Dividends of Development: Fits & Starts in the Expansion of U.S. Securities Markets, 1888-1919

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SYNOPSIS

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Over the last 20 years, economists have become enamoured of the proposition that broad and deep securities markets play a beneficial role in promoting economic growth. Relatedly, their interest has been piqued in the conditions that explain why some countries have highly developed securities markets while other countries do not. Within this literature, the U.S. is taken to exemplify the conditions that generate the kind of liquid and diversified securities markets that economists want to see.

Securities markets do seem inextricable to the functioning of U.S. capitalism today and, in particular, to the ownership and control of its large corporations. And, in comparative perspective, the country's broad and deep markets for corporate stocks and bonds stand out as among the most distinctive features of the U.S. system of capitalism. However, the securities markets have not always been at the heart of U.S. capitalism.

After the Civil War and, indeed, until the late 1880s, the United States could boast active securities markets but they were narrowly based. Dominated by railroad securities, they were largely bereft of other types of corporate securities, notably those of companies in the nations' rapidly developing industrial sector. The country's leading stock exchange, the New York Stock Exchange, looked like the poorer cousin of securities markets across the Atlantic. The London Stock Exchange, in particular, listed a larger number and a greater variety of corporate securities, including those of industrial enterprises.

This book addresses what happened to markets for U.S. corporate securities in the crucial period of transformation for the U.S. economy between the Civil War and the Great War. It was during these years that the United States emerged as a new colossus of the global economy. Its agricultural sector continued to play a crucial role in the country's economic development but something new happened in the transition from the 19th to the 20th centuries. The United States' growing industrial success,[1] built on its manufacturing prowess[2] and the abundance of its mineral resources,[3] transformed the

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[1] Paul Bairoch, 1982, "International Industrialization Levels from 1750 to 1980", *Journal of European Economic History*, 11, 1, pp. 269-333.

[2] In 1860, the United States accounted for 7.2 per cent of world manufacturing output, compared to 19.9 per cent for the UK; by 1913, however, the US was dominant with a share of 32 per cent compared with 13.6 per cent for the UK. In 1913 it was Germany, not the U.K., which was in second place behind the United States (14.8 per cent, up from 4.9 per cent (for its constituent regions) in 1860).

[3] As Wright notes "copper, coal, zinc, iron ore, lead, and other minerals were at the core of industrial technology for that era [speaking of 1913], and in every single case the United States was the world's leading producer by a wide margin" (Gavin Wright, "The Origins of American Industrial Success," *American Economic Review*, 80, 4, pp. 651-668, p. 661). The U.S. abundance in these resources was reflected in the success of industries that mined and refined these minerals but it also contributed to the success of industries that manufactured other products

country into the world's leading industrial power. By 1913, as a result, the United States had become the most important economy in the world.[4]

The story of the United States' economic transformation during this period is closely associated with the emergence of its powerful industrial enterprises. Large-scale enterprises existed by the time of the Civil War but they were concentrated in the railroad sector. Thereafter, they emerged to dominate industries as varied as sugar refining, steel, copper mining and smelting. Increasingly, these enterprises adopted a corporate form of organisation, they divided their capital stock into bonds and shares, thus creating the possibility for the development of broad and deep markets for corporate securities in the United States.

With the transformation of U.S. capitalism after the Civil War, with the growth of large-scale industrial enterprise and the diffusion of the corporate form, one might expect the country's securities markets to have changed. And they did. My main objective in this book is to understand how, when and why markets for U.S. corporate securities outgrew their dependence on railroad securities to become liquid markets for a diversified population of corporate securities.

We are used to hearing of the extraordinary vibrancy that characterised this crucial phase of U.S. economic history. However, U.S. dynamism is not the primary theme of the story I tell about the expansion of the country's securities markets. To the contrary, in explaining how broad and deep markets for corporate securities developed in the United States, the story I tell is one of failure as much as success. Certainly, there were major breakthroughs in the development of a market for U.S. industrial securities but they were followed by slowdowns in, and even reversals of, the momentum on which they relied.

The challenges as well as the opportunities that the United States faced in the expansion of its securities markets can be understood as dividends of the country's dramatic, but volatile, development. It was a country that grew rich in a short period of time but it did so in fits and starts. The unsteady rhythm at which the wealth of the United States accumulated led to a volatile pattern in the expansion of its financial institutions. Given the way the country's leading banks and trust companies invested their deposits and, in particular, their heavy dependence on the securities markets as an outlet for their funds, the volatility of their expansion had a major impact on the expansion of those markets. However, it was not only demand-side factors that contributed to the fits and starts of U.S. securities markets' expansion with supply-side factors, notably the characteristics of the industrial securities offered to investors, also playing an important role. The U.S. industrial sector was slow to generate sufficient numbers of stable and profitable securities that might persuade investors of the appeal of industrial securities as a class. In part, that was a result of the rapidity of the country's industrial development but it also reflected the propensity of its economy to crisis.

As late as 1913, therefore, the United States could not boast liquid and diversified markets for corporate securities despite the fact that it was the world's most important

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like steel. Indeed, Wright's principal argument is that U.S. manufacturing success was inextricably linked to its resource abundance.

[4] Bairoch, 1982, p. 296.

economy. In the end, the development of broad and deep markets for corporate securities in the United States took more than time. It also required luck. That luck came in the form of a war that was bad for some but extremely good for the United States. World War 1 is a defining moment in the story I tell because it administered a series of shocks to both the demand for, and supply of U.S. corporate securities.

Economic historians are used to hearing of the importance of World War 1 for transforming the role of the United States in the global financial system. I make a different claim, arguing that the war also represented a defining moment in the development of the country's domestic securities markets. It did so not only through a dramatic increase in the resources available to the nation's financial institutions but also, and more importantly, because of its profound impact on the profitability and stability of U.S. industrial corporations. By 1919, as a result, the United States had established the bases for the liquid and diversified markets for corporate securities that had, until then, proven so elusive.

The story that I tell in this book is an important one not only for students of financial history but also for those interested in the origins and evolution of systems of capitalism. Precisely because U.S. capitalism is portrayed as the archetype of a capitalist system in which broad and deep securities markets play a central role, it is important to understand how, when and why its markets developed. Indeed, it is for this reason that social scientists often invoke the U.S. case as historical evidence for arguments they make about the development of securities markets. Unfortunately, they have used it to support conflicting theories and in ways that are sometimes difficult to substantiate based on historical evidence. And, for this reason, some historians have called them to task for their use and abuse of the history of U.S. securities markets.[5]

These historians have legitimate criticisms but their intervention has also made it clear that a problem with deriving lessons from the historical experience of U.S. securities markets is that nobody is entirely sure what they are. Certainly, the literature on the crucial phase of the development of the U.S. securities market treated in this book leaves a great deal to be desired. Indeed, its gaps and ambiguities can be seen as creating the possibility for the conflicting ways in which the history of U.S. securities markets has been invoked by social scientists.

For scholars disinclined to undertake historical research themselves, the current state of the literature is a source of frustration. For those with an appetite for historical inquiry, in contrast, the holes and disagreements that pervade the existing literature are an inducement to new research. It is for the purpose of contributing to such new research on the development of U.S. markets for corporate securities that this book is written

The book's primary contributions are threefold. First, it tells us a great deal about the operation of the U.S. markets for corporate securities, about their constituent elements and how they worked, between the Civil War and the Great War. Second, the book

[5] See, in particular, Richard Sylla, 2006, "Schumpeter Redux: A Review of Raghuram G. Rajan and Luigi Zingales's Saving Capitalism from the Capitalists, *Journal of Economic Literature*, 44, 2, pp. 391-404 and Leslie Hannah, 2011, "London as the Global Market for Corporate Securities before 1914, in Laure Quennouëlle-Corre and Youssef Cassis, eds., Financial Centres and International Capital Flows in the Nineteenth and Twentieth Centuries, Oxford.

contributes to our understanding of how, and especially when, the markets for U.S. corporate securities developed. Third, it teaches us about why these markets evolved, about the factors that stimulated and retarded their advance, and thus about the causes of their development.

The book follows a chronological structure. Its story begins with the earliest efforts to bring U.S. industrial enterprises to the securities markets on a significant scale, which occurred not in the United States but in London in the late 1880s and early 1890s. It ends with the restoration of normal conditions for the U.S. securities markets in the aftermath of World War 1.