NBER WORKING PAPER SERIES

DID J.P. MORGAN'S MEN ADD VALUE? A HISTORICAL PERSPECTIVE ON FINANCIAL CAPITALISM

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Working Paper No. 3426

NATIONAL BUREAU OF ECONOMIC RESEARCH
1050 Massachusetts Avenue
Cambridge, MA 02138
August 1990

I would like to thank George Alter, Michael Bordo, David Corbett, Greg Clark, Bill Lazonick, Perry Mehrling, Dan Raff, Elyse Rotella, Andrei Schleifer, Mike Spagat, Eugene White, members of the Cliometrics Society, and participants in seminars at Rutgers, the University of Michigan, and Indiana University for helpful discussions. This paper is part of NBER's research program in Financial Markets and Monetary Economics. Any opinions expressed are those of the author and not those of the National Bureau of Economic Research.

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ABSTRACT

The pre-WWI period saw the heyday of "financial capitalism" in the United States: the concentration of securities issues in the hands of a few investment bankers which had substantial representation on corporate boards of directors. This form of organization had costs: it created a conflict of interest that allowed investment bankers to heavily tax operating corporations. It also had benefits: investment banker representation on boards allowed bankers to monitor the performance of firm managers, quickly replace mangers whose performance was unsatisfactory, and signal to ultimate investors that a company was well managed and fundamentally sound. The presence on one's board of directors of a partner in J.P Morgan and Co. was associated with a rise of perhaps 30 percent in common stock equity value. Some share of the increase in value almost surely arose because investment banker representation on the boards of competing companies aided the formation of oligopoly. But the development of similar institutions in other countries that like the Gilded Age U.S. experienced exceptionally rapid economic growth-Germany and Japan are the most prominent examples-suggests that a substantial share of value added may have arisen because "financial capitalism" improved the functioning of financial markets as social capital allocation mechanisms.

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I. Introduction

In the years before World War I, a corporate security flotation worth more than $10 million invariably passed through the hands of one of a very small number of investment banking houses—J.P. Morgan and Co.; Kuhn, Loeb, and Co.; the First National Bank; the National City Bank; Kidder, Peabody, and Co.; and Lee, Higginson, and Co.[1] The partners and directors of these institutions were directors, voting trustees, or principal stockholders of financial and non-financial corporations with a total market capitalization—debt plus equity—including subsidiaries of perhaps $30 billion.[2] To place this quantity in perspective, this sum bore the same relation to the size of the U.S. economy that $7.5 trillion would bear today: it amounted to about one and a half times a year's national product, and to perhaps forty percent of the country's produced capital stock (Goldsmith, 1954). Investment bankers profited immensely from their role as the key middlemen on Wall Street: the commissions on the flotation of United States Steel were as large a share of the American economy then as $15 billion would be today.

American finance just before World War I was thus several orders of magnitude more concentrated than it has been at any time since World War II. Financiers possessed strong voices, or at least strong potential voices, in corporate management. The implications of this concentration of finance—this "money trust"—and its influence was a major political flashpoint of the first half of this century. Progressives and their allies feared this money trust in finance as an evil much worse and more dangerous than any monopoly in an individual industry. For finance to be concentrated, and for industry to be beholden to finance, was in their eyes a deeply disturbing departure from their populist ideal of small firms and competitive markets.

Historians, by contrast, have often been more approving of the large financial organizations and deals of the Gilded Age and Progressive Era. Alexander Gerschenkron (1962) argued

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[1] When questioned by Samuel Untermyer, chief counsel and guiding spirit of the investigating Pujo Committee (chaired by Louisiana Representative Arsene Pujo), First National Bank Chairman George F. Baker was "unable to name a single issue of as much as $10,000,000... that had been made within ten years without the participation or cooperation of one of the members" of the small group of dominant investment banks. Public securities issues by the members of the investment banking oligarchy then amounted to about $500 million a year.

[2] The Pujo Committee report (Pujo, 1913b) gives a smaller number. Louis Brandeis (1914) points out that the Pujo calculations neglect partially-owned subsidiaries' capitalization not owned by the parent company.

that the heavy capital requirements of the modem technologies of the turn of the century required large firms and large banks. Lance Davis (1963) wondered whether Great Britain's apparent relative failure after 1870 might be linked to its failure to develop "finance capitalist" institutions like those present in Germany and the United States.

Economic theory provides little guidance, as it does not speak with one voice about "financial capitalism." In the early 1970's conglomerate stocks appeared to sell for more than the value their operating companies would bring standing alone. It was then used argued that informed investors are scarce—that it is difficult to assess the prospects of individual industrial firms—and that those skilled at making such assessments could add value by forming conglomerates, closely watching managers, and serving as "miniature capital markets" that direct new resources to areas of greatest opportunity (Williamson, 1975).[3]

The end of the conglomerate boom and stasis in the market for corporate control followed in the 1970's; theoretical arguments were then advanced that the absence of "financial capitalism"—in the sense of an active market for corporate control and of financiers' monitoring managers—would not lead to large efficiency losses. In a world of informed investors, a firm's stock price serves as a signal of its performance; managers can be provided with the correct incentives to act in the interest of shareholders, their principals, by tying their compensation to the stock market's valuation of the firm (see Jensen and Meckling, 1976).[4]

In the early 1980's the relatively close links between banks and industrial firms in the successful Japanese *keiretsu* became the focus of attention. Some observers (for example, Thurow, 1986) then argued that the absence today of links between finance and industry characteristic of the "money trust" is a serious weakness in the U.S. capital market, but today Thurow calls his preferred system "merchant banking" rather than "financial capitalism" or "money

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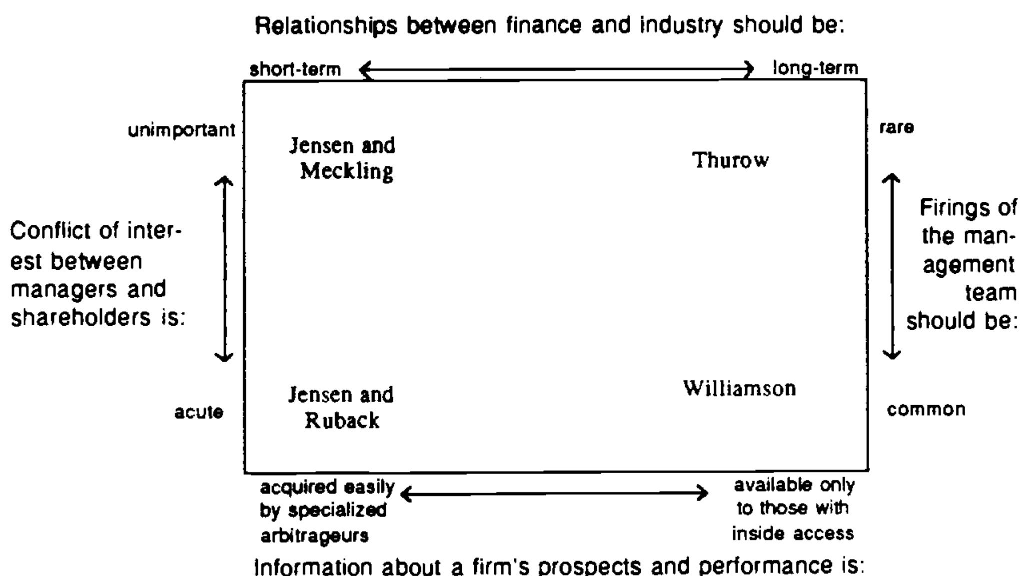
[3] Williamson estimated the transactions costs associated with the exercise of stockholder control over management at fourteen percent of equity value. Since these large costs block the exercise of stockholder control over managers and there "lurks the suspicion that these enclaves of private power will run amok," Williamson argues that conglomerates evolved to do what stockholders cannot do: "organizational innovations... have mitigated capital market failures by transferring functions traditionally imputed to the capital market to the firm instead."

[4] Shareholders can make a manager's incentives congruent with their own by tying his compensation to stock returns even when their interest is his dismissal. English investors obtained Jay Gould's resignation from the Erie Railroad by pointing out that it would trigger a large rise in the stock price which would give Gould substantial gains on his holdings.

trust." The diversification and LBO booms of the 1980's have seen a fourth group (as in Jensen and Ruback, 1982) emerge to argue that there is a substantial difference between managers' and shareholders' objectives. Good market performance then requires an active market for corporate control, and perhaps such a market works best when changes in management are set in motion not by merchant bankers or conglomerate CEO's with long-term links to and thus special knowledge of a particular industrial corporation, but instead by free-lance raiders who have developed expertise in assessing firms' performance in general.[5]

FIGURE 1
THEORETICAL DESCRIPTIONS OF APPROPRIATE CAPITAL MARKET STRUCTURE



If expertise to monitor managers is scarce, it would be inefficient to waste it by long-term links between scarce financiers and industrial corporations. But if monitoring managers requires detailed knowledge of the business, financiers can be useful only with such links. If he conflict of interest between managers and owners is minimal, financier intervention should be rare. But if the conflict of interest is acute managers should frequently be dismissed. Arguments have been

[5]Jensen (1989) takes a more Thurovian position, criticizing "...the dangerous tendency of LBO partnerships...to take more of their compensation in front-end fees rather than in back-end profits earned through increased [long-run] equity value."

advanced for all four possible views on the questions of should links between financiers and firms be long-term, and should financier firings of managers be common.

This paper tries to put some empirical meat on the theoretical bones of the relationship between finance and industry. It tries to untangle the question of what the money trust actually was—what J.P. Morgan and Co. did to add value, where their initial comparative advantage came from, and why the investment banking industry was so concentrated at the turn of the century. Such a study is of obvious historical interest. J.P. Morgan and Co. must have had some striking competitive edge in order to maintain its dominance over American finance at the turn of the century: if not, such a profitable business should have seen the rapid arrival of new competitors to reduce the magnitude of the wealth to be earned. The Morgan-headed "Money Trust" remained a fixed point for more than a generation while all was in flux around it.

Such a study could be of direct interest to those concerned with the regulation of today's securities markets. Perhaps the forces which allowed Morgan and Company to become the focus of the turn-of-the-century capital market are still at work today. In such a case, how the turn-of-the-century market functioned carries information about how today's markets ought to function. On the other hand, perhaps styles of management, means of gathering information, and shareholders' ability to discipline rogue management have all changed sufficiently that capital market institutions that were effective in 1900 would be ineffective today. A look, however, at Germany and Japan—which appear to have kept many "finance capitalist" institutions throughout the past century—leads one to suspect that institutions that were effective in 1900 would still be effective in 1990.

The tentative conclusions I reach are most hospitable to Lester Thurow's position. Morgan and his partners saw themselves, and other participants in the pre-World War I securities industry saw them, as filling a crucial "monitoring" and "signalling" intermediary role between firms and investors in a world where information about firms' underlying values and the quality of their managers was scarce. In such a world it was valuable for a firm to have the stamp of approval from Morgan and Company with its established reputation. The presence of Morgan's men meant that when a firm got into trouble—whether because of "excessive competition" or

management mistakes—action would be taken to restore profitability. The presence of one of Morgan's men may also have reassured investors that a firm appearing well-managed and with bright prospects actually was well-managed and did have bright prospects.

In addition, high concentration may well have played a role in supporting "financial capitalism," in which investment bankers monitored firms and warranted their quality to ultimate investors. A firm with a large market share reaps large benefits from reputation, and will not be tempted to jeopardize it for any one deal. A firm with a small share may decide to "cash in" its reputation by luring investors into a profitable deal that is unsound—as Standard Oil magnates H.H. Rogers and William Rockefeller may have done with Amalgamated Copper (see Lawson, 1904) and as Jay Gould apparently did with the Erie Railroad (see Adams and Adams, 1871). A firm with a small market share might find itself unable to compete with Morgan and Co. or Kuhn, Loeb because no one trusted it not to sacrifice its reputation for immediate profit.

The disadvantages of financial concentration stressed by progressives were present. Conflicts of interest were frequent and potentially severe. Often "Morganization" meant the creation of value for shareholders by the extraction of monopoly rents from consumers: if Westinghouse and G.E. share controlling directors, their competition is unlikely to be too intense.[6] And First National Bank Chairman George Baker sat on the boards of six railroads that together carried 80 percent and owned 90 percent of Pennsylvania anthracite. But there were positives on the other side—positives apparently strong enough to support Morgan dominance over potential competitors for more than a generation. And the breaking of financier control over managers raised a new worry: is better to have managers responsible to no one than to financiers? (See Berle and Means, 1932.)[7]

[6] An explicit watchword in Morgan reorganizations was "community of interest": as long as the Pennsylvania Railroad held a large block of Erie Railroad stock, the Pennsylvania would suffer if its actions undercut the profits of the Erie. On the other hand, as Kolko (1963) points out, industries in which financiers could preserve monopoly by strangling competitors at birth were almost nonexistent. And Brandeis allowed that "lately...the Westinghouse people were complaining that the General Electric's competition was unfair" even though Lamont was a director of one and Steele a director of the other. See Lamont (1913).

[7] An issue present but unnoted in the Pujo report. On the one hand, the report stresses how shareholder apathy allows investment bankers to exercise dominant roles in choosing directors with only a minority of the stock. On the other hand, it calls for direct election of directors and managers by the small shareholders. The possibility that shareholder apathy implies that the elimination of financial capitalism would produce complete managerial autonomy is not considered. Faced with executives who wished to retain absolute control over the railroads they ran, Morgan's response was "Your railroad? Your railroad belongs to my

II. The Money Trust

Concern over the "money trust"—the concentration of the business of issuing the securities of large corporations in the hands of a few banks among which the most prominent was J.P. Morgan and Co., and the associated presence of these investment bankers on boards of directors —dominated the public policy debate over the appropriate role of government in the securities industry for the first third of this century. The debate was resolved only by the Great Depression. The presumed link between the stock market crash and the Depression left the securities industry without political defenders. The Glass-Steagall act broke the links between board membership, investment banking, and commercial banking-based management of asset portfolios that had marked American finance between 1890 and 1930 (see Seligman, 1982), thus fulfilling the progressive desire that "the arteries of credit now clogged well nigh to choking by [the money trust] ...[be] opened [so]... business can be conducted on its merits instead of being subjected to the tribute and good will of this handful of self-constituted trustees of the national prosperity" (Pujo, 1913).

In retrospect, it is surprising that "financial capitalism" in America lasted so long, given the heat of the political hostility to it. The money trust was subject to two major congressional investigations, the first in 1912-3 by a special House committee chaired by Arsené Pujo and counseled by Samuel Untermyer (triggered by the approach of a Presidential election and Minnesota Congressman Charles Lindbergh's denunciation of the money trust: see Cleveland and Huertas, 1987);[8] the second in 1932-3 by the Carter Glass-chaired Senate Banking Committee, counseled by Ferdinand Pecora and perhaps triggered by Herbert Hoover's belief that the NYSE was allowing short sellers to depress the market and so hindering recovery from the Depression (Seligman, 1982).

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clients..." (see Allen, 1935). The elimination of the investment banker willing to watch over and monitor the company produces the problems of managerial discretion outlined by Berle and Means (1932).

[8]Lindbergh's son Charles, the aviator, was to marry the daughter of then Morgan partner Dwight Morrow, later U.S. ambassador to Mexico. Like Rome's *optimates* and *populares*, progressives and robber barons moved in similar and connected social circles.

Progressives like Louis Brandeis were sure that the Morgan and Co.-headed money trust exercised enormous control over industry, and that such control was a bad thing. Brandeis, ever sensitive to conflicts of interest, saw the money trust as a "concentration of distinct functions... beneficent when separately administered [but]... dangerous... when combined." The money trust's possession of monopoly power in the business of issuing securities imposed an unreasonable tax on all companies raising money in the capital market. And the links between corporate boards, investment bankers, and portfolio managers—First National Bank head George F. Baker was on the board of A.T. & T. and the prime mover behind A.T. & T.'s appointment of Theodore Vail as its president; Morgan partner George W. Perkins was also a director of New York Life, which invested heavily in securities underwritten by the Morgan partnership—created a serious conflict of interest. Corporations sought to get as much for their securities as possible, and saving institutions sought to obtain high returns.

Investment bankers like Baker and Perkins were thus in a position to sacrifice the interests of one set of principals to the other—or to increase the spread they received as middlemen.[9] Perkins, testifying before Pujo and Untermyer, believed that he could determine whether a deal had come to him in his capacity as Vice President of New York Life or as partner of J.P. Morgan and Co. and bargain accordingly.[10] The Pujo committee and Brandeis were unconvinced, concluding in Brandeis' words that:

> ...interlocking directorates... must be effectually prohibited before the freedom of American business can be regained. The prohibition will not be an innovation. It will merely give full legal sanction to the fundamental law... that "No man can serve two masters." The surprising fact is that a principle of equity so firmly rooted should have been departed from at all.... For no rule of law has... been more rigorously applied than that which prohibits a trustee from occupying inconsistent positions.... And a director of a corporation is as obviously a trustee as persons... called specifi-

[9] For Brandeis, the freezing of individual initiative because few dared to run the risk of crossing Morgan appears to have been an equally serious problem. As Brandeis said to Lamont: "You may not realize it, but you are feared, and I believe the effect of your position is toward paralysis rather than expansion..." (see Lamont, 1913).

[10] But as National City Bank president Frank Vanderlip wrote, "There were times during [E.H. Harriman's] life... when I opposed underwriting fees because I felt they were too high. As a director I believed my obligation of trusteeship ran to the stockholders, and not to Mr. Harriman. I have in mind recollections of occasions when it was pointed out to me, in a hurt tone, that the City Bank was sharing in those underwriting profits that I thought were too fat..."

cally by that name.

Many contemporary historians of the U.S. financial industry appear to believe that there never was a "money trust" in Brandeis' pejorative sense.[11] Vincent Carosso, for example, argues that investment bankers did not have a lock on their traditional clients. He argues instead that there was "very frequently interference or attempted interference," as Kuhn Loeb head Jacob Schiff told Samuel Untermyer (Carosso, 1970; Pujo, 1913).[12] Carosso further points out that Untermyer knew that there was no "unlawful industrial combination" in finance, and could only proceed by redefining "money trust" as a "loose, elastic term" meaning a "close... understanding among the men who dominate the financial destinies of our country and who wield fabulous power.. through their control of corporate funds belonging to other people." And he concludes that Untermyer was unable to demonstrate "the existence of a money trust... even in the sense in which... [he] defined it":

> The concentration of banking capital in a few New York City institutions was neither planned nor brought about by a few financiers... [but] was the result of the growing needs of a burgeoning economy... an inadequate and poorly functioning banking system... and... the natural consequence of 'economic laws which in every country create some one city as the great financial center'.... The committee's detailed tables and charts on interlocking directorates were equally misleading.... [The bankers did not] purposely act together; and even if they had, they would have been unable to impose their will upon the other directors... always more numerous than the representatives of Wall Street" (Carosso, 1970, p. 151).

In a similar vein, Cleveland and Huertas (1985) also dismiss the existence of a "money trust." They argue that the industry in which Morgan and his peers were engaged was contestable: anyone could accept a block of securities, and then knock on doors until he found willing buyers who would take the placement. They argue that Untermyer, at least, was guilty of bad

[11] In this they take a different tack than earlier historians like Fritz Redlich (1954).

[12] The Committee interpreted Jacob Schiff's evidence differently than Carosso, focusing instead on Schiff's assertion that he did "not think that another banking house of the standing of J.P. Morgan and Co. would accept an offer of the Union Pacific Company to negotiate its securities while it [Union Pacific] was in the hands of Kuhn, Loeb, and Co." The Committee concluded that there was little competition in the business of underwriting securities for large companies.

faith in his investigation.[13] The politically-ambitious Untermyer, Cleveland and Huertas say, as "an aspiring politician the assignment [as counsel to the Pujo Committee] was a godsend." But unfortunately, "not knowing... such an opportunity would come his way, Untermyer had stated in November 1910, 'The fact is that monopolies and substantial domination of industries created in that form could be counted on the fingers of your hand', and he [had] attacked 'political partisans who seek to make personal and Party capital out of a demagogic appeal to the unthinking" (Cleveland and Huertas, 1985, pp. 359-60; citing Kolko, 1963, p. 220).[14] Pecora also is dismissed as a politician seeking press coverage.[15]

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[13]On the other hand, no one (with the exception of NY, NH, and Hartford President Mellen, who suggested Brandeis was working for Boston interests who wanted to loot the railroad) has challenged Brandeis' good faith. Brandeis claimed that his belief in the power of the "money trust" came "...from my own experience....I found that the policy of the New Haven...was loading it down so that...it could not possibly bear the burden....I went to some of the leading Boston bankers....I said—'If this thing continues, the New Haven is going to be bankrupt. Won't you please act in this manner and call Mr. Morgan's attention to it'. Their reply...was that they would not dare to...that the New Haven was Mr. Morgan's particular pet, that he resented any interference...and that it would be as much as their financial life was worth to try to poke their fingers in." See Lamont (1913).

[14]Cleveland and Huertas could have made their indictment stronger. During the formation of Amalgamated Copper, Standard Oil financiers William Rockefeller and H.H. Rogers reportedly discovered that Untermyer was heavily leveraged and forced Untermyer to sign over a mine under threat of being driven into bankruptcy by sudden Rockefeller short selling. This alleged episode—that when Untermyer tried to play with the Robber Barons he lost—may have played a role in Untermyer's subsequent conversion to progressivism. Untermyer tried very hard to subpoena the aging William Rockefeller so that he could examine him on the formation of Amalgamated. See Lawson (1907) and Pujo (1913).

Cleveland and Huertas do not use the tangled relationships between National City Bank President Stillman, Standard Oil magnate William Rockefeller, and lawyer Untermyer to discredit Untermyer. This sword, however, cuts both ways. Stillman's successor as City Bank President, Frank Vanderlip, judged participations in which William Rockefeller appeared on both sides of the deal as "the means of some of the worst abuses that occurred in Wall Street" (Vanderlip and Sparkes, 1935). And Redlich says that the "element of power in business can be sensed... and... becomes evident when William Rockefeller, for instance, 'declared himself in'...on 25 percent of the profits from a New York Central flotation handled by the National City Bank."

[15]Reading the transcripts of the hearings, it is easy to dislike Untermyer and Pecora. Untermyer appears to have had no "theory of the case": He bullies Chicago professor J. Laurence Laughlin, accusing him of being a shill for the money trust in his advocacy of banking system reform—and, worst of all, of having compounded his fault by trying to hide his dependence by refusing to accept money from bankers to fund his National Citizens' League. One moment he attacks Morgan for causing the panic of 1907. The next moment he attacks Morgan for trying to stop the panic by getting the New York Clearing House to issue certificates that circulated as money during the 1907 panic, thus arrogating to himself "a right that is not possessed by other banks or individuals... to have a currency of their own." And the next he attacks the Clearing House for calling its certificates too quickly when the panic has passed.

He attacks speculators like Jay Gould. Then he switches to another target, the stock exchange-created monopoly over the printing and engraving of stocks and bonds, without ever noting that Gould and Russell Sage tried to break this monopoly. And he sums up by painting these many actions as parts of a single grand conspiracy. Robber Barons are Robber Barons, but it is hard to believe that Untermyer conducted his investigation in good faith and made his accusations of conspiracy with clean hands.

Pecora devoted much time to establishing that J.P. Morgan, Jr., and his partners had paid no taxes in 1931 and 1932. He implied that such was the rule in good years as well as bad—working Americans paid taxes but Morgan partners did not. Morgan and Co. had no tax liability in 1931 and 1932 because the collapse of the stock market inflicted huge losses on the partnership; they had correspondingly heavy tax liabilities in the bull market of 1928 and 1929.

I, at least, find it much easier to like and respect Brandeis, and to respect Morgan.

III. The Money Trust's Public View of Itself

But Morgan's supporters and ideologues at the time—for example, the writer and journalist John Moody, founder of Moody's Investment Service—argued that there was a functioning money trust, and that its existence was a good thing. Moody thought that the debate was marked by "...a lack of sincerity on all sides." (Moody, 1904). According to Moody, control of firm managers by financiers was necessary given the need of enterprises for capital and the need of investors for trustworthy intermediaries to handle the selection of firms to invest in (Moody, 1904 and 1912). Without domination of boards of directors by the investment banking oligarchs, there would be no effective way for scattered individual shareholders to monitor the performance of corporate managers. Only investment bankers could effectively monitor firm managers, and the presence of investment bankers on boards signalled to ultimate investors that the firm management was competent and industrious.[16]

Defenders of Wall Street before the Depression thus argued not that economic power was decentralized and in the hands of industrialists, but rather that it was a good thing that power was centralized and in the hands of financiers. It is thus difficult to agree with Carosso and with Cleveland and Huertas that there was no "money trust"—that a few investment bankers did not exercise substantial control over industry—in the years before World War I. The existence of a "money trust," however, does not mean that Untermyer and Pecora were right to advocate its dismantling. Presumably the money trust arose for a reason and continued in existence because it offered investors some valuable services that, although high priced, could not be provided by potential competitors.

John Moody's positive view of the money trust was not his own invention. Moody's

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[16]Such a signal may have been especially valuable given the climate of the turn-of-the-century stock market. In the seven years 1906-1912 the speculative stocks of the Reading, U.S. Steel, Amalgamated Copper, and the Union Pacific turned over at average rates of 27, 5, 8, and 11 times a year, respectively: it took only 2 1/2 months for the cumulative shares of U.S. Steel traded to mount up to the total number of shares outstanding. Demand relative to the number of shares outstanding was extraordinarily volatile. Unless arbitrageurs' stabilizing influences were functioning extraordinarily smoothly, such volatile demand would be likely to lead to large short-run price fluctuations and make market prices poor signals of values. Under such circumstances, the value of signals —like Morgan's stamp—other than current price would be great.

Such a stamp of approval might be unwelcome to a manager who sought to profit by speculating on inside information. Richmond Terminal executive W.P. Clyde, for example, reportedly told Morgan that "I've bought Richmond Terminal at 7 or 8 and sold it at 15 twice in the last few years. I see no reason why I shouldn't do it again." He tried to block Morgan control.

view was more or less the consensus view held by the securities industry and was a commonplace in the early literature on investment banking. Willis and Bogen's early investment banking textbook, for example, argued that the:

> ...investment banker, intimately concerned as he is with the affairs of the corporation for which he has sold bonds, since the continued meeting of the obligation on these bonds is essential to the maintenance of the investment banker's prestige, often takes. ..a voice a control as a matter of course....This kind of power over the affairs of the borrowing enterprise represents the correlative of the moral responsibility which he has assumed toward the holder of the bonds or stock he has sold....[T]his management function...gives the buyer...an assurance that the banker has knowledge of what is being done by the borrowing concern, and also of better management...[and] ... explains why investors...place so much stress, in purchasing securities, on the character and reputation of the house of issue.... The history of American business has hitherto been marked by a steady increase in the influence of the investment banker for these reasons.... (Willis and Bogen, 1929)

The same assessment was made more pithily by New York, New Haven, and Hartford president Charles Mellen, in a private conversation with journalist C.W. Barron: "I wear the Morgan collar, but I am proud of it" (Pound and Moore, 1931).[17]

This assessment of the situation was also the official view of the industry. Morgan and Co. responded to Pujo by writing an open letter giving their view of the functioning of the securities market. This pamphlet (primarily written by Morgan partner Henry Davison) argued that the reason the partnership had control over investors' funds was: "thousands of investors... seeking...securities...have neither the knowledge nor the opportunity for investigating a great... enterprise." They "look to a banking house to perform those functions and to give its stamp of approval." Morgan and Co.'s approval had become "...a large factor which inspires confidence

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[17] A statement made in private and off the record—Barron's notes of his conversations were later found, edited, and published. A similar impression of Mellen's relationship to Morgan is given by Brandeis (in Lamont, 1913), who recalls that when he "hit upon a matter...of manifest advantage to the [New Haven rail]road, and through a friend I submitted it to Mr. Mellen. Mr. Mellen sent back word that he would submit it promptly to Mr. Morgan....Mellen's reply was that Mr. Morgan did not think well of the matter....At my behest, my friend went back to Mr. Mellen...asking if he would not submit it to Mr. Morgan once more. Mr. Mellen said—'What, go to Mr. Morgan a second time on a matter, after he has already expressed his opinion on it? No one would even dream of it!'"

in the investor and leads him to purchase...." The practice of banker representation on boards:

> has arisen not from a desire on the part of the banker to manage the daily affairs of the corporation or to purchase its securities more cheaply than he otherwise would; but rather because of his moral responsibility as sponsor for the corporation's securities, to keep an eye upon its policies and to protect the interests of investors in the securities of that corporation....Inquiry will readily develop the fact that the members of the leading banking houses...are besought continually to act as directors...and that in general they enter only those boards which the opinion of the investing public requires them to enter, as evidence of good faith that they are willing to have their names publicly associated with the management (Davison, 1913).[18]

Morgan and Co., moreover, argued that their influence over investors' choice of securities was not dangerous because it was disciplined by the market. If the firm lost its reputation for "character"—placed investors in securities that were profitable to it but offered poor returns—or another firm acquired a reputation as a superior judge of risk, Morgan control would disappear:

> The public, that is the depositors, are the ones who entrust bankers with such influence and power as they today have in every civilized land, and the public is unlikely to entrust that power to weak or evil hands. Your counsel asked more than one witness whether the present power held by bankers... would not be a menace if it lay in evil hands.... The only genuine power which an individual... can gain is that arising from the confidence reposed in him... by the community.... [M]en are entrusted with such heavy responsibilities because of the confidence which their records have established, and only so long as their records are unblemished to they retain such trusts. These... axioms... apply... more emphatically... to banking than to any other form of commerce. To banking the confidence of the community is the breath from which it draws its life. The past is full of examples where the slightest suspicion as to the conservatism, or the method's of a bank's management, has destroyed confidence and

[18]Lamont provided Brandeis with a similar justification of Morgan representation on boards, saying that "as you realize, we have generally drifted onto these various railroad and industrial boards because we had first undertaken to place a large block of the corporation's securities with our clients, and we felt a sense of responsibility to those clients which we fulfilled by keeping an eye upon the corporation in which they had invested. We have felt that that was a strong factor in enabling us to market these securities, and while the responsibility was a very onerous one, nevertheless, we shouldered it. Don't you think there is quite a little in that point?" Brandeis agreed that it was an important point, but saw no reason why bankers needed to exercise control rather than merely gathering information. See Lamont (1913).

drawn away its deposits overnight (Davison, 1913, pp. 25-6).[19]

The investment bankers saw their oligarchy and their presence on boards as having three benefits: First, investment banker representation on a board warranted that the firm was managed by capable and energetic executives. Promising and well-managed businesses would thus be able to issue securities on more favorable terms with investment banker representation.

Second, investment banker representation provided an easy way to learn about the performance of managers and to dismiss them if they failed to measure up. The investment banking oligarchs provided an effective mechanism for monitoring executives and replacing those who performed badly; in Morgan and Co.'s view such monitoring and supervision was more easily performed on the board than off it.

Third, the concentration of the business improved the functioning of the market. The wealth and dominant position of J.P. Morgan and Company depended on its reputation for character. A firm with a large market share could never be tempted to sacrifice its reputation for the sake of the profits of any one deal; a firm with a small market share might.

It is ironic that defenders of private property and capitalism like Moody and Davison wound up advocating a system for the assessment and allocation of investment that appears suspiciously socialist. The forty-five employees of Morgan and Co. approve and veto proposed top managers, decide what securities they will underwrite, thus implicitly decide what securities will be issued and what lines of business should receive additional capital. Savers follow their advice. And the net effect appears similar to what would be done by a centralized investment planning directorate. The major difference is that the judgment of Morgan and his partners is substituted for that of some bureaucracy in deciding which investment projects are to be undertaken.[20] Instead of being decided by a market, the allocation of investment and the choice

[19] J. P. Morgan and Co. never admitted that they possessed any sort of discretionary power. Lamont, for example, appears unable to understand Brandeis' unwillingness to accept his argument that market discipline constrained J.P. Morgan so tightly as to leave it no freedom to abuse its power. Lamont thinks, or at least, says, that this is an obvious matter of "fact" and not of "opinion."
[20] This is not quite right. On the one hand, Morgan and Co. are shareholders' agents, not the public's. On the other hand, Morgan and Co. have a strong incentive to run an efficient operation and make the "correct" investment decisions from shareholders' point of view: they face potential competition from Kuhn, Loeb, from National Citcy, and from others. Bureaucracies, by contrast, have many other objectives than the accomplishment of their legally-mandated mission.

of firm managers is decided by a hierarchy, albeit a loose one (and one that feels itself subject to market discipline in the long run in which the partnership can gain or lose its reputation for "character").

The negative effects of financial capitalism stressed by Untermyer and Brandeis are not blotted out by these investment-banker arguments that the structure of pre-Depression American finance served useful economic purposes.[21] The conflicts of interest identified remain conflicts of interest; the high fees and relative absence of competition for different firms' business remain a tax on the provision of capital to the industrial sector. But the financial capitalists publicly claimed that they saw themselves as providing value, at least to shareholders.

IV. Case Studies: International Harvester and AT&T

A brief examination of the role of investment bankers in the creation of International Harvester and the expansion of AT&T provides some confirmation that the money trust's public and official view of itself had at least some grounding in reality. The account of International Harvester presented below is taken largely from Garraty (1960); the account of AT&T from Paine (1921) and Brooks (1976). Both accounts stress that investment bankers played a powerful and limited role in that they took great care to make sure that the firms they watched had the right managers. A fair criticism, however, of these two case studies is that they examine successes—that in other firms investment banker intervention either failed to create value or created value only by creating monopoly. These criticisms will be partially addressed in section V below.

An opening to consolidate the farm machinery industry appeared at the beginning of the 1900's. The McCormick firm—established by the inventor of the reaper, Cyrus H. McCormick

[21]For Brandeis, at least, the key objection was in large part not economic but political and psychological. Brandeis tends to speak not of efficiency and productivity but of experimentation and individualism. He told Lamont that he saw J.P. Morgan's power as "dangerous, highly dangerous. The reason, I think, it that it hampers the freedom of the individual. The only way that we are going to work out our problems in this country is to have the individual free, not free to do unlicensed things, but free to work and to trade without the fear of some gigantic power threatening to engulf him every moment, whether that power be a monopoly in oil or in credit." See Lamont (1913).

—had been under heavy competitive pressure from the rapidly expanding Deering firm. Deering's founder, William Deering, died in 1901. His children were much less interested in running their firm and establishing competitive predominance over McCormick. The three sons of the original McCormick—Cyrus, Stanley, and Harold—were also eager to see a reorganization of the industry. But each family was also strongly averse to handing control of their firm over to the other.

There did appear to be substantial economies of scale to be gained by integrating the firms' production operations. U.S. Steel head Elbert H. Gary estimated that the stock of the amalgamated firm would be worth thirty-five percent more than the stock of the two separate firms. Moreover, he attributed this gain to efficiency improvements, writing that "this increase would not be fictitious but real value, owing to the fact that by a combination they would secure stability of prices and diminishing expenses even thought they did not secure increased average prices" (Garraty, 1960).

If monopoly power did allow the new, integrated firm to increase its average prices, the extra profits from amalgamation would of course be higher. J.P. Morgan and Co. felt that such monopoly power would easily be gained, and that as a result the McCormick brothers should not worry that using Wall Street money to combine the firms would harm their reputation with their farmer customers: after all, the Morgan partners remarked, the farmers had no choice but to buy farm machinery.

Morgan partner George W. Perkins explained to the brothers the terms under which J.P. Morgan and Co. would take charge of the deal. Perkins emphasized that "Morgan would... insist on choosing all officers and directors of the new company," and that "this point... Morgan and Co. have found indispensable in making their combinations." The McCormicks, the Deerings, and the owners of two other, smaller firms included in the new International Harvester Corporations took all the stock of the new company; since no issue of securities was required, J.P. Morgan and Co. charged less than their normal fee—they took only three percent of the company up front in fees. After organization, Morgan and Co. retained ultimate control over the firm. All stock was committed to a voting trust, the trustees of which were one McCormick, one

Deering, and Perkins.

For the first few years of its operation, the performance of International Harvester was disappointing. Rationalization of the firm's product lines was blocked; integration of production proceeded only very slowly. In 1906 Perkins, disappointed, forced a showdown to remove all remaining McCormick and Deering family members from management and replace them with salaried professionals. The younger Cyrus H. McCormick alone remained as head of the company. C.S. Funk, a salaried manager with long experience at McCormick and then International Harvester in whom Perkins had confidence, was made general manager. And "the younger element in the company" was advanced to positions of greater influence. Thereafter International Harvester's performance was more satisfactory—according to Garraty, sufficiently good that the Deerings were no longer embarrassed to give its stock as an endowment.

Banker influence on American Telephone and Telegraph can be clearly seen in one action: the return to the Bell System and accession to power of Theodore N. Vail. Vail had been hired for the telephone company by Alexander Graham Bell's father in law, Gardiner Hubbard, at the end of the 1870's. He performed very well as General Manager of American Bell and as president of its long-distance subsidiary during the initial expansion of the telephone network to the urban East and Midwest.

In 1887, however, Vail resigned. A growing dissatisfaction "with his position at this period was due...to the company's reluctance to spend money in keeping the service at maximum" and rapidly expanding the network. Vail had wished to pay low dividends and to plough retained earnings back into the rapid creation of a single comprehensive national telephone network. The major stockholders and their nominees, for example John E. Hudson, President of American Bell from 1889–1900, had a different view. They saw that they owned a money machine; they thought this money machine should pay high dividends. After a clash of views Vail left the company, unwilling to be the chief implementer of competitive strategies with which he disagreed. The 1887 annual report made no mention of his resignation or indeed of his services to the company at all, suggesting a high degree of strain and bad feelings.

After the expiration of Bell's key patents, Hudson's presidency, and to a lesser extent that

of his immediate successors, saw a steady loss of market share to a large group of alternative, local telephone networks. American Bell did pay high dividends. American Bell did not, however, move to consolidate its nationwide natural monopoly.

A general consensus within the reorganized Bell System, now headed by AT&T, toward a shift to renewed rapid expansion developed in the first years of this century. Frederick Fish (President of AT&T from 1902–07) went to the markets to raise money for renewed expansion.

The subsequent securities issues gave the investment bankers their opening. The company's massive financing requirements, and the fact that it had become difficult to raise money as the panic of 1907 drew near, brought the Bell system close to default. The investment bankers' price for continuing to finance the company was that its next president should be someone they trusted: Theodore N. Vail. First National Bank President and Morgan ally George F. Baker had been very impressed with Vail's performance in other dealings. Vail's past record at the telephone company was well known. And who better to head up a company now devoted to rapid nationwide expansion than a man who had been advocating such a competitive strategy twenty years earlier?

Vail did do for AT&T what he was installed to do. He oversaw its expansion to a true nationwide telephone system. And he turned out to be very skillful at keeping the government and public convinced that AT&T was a productive natural—and not an exploitative artificial—monopoly. In the choice of Vail, as in the creation of International Harvester, investment bankers appear to have exerted their influence in a positive direction.

Other case studies might paint a different picture. The International Mercantile Marine Company was a failure from the beginning. The New York, New Haven, and Hartford Railroad was denounced as unsound and monopolistic by Louis Brandeis for nearly a decade, at the end of which Morgan's New England railroad system did collapse.[22] The issue therefore turns on the

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22Thomas W. Lamont, in Lamont (1913), tried to distance J.P. Morgan and Co. as far as possible from the New York, New Haven, and Hartford, protesting "But Mr. Brandeis, we don't attempt to manage railroads....Nobody realizes better than we that that is not our function. We give the best counsel that we can in the selection of good men, making mistakes sometimes, as in the case of Mellen, but on the whole doing fairly well, and we give our very best advice on financial policy..." He tried to make it clear that the "expansion of the New Haven was due, and solely due, to Mr. Mellen's own policy and initiative, and that the mistakes which Mr. Morgan and his fellow directors made...was not of initiation, but of almost blindly following and endorsing

typical relative performance of the firms subject to investment banker influence and control.

V. The Value of Morgan's Men

A preliminary examination of stock market values does not contradict the claim that Morgan control was associated with considerable enhanced value. According to the lists compiled by the Pujo investigation, in 1912 Morgan or his partners sat on the boards of twenty manufacturing, mining, distribution, transport, or utility companies which had actively quoted common stocks—three utilities, nine railroads, and eight other companies. Data on these twenty companies, and on one hundred and forty-two other randomly selected control companies, were collected for 1911 and 1912.[23]

Table 1 reports regressions of the average relative price of the firms' common stock on various measures of fundamental values, industry dummies, and whether or not the firm's board of directors included a Morgan partner. The coefficient on the Morgan partner dummy variable is often large—the addition of a Morgan partner raises the log of common stock values by between five and forty percent, depending on the specification. Standard errors are also large: taking line three of the table as representative we can be confident that there are nineteen chances out of twenty that the Morgan partner effect is positive, but only take two to one odds that the true coefficient lies between 10% and 40%.

The spread of results obtained from Morgan organizations was large—ranging from the International Mercantile Marine Co. to the Lehigh Valley Railroad—and coefficient estimates are quite sensitive to outliers. If the International Mercantile Marine Co. had been a success, then the Morgan touch would have raised common stock prices on average by an additional fifteen to twenty percentage points. Conversely, if the New York, New Haven, and Hartford's

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Mellen's policies. Mr. Morgan had that large nature which led him almost blindly to have faith in a man when once it was established...." Even though Lamont (1913) is a Lamont-side memorandum of the three-hour conversation between Thomas W. Lamont and Louis D. Brandeis, it appears to be an accurate record of the meeting: the same memorandum is in both the Lamont and the Brandeis papers.

23 The Morganized companies are among the largest in the economy. It is possible that the Morgan dummy coefficient is proxying for a size effect.

price had collapsed in 1911 rather than two years later, the estimated Morgan touch would have been to raise common stock prices on average by from five to eight percentage points less.

TABLE 1
HOW MUCH VALUE IS ADDED BY PUTTING A MORGAN PARTNER ON THE BOARD?

Dependent variable is log of average 1911-12 stock price relative to book value
(162 observations, including 20 Morgan Companies)

INDEPENDENT VARIABLES					
Morgan Partner**	Utility Company?	Other Variable(s)		R^2	SEE
0.259				0.021	0.834
(0.161)					
0.270*	0.281			0.038	0.830
(0.161)	(0.197)				
0.253*	0.107	-1.834	Earnings/Price	0.270	0.730
(0.144)	(0.175)	(0.304)			
0.375*	0.441	1.680	Log Book/Par Value	0.180	0.777
(0.151)	(0.186)	(0.374)			
0.055	0.155	5.691	Log Earnings/Book	0.236	0.726
(0.102)	(0.124)	(0.730)			

*P(t) < .05 (one-tailed).
**Corporate board contains a partner of J.P. Morgan and Co.
Standard errors in parentheses.

The estimated impact of adding a Morgan partner does not seem out of line if one considers how much Morgan's financial services cost. For International Harvester—a simple and straightforward deal—the investment bankers' share was about four percent of the capital value floated. For U.S. Steel the investment bankers' share was more than ten percent. Such large fees can be justified—if they can be justified—only if the value added by the financiers is substantial.

The estimated Morgan partner coefficient declines sharply (it is always imprecisely esti-

mated) as variables representing a firm's present earning power are added to the regression. This hints that Morgan partners appear to add value in some of the specifications because they are on the boards of companies that are and are publicly seen to be relatively well-run, not because the presence of a Morgan partner provides an otherwise unobservable signal of a company's likely prospects. Regressions, of course, cannot sort out the causal chain. It could be that the addition of a Morgan partner to the board leads to the replacement of bad and the shaping-up of good managers. It could be that Morgan partners join the board only if they have confidence in the management, that the companies would perform just as well if the Morgan influence was absent, and that Morgan and Co. were skillful investors but had no effect on the performance of the economy as a whole.[24]

Moreover, there are a host of omitted variables uncaused by Morgan and Co. actions for which the Morgan variable could be a proxy. The most that can be claimed is that these regressions are not inconsistent with the idea that perhaps conflicts of interest engendered by having Morgan and Co. present on both sides of negotiations may have been outweighed, at least for shareholders, by the advantages of having Morgan and Co. watching over firm managers.

VI. Financial Capitalism in Comparative Perspective

Other countries around the turn of the century—chiefly Germany and Japan—also saw the growth of their industrial securities markets take on a "finance capitalist" pattern (see Reisser, 1911; Davis, 1965; Eatwell, 1982; Thurow, 1986). Consider first Imperial Germany. In 1914 its largest banks—such as the Deutsche, the Dresdner, and the Darmstädter—dominated the German capital market. These Great Banks were founded in deliberate imitation of the French Crédit Mobilier; Abraham Oppenheim was both a supporter of the Péreires and a founder of the Darmstädter Bank. These banks made it a business principle from the very outset to maintain permanent representation on the boards of directors and to hold a significant number of shares of

[24] These questions can be resolved by studying the performance over time of "Morganized" companies. This is the next step.

the companies they promoted.[25]

The role played by the Great Banks in monitoring and supervising corporate managements was an accepted part of German financial theory in the years before World War I (Riesser, 1911). There was a clear sense that this 'monitoring' role was a very valuable one. Riesser, for example, saw the German banks as valuable because of "both the continuity of their existence and regard for their 'issue credit', i.e., the permanent ability of maintaining among the German public a market for new securities issued under their auspices," which "insured a permanent interest on the part of these banks in the [health of the] newly created [corporations] as well as in the securities which they were instrumental in placing on the market." He criticized the pre-WWI British banking system because of the lack of such a monitoring system: the "complete divorce between stock exchange and deposits...causes another great evil, namely, that the banks have never shown any interest in the newly founded companies or in the securities issued by these companies, while it is a distinct advantage of the German system, that the German banks, even if only in the interests of their own issue credit, have been keeping a continuous watch over the development of the companies, which they founded."[26]

This line of criticism has been taken up and amplified by many who have seen the financial centers in the City of London as having failed industry. For example, as Ronald Dore (1987) summarizes the argument originally made by Lance Davis (1963):

> The rational liquid textbook shareholder exercises pressure on managers in... [the] direction [of doing well] primarily by, in Hirschman's (1970) classification, the 'threat of exit': through, that is to say, managers' knowledge that if shareholders' returns seem about to fall, holders of the stock will sell, share prices will go down, capital will be more difficult to raise, possibilities of managericidal takeovers will

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25Historians have argued that the influence exerted by the Great Banks on industry was substantial: Milward and Saul (1977) report that the Deutsche Bank had its representatives on the boards of 159 companies in 1912. Great Banks were at once promoting syndicates, originating syndicates, acceptance houses, and sources of short- and long-term commercial credit. In the words of Feis (1964), "the holders of shares in a German Great Bank were participants in an investment trust (among many other things).... The risks arising from immobilization of resources" through their commitment to the development of industry "the banks met...through their large capital...their retention of control [and]...subsidiary companies especially founded for this purpose."

26Today the Deutsche Bank votes the shares of many German stockholders, the stockholders presumably believing that the Bank will do a better job of voting their shares than they would.

> increase. The 'committed' shareholder, by contrast, is more loyally willing to wait for better times... but to make sure those better times actually come, he is more likely, not to 'threaten exit', but to 'exercise voice': to complain, cajole, offer constructive criticism... at shareholders' meetings and elsewhere.... [T]he development [at the end of the nineteenth century] of the 'efficient' stock market without trust and commitment—particularly the nature of the new issues market—and the failure to create investment banks as a substitute... was [it has been suggested] a contributing factor in Britain's industrial decline.

In Japan, the prewar *zaibatsu* and their more shadowy postwar replacements, the *keiretsu*, appear to have played a similar role. Japanese firms have historically obtained almost all of their capital from a single bank in the form of loans: Nippon Kokan K.K., Japan's second largest steel producer—and a substantial member of the *keiretsu* associated with the Fuji Bank, had a debt-equity ratio of 9:1 in the early 1970's. In the late 1970's, as Nippon Kokan shifted resources out of steel and into industries based on new materials technology, this was accomplished not by the steel company's acquisition of assets, but by repaying some of its loans to its bankers. Capital thus placed in the hands of the bank was used to set up new enterprises, managed by former staff of Nippon Kokan—but the only formal organizational connection was through the bank.

The pattern of influence of finance over industry is once again reminiscent of J.P. Morgan and Co. (see Hoshi *et al.*, 1989). In the words of Bieda (1970): "the... bank and the trading company exercise some influence over the associated companies' policies and appointments.... However normally the influence of the bank and the trading company is very limited unless the member company is in difficulties." In short, like turn of the century J.P. Morgan and Co., the group monitors (and replaces if necessary) the individual company's management, and decides on the allocation of capital within the group.

VII. The Decline of Financial Capitalism in the United States

Perhaps the Morgan-dominated "finance capitalist" pattern of the 1900's was peculiar to that age, and subsequent changes—chiefly the wider diffusion of available information to individual stockholders—have eroded the informational advantage of financiers that sustained

"finance capitalism" in the early years of this century. It might be that the history of U.S. financial markets in the twentieth century should be written as one in which informational and technological changes drive organizational shifts: as the importance of private information declined, the ability of investors to do their own security analysis grew, and managers' compensation schemes placed greater weight on stock options, the stamp of approval and the service of monitoring managers provided by Morgan and Co. became worth less and less.

Two considerations, however, weigh against this interpretation of the eclipse of Morgan. First, much current thinking in finance argues that the conflict of interest between owners and managers is still a central feature of finance today. Some advocate bringing managerial incentives into line by making managers the residual claimants, and argue that steps in this direction have produced enormous efficiency gains in recent years—Jensen's (1989) admittedly extreme estimate of these gains in the last decade pegs them as worth more than half of the total cash dividends paid by the corporate sector.

It is possible to argue that informational and technological changes gradually made "financial capitalism" and an active market for control obsolete in the first half of this century. It is more difficult to argue that such changes made "financial capitalism" obsolete in the first half of this century, and that subsequent changes in information and technology have made "financial capitalism" viable once again in the 1980's. Occam's razor suggests that if such institutions were viable then, and are viable now, they were probably still viable in between.

Second, historical accounts of the erosion of financial capitalism in the first half of the twentieth century have not focused on informational and technological changes that made J.P. Morgan obsolete. Instead, historical accounts emphasize relatively autonomous political events and psychological shifts in the attitudes of small investors toward the stock market.

As historians like Sobel (1965) see it, the first sign of Morgan's impending decline comes in the aftermath of the WWI door-to-door bond selling campaigns, as Charles Mitchell of the National City Bank comes to recognize that a financial empire does not have to be built by slowly creating a reputation as a shrewd judge of investments but can be built through direct salesmanship by uninformed representatives (Cleveland and Huertas, 1987). The second sign

comes in the aftermath of Edgar Smith's (1924) popularization of the benefits of common stock ownership: Smith argued that for as long back as he could trace stocks' dividends had been only a hair below bonds' coupons, that stocks in addition promised capital gains, and that consequently at every investment horizon longer than five years stocks dominated bonds.

Smith's advice that everyone should shift from bonds to stocks—any stocks, they did not have to be well-selected stocks—coupled with Mitchell's high-pressure sales campaigns and the growing possibility that the New Era might really be a new era of prosperity, helped fuel the stock boom of the 1920's. In the 1920's Morgan's or Kuhn Loeb's willingness to stand behind a security issue was no longer of prime importance. Many investors were willing to bet along with Samuel Insull that he was a financial genius, and that heavily-leveraged utility empires were the way to riches. The subsequent crash led to investigations. And the investigations led to the Securities and Exchange Commission and to the forcible divorce of bankers who had the capital to take substantial long-term positions in firms from their places on boards of directors from which they could easily monitor managerial performance.

This story traditionally told by historians is not a story of a shift in the balance of information flows, or in the form of the efficient organization of the relationship between finance and industry. The SEC took the form that it did largely because the populists in Congress had always believed in Untermyer's and Brandeis' critiques of how the bankers used other people's money, not because Untermyer's and Brandeis' critiques had suddenly become more correct than it had been in 1910 (Seligman, 1982). The Glass-Steagall act was passed because of the Great Depression, not because of an increase in ultimate investors' ability to assess and monitor firms. And organizations like the National City Bank and, later, Merrill Lynch appear to have prospered not because they were the best judges of the worth of securities, but instead because their door-to-door methods were able to directly tap savings that would otherwise have flowed into the life insurance and banking systems, and would presumably have reached the capital market in the hands of more sophisticated money managers.

It may be that historians have missed the true determinants of events. Underlying the politics and the merchandising, perhaps the multiplication of security analysts and a shift in man-

agerial compensation schemes made it easy for investors to assess the fundamental values of securities and aligned managers' interests with owners'.

But in recent years security analysts have continued to multiply, and managerial compensation schemes have become increasingly intricate. If the underlying economic logic made the tide flow away from financial capitalism in the 1920's, it is difficult to see when it reached its ebb, and what shifts in economic logic led to its return flood in the 1980's. This line of analysis suggests—especially when coupled with the presence of "financial capitalist" modes of organization in fast-growing Germany and Japan—that the transformation of Wall Street in the 1930's may have pushed the United States away from a pattern of relationships between finance and industry that offered benefits to investors and financiers, and toward a pattern that offered rents to managers.

VIII. Conclusions

Many issues have not been addressed. Surely the most important unaddressed issue is the balance between J.P. Morgan's adding shareholder value by improving efficiency as opposed to by creating monopoly. This question is close to unresolvable. No one disputes that the Robber Barons sought monopoly; no one disputes that the Robber Barons took advantage of economies of scale; the relative weight to be given these two factors is very difficult to resolve.

This paper, however, has addressed one major element of the progressive critique of the turn-of-the-century organization of American finance: that financiers' presence on corporate boards of directors allowed them to impose an unwarranted tax on industry by exploiting the conflict of interest created for their own benefit. The progressives' fear was well-founded—there were conflicts of interest and investment bankers did exploit them.

But there is evidence that, from shareholders' standpoint, these negatives of financial capitalism were balanced by positives. A strong argument in economics rests on three supports: a coherent theoretical base laying out the strategies available to and the interests of market participants, concrete evidence that actual individual investors, managers, and bankers

understood and acted according to the theoretical logic of the situation. And statistical evidence that such a pattern of action is found not just in isolated anecdotes but is standard operating procedure in the situation.

The first two supports are strong. The theoretical logic for interpreting Morgan's edge in terms of its hard-to-match reputation as an honest broker and a skillful analyst of risk is clear. Many observers at the time thought that the stamp of approval of Morgan and Co. was worth its handsome price and gave confidence. And the large-scale correlation between "finance capitalist" relationships and rapid growth remains intriguing and suggestive. The third support is weaker. The most that can be said is that preliminary regressions are not inconsistent with the argument made. Further investigation of this support is a very high priority for future research.

Since the decline of the House of Morgan, concern over the relationship between finance and industry has centered around two themes. The first is the concern expressed by Berle and Means (1932) that corporate managers had become accountable to no one. The second is the fear that today investment projects are assessed not by far-seeing investment bankers with a keen sense of fundamentals but by an erratic and flighty stock market committed to the short term. In Keynes' words: "The spectacle of modern investment markets has sometimes moved me towards the conclusion that to make the purchase of an investment permanent and indissoluble, like a marriage, except for reason of death or other grave cause, might be a useful remedy for our contemporary evils. For this would force the investor to direct his mind to the long-term prospects and to those only" (Keynes, 1936).[27] Both of these ills seem to call for large-scale financial institutions to take an interest in firm managers, and to establish and hold long-term positions in individual companies. It is an irony that today many of the intellectual children and

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[27]One index of the potential seriousness of such problems is the fact that the combined receipts of NYSE firms currently amount to one-sixth of all corporate profits. Trading costs are thus consuming seventeen percent of the return to capital generated in the corporate sector. In recent years Keynes' position has become more popular. For a recent example see Light (1989), who remains optimistic and believes that investors are becoming more concerned with the long-term prospects and those only. Light argues that "large pools of capital such as pension funds and endowments don't really need the liquidity the public market offers.... Fund managers are also realizing that trading is a tough discipline....[t]rading is a zero-sum game played in an efficient market against equally talented rivals.... Instead of trading a number of small, liquid positions, the funds can buy and own smaller numbers of large, illiquid [LBO] positions in a form where they... participate more actively.... This alternative can be a positive-sum game... large institutional funds can behave more like owners and less like traders." A skeptic would note that all of this has been clear for half a century, and yet most institutions still act like "traders" and not like "owners."

grandchildren of the Progressives appear to call for a return to "financial capitalism."

TABLE 2
COMPANIES WITHIN MORGAN INFLUENCE ON THE EVE OF WORLD WAR I

Adams Express Co.
AT&T
Atchison, Topeka, &Santa Fe Railroad
Baldwin Locomotive Co.
Chicago-Great Western Railroad
Erie Railroad
General Electric Co.
International Mercantile Marine Co.
International Harvester Co.
Lehigh Valley Railroad
New York, New Haven, and Hartford Railroad
Northern Pacific Railroad
New York Central Railroad
Philadelphia Rapid Transit Co.
Public Service Corporation of New Jersey
Pullman Co.
Reading Railroad
Southern Railroad
United States Steel Co.
Westinghouse Co.

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