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# The Whiskey Breath of Wall Street

Social disapproval is the mother of invention ...

**T**he *Poker Face of Wall Street* (John Wiley & Sons, 2006) argued that the modern global derivatives economy evolved from the game of poker. Not surprisingly, the book is popular among poker players and financial traders, and got good reviews from journalists and economists. However, some financial people thought it besmirched the fair name of finance by alleging a gambling ancestry (a smaller number of poker players had the opposite complaint). One critic rhetorically (I think) asked if my next book was going to be *Shit Faced on Wall Street*.

I like that title, but it's a bit strong, so I went with the one you see above. Whiskey was an important early influence on modern finance. Why does finance have such disreputable associates? In addition to gambling and drinking, they include slavery, drug dealing, piracy, smuggling, and war. It's interesting that sex is absent from that list, prostitution is always a cash-and-carry (so to speak) business, without complex financial arrangements. Perhaps if we included less direct sex/money exchanges, like marriage, divorce and what you can expect if you pay for dinner, we'd find some sex-inspired financial innovations.

Things everyone approves of can be organized openly, without a lot of cleverness. It is social disapproval that creates the necessity that is the mother of financial invention — inventions which are later used to organize mainstream legal businesses and governments and even sometimes used honestly. At that point, financial professionals want to invent nobler parentage for their craft. But the unexpurgated history is a lot more fun, and a more reliable guide to making real money decisions.



*From the start Finance had some disreputable associates ...*

Financial traders are always looking for anomalies, things that don't fit the pattern. Great trading ideas begin with anomalies. Here's an example of one. In 1750, Scotland was the poorest country in Europe, with virtually no cultural or economic products exported beyond its borders. A century later, it was the richest coun-

try in Europe, with the leading universities and thinkers in science, medicine and philosophy. A wide variety of its luxury goods were shipped throughout the world. In 1750, the interior of North America was even poorer with fewer exports than Scotland. By 1850, it was the engine of growth for the world economy. It did-

n't have universities or scholars to match Scotland, but it had the majority of the world's great inventors and industrialists who would transform the 19th century. The five richest men in the world in 1890 were in the American West in 1850. No other places in the world had comparable changes during this period.

What do these areas have in common? One thing that immediately jumps to mind is that the world's great whiskeys, with apologies to Ireland, Canada, and Japan, come from two places: Scotch from Scotland and Bourbon from Kentucky and Tennessee. Moreover both places had strong populist movements galvanized by popular disaffection with whiskey taxes imposed by faraway governments: the uprisings associated with Cromwell's Malt Tax in Scotland and the Whiskey Rebellion in the United States west of the Appalachians.

Where does the finance connection come in? Until the last couple of centuries, whiskey was primarily a financial product. It could get you drunk, just like today, but that wasn't the main reason people made it. I know this because it wasn't made everywhere. Most places are content to ferment fruit into wine or grain into beer. Distillation is a lot of work. It requires considerable skill and expensive specialized machinery. Both the manufacture and consumption are dangerous, and even the highest quality product is an acquired taste.

The distilled product has two advantages: it weighs less to ship a given amount of alcohol and it is less apt to spoil (but with early distillation attempts, you could argue that the product was spoiled at the outset). Both attributes make distilled spirits better for long-distance trading so various kinds of brandies and fortified wines were developed near trading centers. They were high quality products, because luxury goods cost no more to ship than lower quality goods, but have higher profit margins.

In the 18th century, neither Scotland nor Kentucky was connected to world markets, and the whiskey each produced was not a high-quality export product. However, whiskey was traded actively in local markets. Ease of transport and durability, the qualities that make distilled spirits good for long-distance trade, are also essential

features of money. Whiskey had the additional feature of reasonably standardized quality. A great port or cognac is a matter of opinion, but whiskey can be easily evaluated by alcohol content and purity. Both Scotland and Kentucky suffered from severe shortages of silver money, so whiskey served as local money, which stimulated the economy (among other things).

Next comes an essential coincidence. During the Revolutionary War, the colonies formerly known as British had warm feelings about France because that country supported our efforts with money and troops. Virginia expressed this by naming some of its far west claims after General Marquis de Lafayette (Fayette County), King Louis

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XVI (the city of Louisville), his palace (the city of Versailles), and his dynasty (Bourbon County). That last one's important. After the war as the population in the area increased, and especially after 1792 when Kentucky became a state in its own right, Bourbon County was broken up into smaller counties, one of which was named Bourbon. That led to people referring to northeastern Kentucky as "Old Bourbon," to distinguish the original large region from the newly-named smaller county.

Oak barrels were one of the export items from Old Bourbon. These were branded with the region of manufacture, and shipped down the Ohio River. They were shipped filled because there's little extra cost to adding the weight in river transportation. The French speakers in St. Louis, of course, had their hearts warmed by seeing old Louis' name (he had been decapitated in the French Revolution by this time) on the barrel, but it was the "old" that electrified them.

You'll understand why if you've been to the French Caribbean island of Guadeloupe. The food is wonderful, and many of the best restaurants

are in single family houses with small kitchens. They prepare meals for one table at a time, so if you arrive and three tables have not yet had their food, you have a two or three hour wait before dinner. That would pose a problem in Manhattan, but in Guadeloupe, they put a free bottle of *rhum* on the table, with a dish of limes and raw sugar, and the longer you wait, the more you can drink. Add a view of a topless beach, or if it's too dark for that, Caribbean stars and phosphorescent fish, and who cares how long the food takes?

That's "*rhum*" to a French speaking North American, but there's also "*rhum vieux*," an extraordinarily smooth and complex drink more like brandy than the stuff you make rum-and-

cokes from and civilized restaurants give away free. *Rhum vieux* is a very long way from free. "*Vieux*," of course, is French for "old," so when the *monsieurs* from St. Louis saw "*Bourbon vieux*," they rushed for their *verre ballons* (snifters, that is).

One taste, and they had to smash the crystal because it was ruined for anything drinkable. The stuff in the kegs was raw corn likker but the St. Louis merchants decided it was either turpentine or some chemical used to cure the barrel. They shipped it right down the Mississippi to New Orleans.

The New Orleans merchants were also French and had the same initial reaction. But they did figure out the stuff inside was alcohol. The quality was so low it would only be served in the worst waterfront bars. Afterwards, the barrels were knocked apart to be shipped to Scotland, where whiskey makers had been deprived by war of their usual supplies of barrels from Jerez in Spain. Of course, New Orleans was supposedly on the same side of the war as Spain, but in the Caribbean it was (and is) easy for goods to change nationality discretely.

## The money shortages in Scotland that led to whiskey money also led to banks that would lend money for risky endeavors for more than 90 days

I don't know how a barrel made it to Scotland filled with the corn likker. I like to think that a ship's purser decided to save money by buying the cheapest rotgut in New Orleans instead of the crew's usual ration of rum. The crew took one taste and threw the purser overboard; the barrel remained untouched until it got to Scotland. In any event, the important thing is the barrel came to the attention of a 20-year old medical student named James Crow. If you're thinking "Old Crow," you're way ahead of me. If you thought "Old Crow" was an Indian name, or don't know what it is, you're way behind me.

My guess is the purserless ship's crew decided to sell the stuff as something to preserve medical specimens, which is why James ended up with it. All we know is he sipped it and wondered why someone would sell a barrel of pretty good whiskey for the price of the barrel. He did some research and discovered the stuff was mistaken for turpentine in St. Louis, considered barely drinkable in New Orleans, and was decent whiskey in Scotland. Having a scientific turn of mind, he figured out the secret was *quercus alba*, the oak used for the barrel. It is native to North America, and is one of only three species suitable for aging spirits (the other two are found in Europe, *quercus robur* and *quercus petraea*, and are inferior).

Okay, now for a little finance. There were a variety of institutions at this time that were called "banks," but some didn't lend money at all, and the ones that did lent only on security of goods in production or transport, and only for short periods of time. Except in Scotland. The money shortages in Scotland that led to whiskey money also led to banks that would lend money for risky endeavors for more than 90 days. Of course, they didn't have much money (remember, poorest country in Europe), so they needed small, high profit potential ideas.

Crow's small, high profit potential idea was to sail to Philadelphia, travel to Kentucky and start shipping these magic barrels to Scotland. If they could turn turpentine into pretty good whiskey, imagine what they would do with good stuff!

When Crow arrived in Kentucky, he found

the cheapest barrels were ones that had been sent down to New Orleans filled with liquor for sailors, and returned filled with salted fish. To get the fish taste out, he had to char the inside of the barrel. He also discovered what the natives already knew, the low-iron limestone water and sweet maize were perfect for making spirits. Crow's scotch whiskey experience and scientific training led him to make many improvements to the initial manufacture of the whiskey. The result was so good, the wealthy Southern plantation owners started drinking the stuff before it could get to New Orleans, and it became the regional drink of choice. Bourbon today is still made in charred oak barrels, which are then shipped to Scotland and used for scotch.

The story does not end there. Crow had established a connection between venture capital in Scotland and the unlimited natural resources of interior North America. Moreover he set up a regular, circular trade network. Information flows along with goods. The Scots were branching out all over the world as the British Empire expanded, working as merchants, army officers, doctors and missionaries (leading to the more-true-than-funny joke that the Empire was won by the Irish in the name of the English for the benefit of the Scots). This worldwide network was connected, far from the attentions of governments and rich people, with adventurers from all over the world opening up the mines, forests, farmlands, ranches and other riches of North America. It evolved into a dynamic economy organized by futures exchanges like the Chicago Board of Trade, which gave the world derivatives, which took over the financial world in the 1970s and rule it today.

Of course, Scotland was not the only country that played a part in this drama, and whiskey is not the only link between Scotland and Kentucky, and Crow was not the only whiskey innovator and diplomat. But if you make a fortune trading derivatives, it's entirely appropriate to have a good single malt or small batch bourbon to celebrate. And if your job and dreams are wiped out by derivatives traders, have one to ease the pain. For better or worse, there's whiskey breath on Wall Street.