-century financial victims make no protest against the Federal Reserve's policy of showering dollars on the people who would seem to need them least.

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Why No Outrage? From top to bottom: New York's Sub-Treasury Building in 1929; Angelo Mozilo, former CEO of mortgage lender Countrywide Financial; Unemployed men, circa 1935; Foreclosure sign, April 2008, Stockton, Calif. Strikers, 'scabs' battle, circa 1935; Bear Stearns executive arrested, June 2008; Hooverville shantytown; NYSE trader, 2008; Mary Lease

Long ago and far away, a brilliant man of letters floated an idea. To stop a financial panic cold, he proposed, a central bank should lend freely, though at a high rate of interest. Nonsense, countered a certain hard-headed commercial banker. Such a policy would only instigate more crises by egging on lenders and borrowers to take more risks. The commercial banker wrote clumsily, the man of letters fluently. It was no contest.

The doctrine of activist central banking owes much to its progenitor, the Victorian genius Walter Bagehot. But Bagehot might not recognize his own idea in practice today. Late in the spring of 2007, American banks paid an average of 4.35% on three-month certificates of deposit. Then came the mortgage mess, and the Fed's crash program of interest-rate therapy. Today, a three-month CD yields just 2.65%, or little more than half the measured rate of inflation. It wasn't the nation's small savers who brought down Bear Stearns, or tried to fob off subprime mortgages as "triple-A." Yet it's the savers who took a pay cut -- and the savers who, today, in the heat of a presidential election year, are holding their tongues.

Possibly, there aren't enough thrifty voters in the 50 states to constitute a respectable quorum. But what about the rest of us, the uncounted improvident? Have we, too, not suffered at the hands of what used to be called The Interests? Have the stewards of other people's money not made a hash of high finance? Did they not enrich themselves in boom times, only to pass the cup to us, the taxpayers, in the bust? Where is the people's wrath?

Getty Images

Crowds at the New York Stock Exchange in 1929.

The American people are famously slow to anger, but they are outdoing themselves in long suffering today. In the wake of the "greatest failure of ratings and risk management ever," to quote the considered judgment of the mortgage-research department of UBS, Wall Street wears a political bullseye. Yet the politicians take no pot shots.

Barack Obama, the silver-tongued herald of change, forgettably told a crowd in Madison, Wis., some months back, that he will "listen to Main Street, not just to Wall Street." John McCain, the angrier of the two presumptive presidential contenders, has staked out a principled position against greed and obscene profits but has gone no further to call the errant bankers and brokers to account.

The most blistering attack on the ancient target of American populism was served up last October by the then president of the Federal Reserve Bank of St. Louis, William Poole. "We are going to take it out of the hides of Wall Street," muttered Mr. Poole into an open microphone, apparently much to his own chagrin.

SCOUNDRELS ON THE STREET

There's a gripping story behind every financial scandal. Here's a roundup of movies that examine the money-making industry's dark side:

'Clancy in Wall Street' (1930)
Starring: Charles Murray, Lucien Littlefield, Aggie Herring and Eddie Nugent
An Irish-American plumber, Clancy (Murray), happens on some good stock-market bets , eventually making millions and elevating him in society. But once the market crashes and he's left with nothing, he returns to his roots in hopes that old friends will take him back.

'It's a Wonderful Life' (1946)
Starring: James Stewart, Donna Reed and Lionel Barrymore
Generally filed away in the holiday-favorite category, this film's run-on-the-bank scene and its fallout is a classic example of financial duress on the silver screen.

silver screen.

'Wall Street' (1987)
Starring: Michael Douglas, Charlie Sheen, Daryl Hannah and Martin Sheen
Oliver Stone's classic film centers on Gordon Gekko (Douglas, pictured right), a ruthless Wall Street corporate raider who takes an ambitious young stockbroker (Charlie Sheen) under his wing and exposes him to the perks and pitfalls that come with the high-stakes territory.

'Glengarry Glen Ross' (1992)
Starring: Al Pacino, Jack Lemmon, Alec Baldwin and Alan Arkin
In this film based on David Mamet's Pulitzer Prize-winning play, a group of tough real-estate salesmen struggle to deal with a downturning housing market -- or face the ax.

'Rogue Trader' (1999)
Starring: Ewan McGregor, Anna Friel, Yves Beneyton and Betsy Brantley
In this film, based on a true story, Ewan McGregor plays a trader working in Singapore who makes illegal trades to cover up his losses. He ends up in jail.

If by "we," Mr. Poole meant his employer, he was off the mark, for the Fed has burnished Wall Street's hide more than skinned it. The shareholders of Bear Stearns were ruined, it's true, but Wall Street called the loss a bargain in view of the risks that an insolvent Bear would have presented to the derivatives-laced financial system. To facilitate the rescue of that system, the Fed has sacrificed the quality of its own balance sheet. In June 2007, Treasury securities constituted 92% of the Fed's earning assets. Nowadays, they amount to just 54%. In their place are, among other things, loans to the nation's banks and brokerage firms, the very institutions whose share prices have been in a tailspin. Such lending has risen from no part of the Fed's assets on the eve of the crisis to 22% today. Once upon a time, economists taught that a currency draws its strength from the balance sheet of the central bank that issues it. I expect that this doctrine, which went out with the gold standard, will have its day again.

Wall Street is off the political agenda in 2008 for reasons we may only guess about. Possibly, in this time of widespread public participation in the stock market, "Wall Street" is really "Main Street." Or maybe Wall Street, its old self, owns both major political parties and their candidates. Or, possibly, the $4.50 gasoline price has absorbed every available erg of populist anger, or -- yet another possibility -- today's financial failures are too complex to stick in everyman's craw.

I have another theory, and that is that the old populists actually won. This is their financial system. They had demanded paper money, federally insured bank deposits and a heavy governmental hand in the distribution of credit, and now they have them. The Populist Party might have lost the elections in the hard times of the 1890s. But it won the future.

Before the Great Depression of the 1930s, there was the Great Depression of the 1880s and 1890s. Then the price level sagged and the value of the gold-backed dollar increased. Debts denominated in dollars likewise appreciated. Historians still debate the source of deflation of that era, but human progress seems the likeliest culprit. Advances in communication, transportation and productive technology had made the world a cornucopia. Abundance drove down prices, hurting some but helping many others.

The winners and losers conducted a spirited debate about the character of the dollar and the nature of the monetary system. "We want the abolition of the national banks, and we want the power to make loans direct from the government," Mary Lease -- "Mary Yellin" to her fans -- said. "We want the accursed foreclosure system wiped out.... We will stand by our homes and stay by our firesides by force if necessary, and we will not pay our debts to the loan-shark companies until the government pays its debts to us."

By and by, the lefties carried the day. They got their government-controlled money (the Federal Reserve opened for business in 1914), and their government-directed credit (Fannie Mae and the Federal Home Loan Banks were creatures of Great Depression No. 2; Freddie Mac came along in 1970). In 1971, they got their pure paper dollar. So today, the Fed can print all the dollars it deems expedient and the unwell federal mortgage giants, Fannie Mae and Freddie Mac, combine for $1.5 trillion in on-balance sheet mortgage assets and dominate the business of mortgage origination (in the fourth quarter of last year, private lenders garnered all of a 19% market share).

Thus, the Wall Street of the Morgans and the Astors and the bloated bondholders is today an institution of the mixed economy. It is hand-in-glove with the government, while the government is, of course -- in theory -- by and for the people. But that does not quite explain the lack of popular anger at the well-paid people who seem not to be very good at their jobs.

Since the credit crisis burst out into the open in June 2007, inflation has risen and economic growth has faltered. The dollar exchange rate has weakened, the unemployment rate has increased and commodity prices have soared. The gold price, that running straw poll of the world's confidence in paper money, has jumped. House prices have dropped, mortgage foreclosures spiked and share prices of America's biggest financial institutions tumbled.

One might infer from the lack of popular anger that the credit crisis was God's fault rather than the doing of the bankers and the rating agencies and the government's snoozing watchdogs. And though greed and error bear much of the blame, so, once more, does human progress. At the turn of the 21st century, just as at the close of the 19th, the global supply curve prosperously shifted. Hundreds of millions of new hands and minds made the world a cornucopia again. And, once again, prices tended to weaken. This time around, however, the Fed intervened to prop them up. In 2002 and 2003, Ben S. Bernanke, then a Fed governor under Chairman Alan Greenspan, led a campaign to make dollars more plentiful. The object, he said, was to forestall any tendency toward what Wal-Mart shoppers call everyday low prices. Rather, the Fed would engineer a decent minimum of inflation.

In that vein, the central bank pushed the interest rate it controls, the so-called federal funds rate, all the way down to 1% and held it there for the 12 months ended June 2004. House prices levitated as mortgage underwriting standards collapsed. The credit markets went into speculative orbit, and an idea took hold. Risk, the bankers and brokers and professional investors decided, was yesteryear's problem.

Now began one of the wildest chapters in the history of lending and borrowing. In flush times, our financiers seemingly compete to do the craziest deal. They borrow to the eyes and pay themselves lordly bonuses. Naturally -- eventually -- they drive themselves, and the economy, into a crisis. And to the scene of this inevitable accident rush the government's first responders -- the Fed, the Treasury or the government-sponsored enterprises -- bearing the people's money. One might suppose that such a recurrent chain of blunders would gall a politically potent segment of the population. That it has evidently failed to do so in 2008 may be the only important unreported fact of this otherwise compulsively documented election season.

Mary Yellin would spit blood at the catalogue of the misdeeds of 21st-century Wall Street: the willful pretended ignorance over the triple-A ratings lavished on the flimsy contraptions of structured mortgage finance; the subsequent foreclosure blight; the refusal of Wall Street to honor its implied obligations to the holders of hundreds of billions of dollars worth of auction-rate securities, the auctions of which have stopped in their tracks; the government's attempt to prohibit short sales of the guilty institutions; and -- not least -- Wall Street's reckless love affair with heavy borrowing.

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For every dollar of equity capital, a well-financed regional bank holds perhaps $10 in loans or securities. Wall Street's biggest broker-dealers could hardly bear to look themselves in the mirror if they didn't extend themselves three times further. At the end of 2007, Goldman Sachs had $26 of assets for every dollar of equity. Merrill Lynch had $32, Bear Stearns $34, Morgan Stanley $33 and Lehman Brothers $31. On average, then, about $3 in equity capital per $100 of assets.

"Leverage," as the laying-on of debt is known in the trade, is the Hamburger Helper of finance. It makes a little capital go a long way, often much farther than it safely should. Managing balance sheets as highly leveraged as Wall Street's requires a keen eye and superb judgment. The rub is Wall Street, sweating to fill out this year's bonus pool, runs itself and the rest of the American financial system right over a cliff.

A LIBRARY OF MARKET MAYHEM

Some classic nonfiction and fiction on financial troubles.

'L'Argent' by Émile Zola (1891)

First published as a newspaper serial, Zola's "L'Argent" ("Money") tells of Aristide Saccard, a down-and-out financier who founds a bank. As speculation flourishes, Saccard goes to great lengths to keep the stock rising, lying to investors and covering up schemes.

'Little Dorrit' by Charles Dickens (1855-57)

The novel features Mr. Merdle, a banker whose schemes lead to financial ruin for many.

'Extraordinary Popular Delusions & The Madness of Crowds' (1841)

Scottish writer Charles Mackay's classic examines the psychology of crowds, touching on everything from the popularity of beards to witch hunts. The last three chapters look at financial manias, such as the Dutch tulip bubble of the 17th century.

'The Great Crash 1929,' by John Kenneth Galbraith (1954)

A best seller when it was first published in 1954, this book by the noted Harvard economist details the U.S.'s most famous crash and the events that precipitated it.

It's just happened, in fact, under the studiously averted gaze of the Street's risk managers. Today's bear market in financial assets is as nothing compared to the preceding crash in human judgment. Never was a disaster better advertised than the one now washing over us. House prices stopped going up in 2005, and cracks in mortgage credit started appearing in 2006. Yet the big, ostensibly sophisticated banks only pushed harder.

Bear Stearns is kaput and Lehman Brothers is reeling, but Morgan Stanley perhaps best illustrates the gluttonous ways of Wall Street. Having lost its competitive edge on account of an intramural political struggle, the firm, under Chief Executive John Mack, set out to catch up to the rest of the pack. In the spring of 2006, it unveiled a trillion-dollar balance sheet, Wall Street's first. It expanded in every faddish business line, not excluding, in August 2006, subprime-mortgage origination (the transaction, intoned a Morgan Stanley press release, "provides us with new origination capabilities in the non-prime market, which we can build upon to provide access to high-quality product flows across all market cycles"). Nor did it pull in its horns as the boom wore on but rather protruded them all the more, raising its ratio of assets to equity to the aforementioned 33 times at year-end 2007 from 26.5 times at the close of 2004. Naturally, it did not forget the help. Last year, Morgan Stanley paid out 59% of its revenues in employee compensation, up from 46% in 2004.

Huey Long, who rhetorically picked up where Lease left off, once compared John D. Rockefeller to the fat guy who ruins a good barbecue by taking too much. Wall Street habitually takes too much. It would not be so bad if the inevitable bout of indigestion were its alone to bear. The trouble is that, in a world so heavily leveraged as this one, we all get a stomach ache. Not that anyone seems to be complaining this election season.

James Grant is the editor of Grant's Interest Rate Observer.