

THE EVOLUTION OF  
FINANCE CAPITALISM

BY

GEORGE W. EDWARDS, PH.D.

CHAIRMAN, DEPARTMENT OF ECONOMICS, THE CITY COLLEGE,  
COLLEGE OF THE CITY OF NEW YORK

New York: Longmans, Green & Co., Inc., 1938

RESPICE

ADSPICE

PROSPICE

## PREFACE

THE title of this book, *finance capitalism*, is employed as a concession to popular usage, for this study is essentially an inquiry into the nature of the non-financial and the financial institutions of *security capitalism* which is a more accurate term. The study is based on the general theory that economic processes are determined not by laws which remain fixed but by institutions which change. The evolution of these institutions is therefore traced for the purpose of indicating the principles of private and public control which should be exercised in the future in order that the system may produce the highest results from the standpoint not only of individual wealth but also of social welfare. The non-financial institutions considered in this study include the political, social, economic, philosophic and legal forces which have moulded the evolution of the system. Analysis is made of such political institutions in the domestic field as the rise and decline of parliamentary government and in the international field as the coming and passing of world peace; of such social institutions as the rise and decline of the rate of population growth and the changes in the welfare of the various groups in society; of such economic institutions as the adjustment between production and consumption; of the schools of economic philosophy such as the rise of classicism and of such legal institutions, as the growth of corporate law. A survey is also made of the purely financial institutions such as the central bank, commercial and investment banks, and the stock exchange, as well as the force of investment and of saving in the capital market.

These institutions are treated historically, comparatively and statistically. The historical approach is used, for security capitalism should be studied in relation to the past. The dramatic financial events of recent years do not constitute an isolated episode which suddenly crashed upon an unsuspecting world in October, 1929, but rather they were the inevitable results of tendencies in operation for decades. Instead of viewing merely the recent day-to-day events of security capitalism, it is necessary to study the long-range trends which are the antecedents of the current movements. A comparative analysis is undertaken to contrast the growth of institutions in various countries. This study is also based on a statistical foundation, for the economic historian must make full use of the statistical technique developed in recent years. Particularly in the field of financial history is it necessary to apply the science of sta-

tistical analysis. In recent years considerable progress has been made in developing more exact measurements, and quantitative tests have been used effectively in applied finance in analyzing the position of a particular corporation or government. This study seeks to employ in the field of social finance for the public interest, the same measurements which were heretofore utilized purely for individual gain. As far as possible the text is kept free of the statistical data which are presented either in tables accompanying the text or in appendices in those instances where the data are the basis for conclusions in more than one chapter.

Throughout the book the same general order of presentation is followed in considering each country. The stages of the rise, the development and the crisis of security capitalism are studied. Consideration is given successively to the political, social, economic, philosophic and legal background of the system, to the growth of financial organization in the form of the central bank, the commercial and investment banks and the stock exchange, to the demand for capital as expressed in governmental and corporate security investment, to the supply of capital as reflected in saving, to the various problems arising from the operation of security capitalism, to the criticism of the system and finally to the efforts at public control.

The evolution of security capitalism in leading countries, as England, France and Germany, as well as the general trends in world security capitalism are first traced. These studies serve as a setting for the comparative analysis of the evolution and the problems of security capitalism in the United States which constitutes the major part of the book. The rise and the development of the system in the United States from approximately 1820 to 1914 is first traced; consideration is given to the relation of American security capitalism to the World War and the political, economic and social background of post-war security capitalism in the United States is then surveyed. The changing function of the financial organization is presented, and a study is made of the problems arising out of the demand for capital in the fields of corporate and governmental investment. There are next presented an analysis of investment policies and a financial statement of American security capitalism. Public control of the demand for and the supply of capital is critically analyzed. The final chapter presents the principles and policies which should form the basis for reconstructing security capitalism.

The system of security capitalism is highly technical, and in practical operation is as intricate as the most highly developed industry. However, in these days of rapid change, a study of technical

security practice is of little more than antiquarian interest, since the old methods are being largely discarded, and the new methods have not yet been formulated. Many parts of the financial machine have broken down, and the experts are still doubtfully experimenting with the repairs. The student of security capitalism, therefore, faces the danger of losing his way in the maze of an intricate and ever-changing financial machinery and of not arriving at an understanding of the basic forces which at first aided the development of the system and later checked it. In view of the technical and complicated nature of the subject it would be an error to oversimplify it. Persons who would hesitate to air their views on an intricate problem in physical science, think nothing of surveying the entire subject of security capitalism in a five-hundred word article or in a fifteen-minute radio broadcast. The presentation should not be brought down to the reader, but realizing the challenge to his intellectual power, the reader should rise to an understanding of the subject.

A further difficulty which obstructs an inquiry into security capitalism is that over all the years of its operation, little progress has been made in placing security capitalism on a scientific basis by developing a classified and verified body of knowledge about it. As a result of this lack of scientific progress, security capitalism is presented, and often taught, as an incoherent mass of fragmentary, unsubstantiated and confused statements. The student of the subject of security capitalism should, therefore, seek to produce a body of classified and verified facts which taken together has some coherence.

It should also be realized that security capitalism is an imperfect system which, at times, has not functioned satisfactorily from the standpoint either of the individual or of society. As a result, critics of security capitalism overemphasize the dramatic and sensational misdeeds of particular individuals. On the other hand apologists, unwilling to admit the limitations of security capitalism, seek to veil the failure of both public and private financial statesmanship by senseless propaganda. Critical iconoclasts and apologetic idolators have built up prejudices and myths which have found widespread acceptance not only among the general public but even unfortunately among professional economists. Security capitalism therefore needs understanding both from those who have little realization of the practical difficulties in finance and from those who have scant appreciation of the social consequences of their errors. Too often in recent years attack has come from those who cannot very well be considered deep students, from those who write sweepingly and condemn in broad generalization; too frequently defense

has come blindly from those who lack understanding, and from those who in self-interest tolerate no honest criticism. The limitations of security capitalism should be viewed with neither destructive assault nor uncritical defense, but rather with constructive criticism and objective detachment. To the radically inclined mind the following presentation of security capitalism will seem merely another useless disclosure of the known weaknesses of the system and a futile effort to bolster up a decadent institution. To the reactionarily inclined mind the presentation will appear as just another inquisitorial venture. It is the hope of the author that the book will attain the fundamental test of scholarship in being an honest search for truth, whether pleasant or unpleasant, and based on this truth in proposing a constructive program of controlling security capitalism which, despite its imperfections in the past, has served the interests of society.

We should therefore approach the subject for the purpose of understanding the underlying principles, of grasping the significance of its complicated organization, of assembling and co-ordinating a body of classified and verified facts concerning the system and of searching out its imperfections with a view toward reconstruction.

For the general method of treatment the author is indebted to Dr. Charles A. Beard under whom he studied at Columbia University a quarter of a century ago. Dr. Beard developed a technique of historical institutional research which had been sadly lacking in financial investigation.

The manuscript has been read by Professor James D. Magee of New York University, Professor Nelson P. Mead and other members of the History Department of the City College of the City of New York, Professor Joseph L. Tynan of the English Department and by Mr. Jerome B. Cohen of the Economics Department. Acknowledgment is due to Dr. Harold G. Moulton who gave the author the idea of an integrated study of the financial system. The initial compilation of the tables and appendices was undertaken by members of W. P. A. Project 165-97-6999 (6051) which I sponsored. I owe a debt to my students of the City College of the City of New York who over the years have constituted a critical though always a friendly and stimulating audience. My deepest obligation is to my wife not only for her painstaking research and careful preparation of the manuscript but particularly for her encouragement and inspiration which have made the writing of this book a joyful experience.

The later chapters dealing with American security capitalism are in a large measure based on the findings of the various governmental investigations of the system. The results of these findings

have been analyzed and an attempt has been made in this book to give a critical and orderly presentation of these data. The student of security capitalism is deeply indebted to Joseph Healy, Ferdinand Pecora and Max Lowenthal for the wealth of information which they have disclosed respectively in the hearings on public utility, banking and railroad finance. Liberal use has also been made of the findings of the munition industry inquiry and the reports of the Securities and Exchange Commission. In writing the chapters on the history of security capitalism on the Continent, the author was fortunate in having available the studies of Alfred Neymarck, the comments of Werner Sombart and the work of Jacob Rieser.

The source material for the early chapters was obtained over a period of years from libraries in this country and abroad, as the New York Public Library, the Congressional Library, the libraries of Harvard University, of the Federal Reserve Board, of the American Bankers' Association, of the British Museum, of the London School of Economics and of a number of French, German, Belgian, Austrian and Scandinavian banks. The general plan of this book was conceived in Germany in 1922 while undertaking a study of European financial organization and part of the data was gathered in subsequent visits to Europe. In the chapters on post-war tendencies the author has drawn upon his own direct observations in this country and abroad. He was fortunate in having had the opportunities for such direct observations through association with various departments of the federal government and also with private organizations such as in founding the Institute of International Finance for the Investment Bankers' Association of America and in working with the American Bankers' Association at various times in recent years.

GEORGE W. EDWARDS

Hartsdale, New York  
April, 1938

## CONTENTS

<i>PART I—EVOLUTION OF WORLD SECURITY CAPITALISM</i>	
CHAPTER	PAGE
1. FINANCIAL INSTITUTIONS OF SECURITY CAPITALISM . . . . .	1
2. RISE OF BRITISH SECURITY CAPITALISM . . . . .	9
3. TRIUMPH OF BRITISH SECURITY CAPITALISM . . . . .	27
4. PRE-WAR CRISIS OF BRITISH SECURITY CAPITALISM . . . . .	39
5. RISE AND DEVELOPMENT OF FRENCH SECURITY CAPITALISM . . . . .	46
6. RISE AND DEVELOPMENT OF GERMAN SECURITY CAPITALISM . . . . .	61
7. RISE AND DEVELOPMENT OF EUROPEAN SECURITY CAPITALISM . . . . .	77
8. CRISIS OF BRITISH, FRENCH AND GERMAN SECURITY CAPITALISM . . . . .	92
9. CRISIS OF WORLD SECURITY CAPITALISM . . . . .	118
 <i>PART II—EVOLUTION OF AMERICAN SECURITY CAPITALISM</i> 	
10. RISE OF AMERICAN SECURITY CAPITALISM . . . . .	140
11. DEVELOPMENT OF AMERICAN SECURITY CAPITALISM . . . . .	161
12. AMERICAN SECURITY CAPITALISM AND THE WORLD WAR . . . . .	203
13. CRISIS OF AMERICAN SECURITY CAPITALISM . . . . .	214
 <i>PART III—PROBLEMS OF AMERICAN SECURITY CAPITALISM</i> 	
14. FINANCIAL ORGANIZATION . . . . .	223
15. CORPORATE INVESTMENT . . . . .	236
16. GOVERNMENT INVESTMENT . . . . .	251
17. SECURITY POLICIES . . . . .	261
18. A FINANCIAL STATEMENT . . . . .	273
19. PUBLIC CONTROL . . . . .	287
20. RECONSTRUCTION . . . . .	319
NOTES . . . . .	339
 <i>APPENDICES</i> 	
I. EVOLUTION OF BRITISH SECURITY CAPITALISM, 1820-1935 . . . . .	389
II. EVOLUTION OF FRENCH SECURITY CAPITALISM, 1820-1935 . . . . .	394
III. EVOLUTION OF GERMAN SECURITY CAPITALISM, 1870-1935 . . . . .	400
IV. EVOLUTION OF WORLD CAPITALISM, 1820-1935 . . . . .	406

CHAPTER	PAGE
V. NATIONAL DEBTS OF LEADING COUNTRIES, 1870-1935 . . . . .	409
VI. EVOLUTION OF AMERICAN SECURITY CAPITALISM, 1906-1935 . . . . .	410
VII. EVOLUTION OF AMERICAN SECURITY CAPITALISM, 1820-1935 . . . . .	414
VIII. FINANCIAL POSITION OF NATIONAL BANKS, 1870-1935 . . . . .	419
IX. FINANCIAL POSITION OF THE RAILROADS, 1890-1934 . . . . .	420
X. PROPORTION OF SECURITY INVESTMENTS TO TOTAL ASSETS OF FINANCIAL INSTITUTIONS, 1890-1935 . . . . .	422
INDEX . . . . .	423

## LIST OF TABLES

TABLE	PAGE
1. FOREIGN LOANS OF LEADING BRITISH INVESTMENT HOUSES, 1823-1825 . . . . .	17
2. SECURITIES LISTED ON THE LONDON STOCK EXCHANGE, 1843 . . . . .	19
3. SECURITIES LISTED ON THE LONDON STOCK EXCHANGE, 1875 . . . . .	34
4. SECURITIES LISTED ON THE PARIS BOURSE, 1906 . . . . .	55
5. PROPORTION OF JEWS CONTROLLING GERMAN INDUSTRIES IN THE PRE-WAR PERIOD . . . . .	70
6. COMPARATIVE ECONOMIC EXPANSION OF LEADING COUNTRIES, 1870-1913 . . . . .	79
7. TOTAL SECURITIES OUTSTANDING IN LEADING COUNTRIES, 1910 . . . . .	89
8. CHANGES IN YIELD OF BONDS OF LEADING GOVERNMENTS, 1873-1912 . . . . .	91
9. FINANCIAL POSITION OF BRITISH COMMERCIAL BANKS, 1925-1934 . . . . .	95
10. SECURITIES LISTED ON THE LONDON STOCK EXCHANGE, 1933 . . . . .	96
11. RESERVE POSITION OF GERMAN BANKS, 1929 AND 1931 . . . . .	114
12. EVOLUTION OF JAPANESE SECURITY CAPITALISM, 1920-1935 . . . . .	126
13. PRODUCTION AND TRADE OF THE WORLD, 1932-1935 . . . . .	131
14. CHANGES IN PROPORTION OF NATIONAL WEALTH TO NATIONAL DEBT OF LEADING COUNTRIES . . . . .	136
15. FINANCIAL POSITION OF THE NEW HAVEN RAILROAD, 1903 and 1909 . . . . .	177
16. STATE GOVERNMENT DEBT, 1870-1913 . . . . .	180
17. RAILROAD FINANCE, 1880-1889 . . . . .	181
18. TOTAL ASSETS OF FINANCIAL INSTITUTIONS, 1873-1911 . . . . .	184
19. LABOR AND PRODUCTION, 1929 . . . . .	218
20. MEMBERSHIP IN THE INVESTMENT BANKERS ASSOCIATION, 1912-1936 . . . . .	229
21. DATES OF ISSUE OF DEFAULTED BONDS, DECEMBER, 1931 . . . . .	232
22. ELECTRIC LIGHT AND POWER FINANCE, 1912-1931 . . . . .	239
23. ELECTRIC RAILWAY FINANCE, 1912-1931 . . . . .	240
24. MANUFACTURING FINANCE, 1924-1933 . . . . .	241
25. TRADING FINANCE, 1924-1933 . . . . .	242
26. URBAN REAL ESTATE FINANCE, 1913-1931 . . . . .	246
27. STATE GOVERNMENT FINANCE, 1915-1932 . . . . .	254
28. CITY GOVERNMENT FINANCE, 1915-1933 . . . . .	256

TABLE	PAGE
29. SOUTH AMERICAN GOVERNMENT FINANCE, 1920 AND 1930	259
30. DISTRIBUTION OF HOLDINGS OF FUNDED DEBT IN THE UNITED STATES, 1932 . . . . .	262
31. DISTRIBUTION OF HOLDINGS OF UNITED STATES GOVERNMENT BONDS, 1917-1934 . . . . .	263
32. DISTRIBUTION OF SECURITY INVESTMENTS OF NATIONAL BANKS, 1910-1935 . . . . .	266
33. DISTRIBUTION OF SECURITY INVESTMENTS OF MUTUAL SAVINGS BANKS, 1890-1935 . . . . .	267
34. DISTRIBUTION OF SECURITY INVESTMENTS OF LIFE INSURANCE COMPANIES, 1924-1935 . . . . .	268
35. INVESTMENT EXPERIENCE OF FINANCIAL INSTITUTIONS BY YEARS, 1920-1934 . . . . .	270
36. INVESTMENT EXPERIENCE OF FINANCIAL INSTITUTIONS BY SECURITIES, 1920-1934 . . . . .	270
37. LOSSES ON SECURITIES TO NET CAPITAL OF FINANCIAL INSTITUTIONS, 1931 . . . . .	271
38. FINANCIAL STATEMENT OF AMERICAN SECURITY CAPITALISM, 1920-1935 . . . . .	274
39. NEW SECURITIES ACCORDING TO ISSUERS, 1920-1935 . . . . .	276
40. INTEREST ON BONDED DEBT IN THE UNITED STATES, 1921-1933 . . . . .	278
41. BONDED DEBT IN THE UNITED STATES, 1925-1933 . . . . .	279
42. TOTAL SECURITIES OUTSTANDING IN THE UNITED STATES, 1925-1933 . . . . .	281

THE EVOLUTION OF  
FINANCE CAPITALISM

# THE EVOLUTION OF FINANCE CAPITALISM

## *Part I—Evolution of World Security Capitalism*

### CHAPTER 1

#### *FINANCIAL INSTITUTIONS OF SECURITY CAPITALISM*

THROUGHOUT its evolution, capitalism has taken various forms, and can be grouped according to its territorial extent as local, national or international capitalism; according to its relation to the state, as private or as public capitalism; according to the economic class which dominates the system as agrarian, mercantile, industrial or banking capitalism. A more important principle of classifying capitalism is according to the nature of the transfer of capital. Thus a distinction should be drawn between individual capitalism and security capitalism.<sup>1</sup>

Under individual capitalism the funds for financing economic activities are furnished by the entrepreneur operating as a single owner or in partnership with others. These funds may be applied either to private or to public undertakings. In the former case the funds are generally used by the entrepreneur in his own business where capital ownership and executive management are combined. In the latter the entrepreneur, singly or with a group, turns over his funds to the ruler as an individual. In private finance the single-ownership and the partnership have been gradually replaced by the corporation while in public finance the ruler, as the borrowing party, has been supplanted by a legislative body, and in both fields today the transfer of capital is largely evidenced by securities. Individual capitalism thus has given way to "stock-and-bond" or security capitalism.<sup>2</sup>

Individual capitalism and security capitalism differ in several essential respects. Individual capitalism depends largely on entrepreneur capital, it is personal in nature and the basis underlying

its capital consists largely of tangible assets as farms, factories or ships. Security capitalism rests on investor capital, it is essentially impersonal and the instruments evidencing claims to wealth are based on intangible as well as tangible assets.<sup>3</sup>

Under individual capitalism, the entrepreneur finances himself for short periods of time by commercial credit, while under security capitalism there is more reliance on investment credit. Under individual capitalism, labor and land are the important factors in production, but capital is dominant under security capitalism.

#### MEANING OF SECURITY CAPITALISM

Security capitalism may be defined as the economic system which is financed through the conversion of the saving of investors into security investment. Security capitalism is thus the system which brings together the forces of saving and of investment as far as they relate to securities.

Saving, on the one hand, results from the collective choice of individuals willing to restrict their expenditures in relation to their immediate income, while investment arises from the collective action of entrepreneurs or governments desiring to increase their expenditures beyond their current income. Saving refers to the accumulations of the consumers, whether individuals or corporations, while investment denotes the forms evidencing the transfer of the saving to entrepreneurs or governments. This investment may be evidenced in various forms such as commercial paper, mortgages and particularly securities. This study deals with the application of saving to security investment which today constitutes the greater part of total investment.

The relation between saving and investment can be studied from the standpoint of the individual saver and the individual entrepreneur. Such a treatment lies in the province of a treatise in the field of investment practice presented from the standpoint of individual profit. This book is concerned rather with the relation between saving and investment from the social viewpoint and deals with the operation of these two forces from the standpoint of public interest. Saving will therefore be considered as the excess of national income over expenditure. National income will be used in the sense of the money value of the goods and services received by the individuals composing the nation over a definite period of time such as a year.

#### PARTIES TO SECURITY CAPITALISM

There are three leading parties to the system of security capitalism namely the saving-investor, the saving-receiver and the saving-

dealer or the investment banker.<sup>4</sup> The first party, whom we will call for brevity the investor, retains the ownership of his saving, but transfers the executive management to the receiver who in exchange gives paper claims in the form of shares or of bonds. The incentive which induces the investor to part with the control of his saving is the expectation of income in the form of dividends on stock, interest on bonds, or of profit through the appreciation of the market value of these securities. The expectation of income by the investor is based on his confidence in the earning power of the corporation or in the fiscal power of the government.

The receiver of saving may be either a corporation which applies it to some private enterprise or a government which directs the saving to some public undertaking. It is important throughout this entire discussion to keep in mind that security capitalism facilitates the application of saving not only to private but also to public financial operations. The third party to the system is the investment banker. He is not an essential party, for saving can be converted into security investment through the sale of securities by a corporation or a government directly to the investor. However, such direct sales are relatively unimportant. The investment banker is primarily a dealer who purchases securities and sells them to the investor. The purchasing operation of the investment banker has become an important activity in the modern capitalist system. It is a power which has deep social and economic significance. Through the purchasing function the investment banker exercises a selective power by which he can either grant or withhold new capital so essential to financing the needs of corporations and of governments. By the exercise of this selective power the investment banker therefore controls the flow of new capital.

After purchasing an issue of securities, the investment banker sells them to the investor either directly or indirectly through other financial institutions, such as deposit banks, including both savings banks and commercial banks receiving savings deposits, investment trusts, or life insurance companies. Under the direct relationship between the investment banker and the investor, the latter exchanges his saving for the securities of the receiving corporation or government. Under the indirect system, the investor obtains a claim on a financial institution which in the case of the bank is a deposit account, in the case of the investment trust is a stock or a bond, and in the case of the life insurance company is a policy. These institutions in turn may place the funds of the investor in securities of corporations or governments.

Old capital, as represented in securities already outstanding, is bought and sold through brokers, who act as agents, and derive their

return from a commission on the purchase or the sale of securities. Such brokers are grouped in either fully organized stock exchanges which trade in listed securities or more loosely in over-the-counter markets for the purchase and sale of unlisted securities. The so-called commercial bank has also become an important party to the system of security capitalism. As mentioned before, it may serve as an institution of indirect investment. Another important function is to supply credit for carrying securities. Similarly the operation of the central bank, as the keystone of the commercial banking system, has been influenced by security capitalism. In practically every country the central bank grants advances collateralized by securities, and in certain countries it performs other security services.

#### RELATION BETWEEN MANAGEMENT AND BANKING

It is frequently held that the prominence of the investment banker in the financial system necessarily leads to his assuming the function of capital management. In American economic literature this extension of his function is generally described as domination by Wall Street and in European literature there is a similar criticism of the grip which the investment banker is supposed to hold over the industrial life of the nation. As will be indicated in later chapters describing the financial organization of various countries, there is not always a close relation between investment banking and industry, and banking domination is not necessarily an essential characteristic of security capitalism.

The evolution of the financial relation between capital management and investment banking generally passes through three stages. In the early history of a particular corporation or industry, or even economic system, the relation between capital management and investment banking is generally negligible. Industry finances itself internally through the reinvestment of its earnings and this policy is usually the result not of choice but of necessity, for the untried corporation or the young industry or the new system is unable to finance its growth by the sale of securities to the public. In the course of time the particular corporation or the industry or system, if operations are profitable, is in a stronger position to finance its growth by the sale of securities. At this point a close relationship between management and investment banking may develop. This tie is not a necessary result, for if the needs of the corporation are not pressing the management may readily retain control of its own business. Furthermore, the same result may follow if the supply of capital in the market is abundant, as was the case in England in the nineteenth century. If the expansion is so rapid that the

corporation must have a large and continuous supply of capital, and if the supply of available capital is limited, then the investment banker may very well obtain control over the management of the affairs of the corporation. Such conditions prevailed in Germany in the period of rapid industrial expansion in the last quarter of the nineteenth century.

In the course of time there comes a third stage in the relationship between industry and investment banking. As a nation attains economic maturity the supply of capital funds directly owned by corporations increases, and under these conditions they are less dependent upon investment banking. Similarly, the increase of profits enables the management to finance its expansion more and more from the reinvestment of earnings, and as a result the control of investment banking over industry is weakened. Such was the history of the relationship of investment banking to industrial management in the post-war period in the United States when banker control was lessened. The decline of control by the banker and the re-assertion of control by industry also occurred in Germany in the post-war years, but unfortunately was accompanied by sweeping political changes. The history of security capitalism indicates that control of the management of industry by banking capitalism is but a transitory stage.

#### CHARACTERISTICS OF SECURITY CAPITALISM

The underlying characteristics of security capitalism may next be noted. In the first place, while the investor retains the ownership of his capital, he generally loses control over its management. This divorce of management from ownership of capital is particularly true in indirect investment where the investor turns over the disposition of his funds to the deposit bank, to the investment trust or to the life insurance company. Even under direct investment in corporate finance, the investor has frequently been separated from control of his funds through the creation of such divorcing agencies as the voting trust, non-voting class A stock and the holding company. In public finance, the investor has practically no control of his capital. Furthermore, security capitalism has led to wide diffusion of the ownership of corporations. This tendency is frequently described as the "democratization" of capitalism. It is true that security capitalism has transferred corporate ownership from the few to the many, but because of the diffusion of securities among many holders, control still continues in the hands of the few who manage not only their own capital but also that of the multitude. Security capitalism thus effects democratization of the

ownership of capital but brings about monopolization of the control of capital.

A second necessary feature of security capitalism is the creation of stocks and bonds. Since the owner of capital surrenders its management, he must receive some instrument which indicates his retention of ownership and which describes the conditions governing the relation between the investor and the saving-receiver, such as that governing the payment of interest or of dividends and the ultimate repayment of the principal in the case of a bond. These stocks and bonds are the paper representatives of the assets of the corporations or of governments which have issued them.

The third characteristic of security capitalism is the impersonalization of the financial relation between the saving-investor and the saving-receiver. Their relationship is no longer based on personal acquaintance, for the two parties seldom know each other. This change in relationship has occurred both in private and in public finance. In early public borrowing the banker gave his own funds to the king, and the loan was a purely personal transaction between these two parties. Under modern security capitalism, the state by an act of the legislative body obtains funds through the sale of its bonds to investors, and the relationship has therefore become impersonal on both sides.

#### FINANCIAL PROBLEMS OF SECURITY CAPITALISM

Each of these characteristics of security capitalism has led to certain inevitable financial problems. The separation of the ownership of capital from its management has frequently tended toward irresponsibility in its administration. Under the system of individual capitalism where ownership and management of capital are combined in the single individual or the partnership, extreme prudence is naturally exercised by the managers in the handling of their own funds. On the other hand, under security capitalism where the owners of capital transfer its management to the directors or officers of a corporation or to the officers of a government, it is inevitable that the latter will not generally be inclined to exercise the same prudence in the handling of the funds of others as they would in the care of their own.<sup>5</sup>

The creation of securities based on underlying assets has given rise to the problem of capitalization, or the actual pecuniary relationship between the face or the par value of outstanding securities and the true valuation of the underlying assets of the corporation or the government. The true value of these assets in the case of a corporation is based primarily on its earning power and in the case of a government on the return from its own revenue-producing

property or on the receipts from the taxable property and income of its inhabitants. Overcapitalization is the issuance of securities with a face or a par value in excess of the true value of the underlying assets. Overcapitalization is also the overstatement of this asset value and results in the creation of paper claims in the form of securities unsupported by underlying assets.<sup>6</sup>

A third result of security capitalism in recent years has been the growth of financial instability as reflected in the widening range of security prices. One cause has been the impersonality of the financial relations under security capitalism as described above, whereby the investor exchanges his capital either for securities under the method of direct investment or for a bank deposit, or a life insurance policy under indirect investment. Either method accelerates the shiftability of capital.<sup>7</sup>

Shiftability of capital is accomplished under direct security investment by the sale of a stock or a bond in the security market. Under indirect investment the conversion of a bank deposit into cash is accomplished by its withdrawal, and a life insurance policy by obtaining its cash-surrender value. This indirect method in the end necessitates the marketing of securities or other assets, since the deposit bank or the life insurance company must sell some of its assets in order to meet the demand of the depositor or of the policy holder. Economists in the past have generally looked with favor upon this increase in the shiftability of capital resulting from the wider use of securities.<sup>8</sup> Defenders of the stock exchange have generally pointed out that this institution, by providing a so-called free market and enhancing shiftability, tends to stabilize security values. As a matter of fact, the improvement of the machinery of the stock exchange in recent years has been accompanied by greater financial instability, as evidenced by the everwidening upward and downward swings of security prices. The increase in the shiftability of capital has been the mechanical factor leading to the instability of security capitalism.

A second factor causing instability has arisen out of the policy of recapitalization. Whether such recapitalization has meant overcapitalization or undercapitalization, the change in the capital structure creates uncertainty over the pecuniary valuation of the securities in relation to their underlying assets. The valuation of tangible assets as evidenced by a factory or a farm is hard enough, but the appraisal of securities issued on intangible assets, as good will and franchises, is much more difficult. A third factor which has increased the uncertainty of determining the value of stocks and bonds has been the growing complexity of corporate and governmental finance. In recent years many new characteristics as

the closed mortgage bond and the participating warrant have been devised for the purpose of seeking to protect or to benefit the investor. More usually such characteristics have been added to securities and placed in corporate indentures by the issuers for the purpose of obtaining a greater control of the invested capital. As a result, securities have become more complicated, and in consequence their valuation has been rendered more difficult. There has been a growing complexity also in public finance. There have been many cases of one government guaranteeing the obligations of another government or of a semi-public corporation; of a government issuing not only general credit obligations but also bonds based on specific security; and of a government creating overlapping political bodies with separate taxing powers.

A further problem of security capitalism is the adjustment between saving and investment in the form of the supply of and the demand for capital. A relative surplus of saving results in what may be described as capital market deflation, while a relative excess of investment really amounts to capital market inflation. It is true that theoretically the volume of investment cannot exceed the amount of saving, but actually over a short space of time such temporary excess of investment may be rendered possible through the use of credit extended for the purpose of carrying securities which have been issued but which have not yet been sold. Capital responsibility, security capitalization, financial stability and saving-investment adjustment are among the major problems relating to the financial institutions of security capitalism.

## CHAPTER 2

### *RISE OF BRITISH SECURITY CAPITALISM*

IN WORLD history, economic systems pass successively through their rising, developed and declining stages. Within the framework of the declining stage of the old system appears the rising stage of the new system. In the developed stage the new system acquires the characteristics of its pure form, and in the declining stage it disappears within the framework of the rising stage of the succeeding system. The rapidity of these movements has varied. The evolution of early economic systems, as the growth and the disintegration of the Roman Empire, the coming and the passing of European feudalism and the rise of individual capitalism slipped over the centuries with the imperceptibility of a slow-moving glacier. The evolution of security capitalism however has been one of the swiftest-moving dramas in all the history of human civilization, and its course has sped onward with the rush of a fast-flowing mountain stream.

The evolution of individual capitalism in Western Europe covered the period from the thirteenth century through the first half of the nineteenth century. This period was marked by momentous developments in the field of politics, technology, philosophy and finance.<sup>1</sup>

The dominant political movement was the growth of national government in France, Spain and England. Now for the first time in centuries property received protection and as a result capital was accumulated. With the growth of towns came the rise of the middle class which in time wrested the political power from the hands of the agrarian aristocracy and later from the king. The mechanical tools of society were developed; the improvement in navigation facilitated the crossing of the oceans and the age of discovery was initiated. Technological progress also made possible the erection of public buildings. The dominant economic philosophy was that of mercantilism which preached the importance of a powerful self-sufficient state, and urged that all economic policies be directed to this end. The financial organization of individual capitalism came with the rise of the private merchant bankers, as the Peruzzi, the Medici and the Fuggers. In the later years of this period came the crude beginning of central banks as feeble organizations to bolster government treasuries and not yet institutions to

regulate the credit of nations, and the start of stock exchanges as mere fairs to exhibit goods and not yet powerful security markets to transfer paper claims to wealth.

#### DEVELOPED INDIVIDUAL CAPITALISM IN ENGLAND

In England the developed stage of individual capitalism extended from the end of the seventeenth century to the close of the Napoleonic Wars. This period included the first industrial revolution of the eighteenth-nineteenth centuries. The vast transformation in the industrial life in England over these years was financed almost entirely by entrepreneur capital. Although the canal, turnpike and dock enterprises of the later eighteenth century were organized as corporations, their securities were almost entirely held by the managers and were not usually offered for sale to the general public. By the beginning of the nineteenth century the sweeping changes in the textile and mining industries were likewise undertaken almost entirely by individuals who contributed their own capital, and the expansion of these early enterprises was financed out of the reinvestment of their subsequent earnings. Save for listing the stocks of a few mining companies, the London Stock Exchange until the first quarter of the nineteenth century had practically no contact with the vast movements which were completely transforming the industrial life of England.

From the days of Athens and Rome until the close of the eighteenth century there had been little widening in the forms of investment, for land and shipping still dominated as outlets for the placement of funds. The stock of the Bank of England and of the East India Company offered a possible but limited corporate demand for the rapidly accumulating capital of the eighteenth century. The paucity of satisfactory media of investment is well illustrated by the predicament of Alexander Pope's father who, upon retiring from his successful linen draper's business, had a considerable fund. He was apparently unable to find a suitable form of investment and so he placed his money in a strong box from which he took out sums whenever needed for his household expenses.<sup>2</sup>

Practically the sole form of security investment throughout the eighteenth and early nineteenth centuries was the national debt. The successive wars of the eighteenth and early nineteenth centuries necessitated extensive public borrowing, so that the national debt rose from £13,000,000 in 1709 to £900,000,000 in 1816 when Napoleon was finally banished to St. Helena.<sup>3</sup> As Napoleon's armies overran Europe, many capitalists transferred their funds from the Continent to England for safety and a large part was placed in

British government bonds. National government securities constituted the bulk of the trading conducted on the London Stock Exchange.

Throughout the eighteenth century the Exchange evolved from a mercantile market essentially for the purchase and sales of goods into a true stock exchange for the transfer of securities. Francis Hirst placed the beginning of the modern security exchange in 1773, when the brokers resolved that it should be called the "Stock Exchange."<sup>4</sup> In 1802 the Exchange took over the building which it was to occupy up to the present time. In the same year the Exchange received a deed of settlement,<sup>5</sup> and it was deemed unnecessary to obtain any further legal basis for its existence, such as an enabling act from Parliament or a charter under the Companies Act. At first any one could obtain daily admission to the Exchange on payment of six pence.<sup>6</sup>

However, as reported in the official history of the Stock Exchange, "it became apparent that the indiscriminate admission of the public was calculated to expose the dealers to the loss of valuable property." As a result the Exchange established a privileged group of security dealers who ultimately gained monopoly in the handling of security transactions.<sup>7</sup>

The Stock Exchange during this early stage, had an unsavory record. In 1810 Abraham Goldsmid the so-called King of the Stock Exchange became involved in scandal and committed suicide. So serious was the effect of Goldsmid's death, that the news was sent by a special messenger to the King and the Prince of Wales. Another stockbroker, Benjamin Walsh, who had raised himself to membership in Parliament, was finally excluded from the House on the ground of fraud. In 1814 Admiral Cochrane, prominent in the British Navy and in politics, was one of a group which circulated a false rumour concerning the death of Napoleon for the purpose of putting through a stock market deal. For this offense the Admiral was deprived of his seat in Parliament.<sup>8</sup>

Thus in the developed stage of individual capitalism the system of security capitalism made its appearance in the growing volume of the national government bonds and in the formation of a market for dealing in these securities.

#### BACKGROUND OF RISING SECURITY CAPITALISM

The declining stage of individual capitalism in England was the period from the close of the Napoleonic wars until the middle of the nineteenth century when British security capitalism was passing through its rising stage. The general institutional forces which

brought about the growth of security capitalism may be found in fields of politics, economics, philosophy and law. International political relations, after the almost century-long duel between England and France, were fortunately quiet, and for almost a half century there were no major wars. Domestic politics in England was marked by the rise of liberalism, for suffrage was widened and with the abolition of the rotten boroughs, Parliament came to be fairly representative of the popular will. The complexion of British politics was changing, and the issues were revolving more over social welfare rather than merely private gain. The Whigs and their more progressive associates were influenced by the humanitarian movement of the day, and were gradually forcing measures for political and social betterment upon Parliament.

This changing political ideology had its effect upon England's foreign investments in stimulating particularly the flow of funds to Greece, South America and the United States. The British public sympathized deeply with Greece in its efforts to throw off the Turkish yoke, and large sums were raised to finance this movement. There was also widespread popular support for the revolutionary struggles in South America. After the successful outcome of these uprisings British investors loaned millions of pounds to the newly-founded republics. The British Whigs also felt a deep kinship with Jacksonian democracy which was sweeping away the last vestiges of federalism in the United States. In all three fields British humanitarianism was rewarded with heavy financial reverses. The Reverend Sydney Smith's "Humble Petition to the House of Congress at Washington" expressed not only the injured feelings of British bondholders who held defaulted American state obligations, but also the keen disappointment of the British liberals who regarded these defaults as a betrayal of the new political philosophy. The petition and letter read in part as follows:

Nor is it only the loss of property which your petitioner laments; he laments still more, that immense power which the bad faith of America has given to the aristocratical opinions, and to the enemies of free institutions, in the Old World. It is in vain any longer to appeal to history, and to point out the wrongs which the many have received from the few. The Americans, who boast to have improved the institutions of the Old World, have at least equalled its crimes. A great nation, after trampling under foot all earthly tyranny, has been guilty of a fraud as enormous as ever disgraced the worst king of the most degraded nation of Europe.

The letter concludes with the parting comment that:

. . . having eased my soul of its indignation, and sold my stock at 40 percent discount, I sulkily retire from the subject, with a fixed intention of lending no more money to free and enlightened republics, but of employing my money henceforth in buying up Abyssinian bonds, and purchasing into the Turkish Fours.<sup>9</sup>

These were years of economic progress. The industrial revolution initiated a half century before was now well under way and British mines and factories were increasing their operations enormously.<sup>10</sup> The increased manufacturing production was absorbed not only by an expanding domestic but also by ever-increasing overseas market.<sup>11</sup> Early British security capitalism was given a firm monetary foundation, for in 1821 the Bank of England resumed specie payment thus making England the first nation to adopt the modern gold standard.<sup>12</sup> Among the advocates of specie resumption were the Ricardos. No doubt they sincerely believed in the validity of their economic argument for specie resumption, but it is also worth noting that the stock exchange house was short on stocks and therefore stood to profit whenever specie payment was resumed by the Bank of England.<sup>13</sup>

British economic philosophy was travelling fast along the road of classicism as marked out by Adam Smith. By the first quarter of the nineteenth century it seemed that the majestic laws of classicism had definitely settled most of the great economic problems of the world, and that there was little further labor for future economists except to follow the beaten paths laid out by the founders of the new science. The insignificant position of security capitalism in these early years was reflected in the scanty references to it in the economic literature of the day. Adam Smith, writing in the period of developed individual capitalism, made only passing reference to the security market.<sup>14</sup> He failed entirely to foresee the future importance of the corporation as reflected in his statement "though such companies may not, in the present times be very oppressive, they are certainly altogether useless."<sup>15</sup> Malthus, although writing at the time that security capitalism was rising showed little interest in it. Even Ricardo, a leading figure in the security capitalism of his day, gave the system only passing notice. The significance of security capitalism was however appreciated by David Hume even though he was writing in the second half of the eighteenth century. In his essay "Of Public Credit." Hume wrote: "Public securities are with us become a kind of money, and pass readily at the current price as gold or silver."<sup>16</sup>

Hume believed that the burden of the national debt was so heavy that the government was headed for bankruptcy.<sup>17</sup> Hume was critical of the stock exchange, and stated that: "What production we owe change-alley, or even what consumption except that of coffee, and pen, ink and paper, I have not yet learned."

He believed that the turnover of securities did not have the same economic significance as the turnover of commodities, a statement which was true in his day.<sup>18</sup>

The economic philosophy of the period generally accepted with little question the social value of individual saving. Malthus however had certain reservations on the value of thrift as may be seen in his statement that :

. . . if, at the very time that the supply of commodities compared with the demand for them, clearly admonishes us that the proportion of capital to revenue is already too great, we go on saving from our revenue to add still further to our capital, all general principles concur in shewing that we must of necessity be aggravating instead of alleviating our distress.<sup>19</sup>

#### DEVELOPMENT OF CORPORATE ORGANIZATION

The development of corporate organization may best be considered as a result rather than a cause of the economic changes of the period. The increasing demand for capital made necessary an improvement in the form of business organization, as the demand for capital became so great that it could no longer be supplied from resources mobilized by the forms of business organization under individual capitalism, namely, the single ownership or the partnership. It was therefore essential to develop the corporate form in order to provide co-operative capital tapped from innumerable private sources. Although the principle of corporate organization had been recognized in the eighteenth century, the number of corporations remained small and their range limited until the second quarter of the nineteenth century.<sup>20</sup> The formation of new corporations was still checked by restrictive legislation of the eighteenth century, particularly by the Bubble Act. Peter Moore, one of the leaders of the new security capitalism and a member of Parliament, attacked the statute, and through his leadership in 1825 it was repealed.<sup>21</sup> As a result corporations now grew in number and in capitalization from only 127 with a paid-up capital of £15,000,000 in 1827 to 994 with a capital of £345,000,000 in 1844.<sup>22</sup>

These corporations were supposed to express the general theory of democracy then being developed in the field of domestic politics. Democratic corporate control was to be achieved by giving one vote to each share, and the shareholders were to elect a board of directors at the annual meeting. In this way the principle of representative government was to apply to the field of business. However, even in this early stage of corporate history, the movement for the separation of the management from the ownership of capital developed quickly. Shareholders surrendered their proxies at the annual meetings in return for the small payment of the stamp duties by the management and so actually had little voice in the administration of their capital.<sup>23</sup>

#### FINANCIAL ORGANIZATION OF THE NEW CAPITALISM

With the close of the Napoleonic wars, the Bank of England assumed a more important position in the money market. After 1819 the membership of its board of directors improved in quality, and included persons who grasped the theoretic problems of the institution. The Bank was fortunate in having as governor, Horsley Palmer, who made a real contribution in developing not only sound banking practice but also sound credit theory. Under Palmer's guidance the Bank took recognition of the importance of the government security market by borrowing on consols, that is, selling government bonds and repurchasing an equal quantity to be paid for at a later date and following what may be today termed an open market policy.<sup>24</sup> However, over these years the Bank was none too successful in coping with the problems arising out of the new security capitalism, for in the crisis of 1825 and again in 1839 the Bank of England had to turn for assistance to the Bank of France.<sup>25</sup>

Commercial banking developed rapidly both in the provinces as well as in London. In hundreds of towns throughout England a local merchant, manufacturer or shopkeeper, having attained a measure of business success in his own field, would dabble in banking by receiving the deposits of his fellow townsmen. Since his credit was generally better known than that of the others in his community, in the course of time he would permit bills of exchange to be drawn on himself on behalf of his less-known neighbors and would charge a fee for this service. Later on he would discount or purchase bills drawn on other parties. After a while these activities increased in importance, and the individual would limit himself to these banking operations. In addition to these private banks, there was a growth in the number of incorporated banks.

The private or the incorporated commercial bank, and not the investment bank was the institution which aided in financing the industrial revolution. Capital for the new manufactures came largely from the personal resources of the individual entrepreneurs, but credit came from the commercial banks particularly in the provinces. These institutions financed the manufacturers to enable them to pay their employees and to purchase raw materials, and these loans were repaid out of the sale of the finished goods. The banks also extended credit to the merchants engaged in marketing goods to domestic and to foreign buyers.

These conditions gave rise to the so-called classical or orthodox theory of the function of the commercial bank. Adam Smith, writing in 1776 when the banks were lending mainly to merchants

under individual capitalism, stated the classical theory of the function of the commercial bank as follows :

What a bank can with propriety advance to a merchant or undertaker of any kind, is not either the whole capital with which he trades, or even any considerable part of that capital; but that part of it only, which he would otherwise be obliged to keep by him unemployed, and in ready money for answering occasional demands.<sup>26</sup>

In order to enable a bank to maintain a sufficiency of quick assets to meet its demand liabilities, the orthodox theory held that a bank should confine its operations to the granting of loans which were liquid in the sense of supplying their own means of self-extinguishment at maturity. Unquestionably the orthodox theory was fully justified under the financial system prevailing in England in the early nineteenth century. Credit was needed primarily over a short period of time either for converting raw materials into finished products or moving them to market whether at home or abroad. Such commercial bank credit was extended not as today by granting the borrower an increase in his deposit account, but by giving him bank notes. These continued to be the dominant form of bank credit until 1844 when the Act of that year limited the amount of the notes of the existing banks and prohibited new banks from issuing such obligations.<sup>27</sup>

Because of his control of credit, the commercial banker exercised an important influence on the political and social life of England. William Cobbett commented satirically on the large number of parliamentary seats which were bought up by the country bankers or "rag merchants" as he termed them.<sup>28</sup> A parliamentary seat was a distinct asset to a banker, for he was thereby in direct touch with the political and economic currents of the day. Even more valuable to a banker was a cabinet portfolio. The commercial banker also held a high social position. Usually the banker and the merchant classes constituted the local aristocracy, for the manufacturer had not yet been admitted to this social group.

The investment banker differed from the commercial banker in that the former granted no commercial credit and therefore issued no notes. Most of the investment banking houses did not receive deposits. In fact, with the exception of Ricardos, they did not even conduct a stock brokerage business. They performed solely the function of issuing new securities and selling them to investors, and further limited these transactions largely to government bonds. The investment banking houses had little to do with the financing of corporations or with industrial undertakings.<sup>29</sup> The great investment houses bitterly opposed the numerous corporate issues which were floated in 1824 and 1825. Alexander

Baring, in a speech to Parliament, strongly denounced these early issues in the statement that : "it was ridiculous to see the objects for which joint-stock companies were forming every day."<sup>30</sup> The investment houses for a long time refused to take part even in the financing of the British railways.<sup>31</sup>

The business of investment banking was highly remunerative, for the sources of profit were quite extensive. The investment banker first derived a large commission from the loan which he floated particularly since the commission was calculated on the par value of the issue and it was customary to issue bonds with a low coupon at a low price.<sup>32</sup> The banker also usually retained a part of the issue for himself, and so controlled a large portion of the floating supply. He was thus able to manipulate the market price, and derive profits from this speculative operation. The banker was also generally appointed agent for the handling of the interest and sinking fund payments, and the fees for this service were high. Furthermore, he was usually given an option on subsequent flotations. In contrast to the large number of commercial banks, the investment houses were few in number. The leading houses were Baring Brothers, Rothschilds, Ricardos and Goldschmidts. The record of these houses as judged by the investment experience of the foreign loans which they floated in the period from 1823 to 1825 may be seen in the following table :

TABLE I  
FOREIGN LOANS OF LEADING BRITISH INVESTMENT HOUSES, 1823-1825.<sup>33</sup>

NAME OF HOUSE	NUMBER DEFAULTING	NUMBER NOT DEFAULTING
Barings . . . . .	2	0
Goldschmidts . . . . .	3	0
Ricardos . . . . .	1	0
Rothschilds . . . . .	0	8
Other houses . . . . .	10	2
Total . . . . .	16	10

From this table it is seen that Rothschilds' record was perfect, since every one of its foreign loans continued to pay interest. This record is all the more outstanding in view of the poor investment experience of other foreign loans. Both loans made by Barings went into default, as did those of Goldschmidts, while the single foreign loan of Ricardos likewise brought loss to its holders. If the eight successful loans of Rothschilds are omitted, all the other issuing

houses had a record of sixteen defaults and only two successful issues. It is therefore little wonder that Rothschilds acquired a high reputation in these years, for they made profits not only for themselves but also for their clients. The successful operations of the Rothschilds added prestige to the entire investment banking fraternity. Contemporary recognition of the importance of the investment banker is seen in the comment of the Reverend Sydney Smith that:

If Caesar were to reappear upon earth . . . Rothschild would open and shut the Temple of Janus; Thomas Baring, or Bates, would probably command the Tenth legion, and the soldiers would march to battle with loud cries of Scrip and Omnium reduced, Consols, and Caesar.<sup>84</sup>

#### GROWING DEMAND FOR CAPITAL

Throughout the eighteenth and early nineteenth centuries the most important demand for capital, as mentioned before, came from the national government. However, after the close of the Napoleonic conflict, the national debt declined, and as this form of investment ceased to absorb the saving of the British public it turned to investment in European, South American government bonds as well as South American mining securities.<sup>85</sup> In 1817 the French indemnity loan was floated, and in 1818 Rothschilds placed a Prussian loan which was the first unguaranteed foreign-government issue to make its appearance on the London money market.<sup>86</sup> The London market also took one-half of an international Russian loan, and in 1824 made liberal advances to Greece to enable that country to free itself from Turkey. The Greek loan of 1824 was handled by a committee of which Lord Byron was a member, and the loan of 1825 was issued by Ricardos. Only a small part of the proceeds was ever applied to the lofty purpose for which the loans were issued. The greater part went to various intermediaries as the Greek commissioners to pay them for their arduous labors in negotiating the loan, several well-known English Philhellenes to compensate them for their losses in a falling security market, Admiral Cochrane to enable him to spend the rest of his life in ease and several Brooklyn shipbuilders to pay them for frigates, most of which never saw service in the cause of Greek liberty. The Greek Government did not pay the interest on these bonds for over a half century.<sup>87</sup> In this period of foreign loans Colombia by contracting a loan in 1820, repudiating in 1828 and settling by means of a new issue in 1845, began the succession of loan flotation, loan repudiation and loan settlement which was destined to stand as a lasting tribute to the patience and to the endurance of the internationally-minded British investor. A bond issue was even floated for the non-existent "King-

dom of Poyais."<sup>88</sup> At least the South American loans floated by our New York bankers in recent years in every case were extended to governments which actually existed.

The demand for capital by domestic corporations was small until the second quarter of the nineteenth century. Until then corporate securities were floated only by public utility (canal, dock, turnpike) and by financial (bank and insurance) companies. For a number of years George Stephenson had urged the application of steam to transportation, but his proposals were met with ridicule.<sup>89</sup> However, in 1825 Stephenson, aided by the funds of individual capitalists, opened the first railroad from Stockton to Darlington. By the early forties the railroads accounted for most of the corporate securities issued in England.

A statement of the nominal value of the total securities listed on the London Stock Exchange in 1843 is given in Table 2.

TABLE 2  
SECURITIES LISTED ON THE LONDON STOCK EXCHANGE, 1843.<sup>40</sup>  
(pounds sterling)

CLASSES OF SECURITIES	AMOUNT	PER CENT OF TOTAL
National government . . . . .	773,000,000	69.09
Foreign governments . . . . .	121,501,410	10.86
Banking corporations . . . . .	46,449,694	4.15
Other corporations . . . . .	177,880,070	15.90
Total . . . . .	1,118,831,174	100.00

From this table it is seen that the securities of the national government constituted 69.09 percent of the total, while foreign government securities accounted for another 10.86 percent. The securities of banking and other corporations amounted to only 20.05 percent of the total.

#### INCREASE IN CAPITAL SUPPLY

The volume of capital available for the security market increased sharply throughout the second quarter of the century.<sup>41</sup> This increase was due to the profits derived from England's rapidly expanding foreign trade, from her developing finance and particularly from her new factory system. Throughout the nation thousands of small manufacturers were enlarging their shops and mills, artisans were raising themselves to be proprietors of their own establishments, and even tenant farmers were deserting the plough to become

manufacturers. These individuals generally furnished their own initial capital, and usually preferred to reinvest their subsequent profits in their businesses rather than spend them on consumption goods. Unquestionably the expansion of British manufacture was financed by entrepreneur and not by investor capital.<sup>42</sup>

The expansion of manufacture brought increased income to the land-owning class. Many of these families, after struggling for years with rising taxes, suddenly found themselves wealthy, due to no effort of their own but to the increase in the rent rolls on their properties either near a newly erected factory town or a recently-opened coal mine. Thus the Earl of Derby rejoiced to see the rent rolls on his Lancashire estates rise from £14,000 a year to £180,000 a year.<sup>43</sup> As a result of these profits from industry and from the unearned increment on land, national wealth almost doubled from 1820 to 1840.<sup>44</sup>

Capital accumulation was going forward not only because of the active force of saving, but also because of the negative influence of the relative decline of government taxation as compared with the rise in national income. It was estimated that in 1815 taxation absorbed 9.0 percent. of the national income, but by 1843 this proportion had dropped to 5.5 per cent.<sup>45</sup>

#### DIFFUSION OF SECURITY HOLDINGS

Diffusion of security holdings is an inherent characteristic of security capitalism, and by the end of the second quarter of the nineteenth century both government and corporate securities were widely held. The new capitalism involved a large number of persons, and so the tendency in finance paralleled the movement in British politics. Just as suffrage, narrowly confined in the eighteenth century, was widened in the early nineteenth century, so the holding of the government's securities was similarly broadened. In the eighteenth century, according to the estimate of Hume, the number of fundholders was only 17,000,<sup>46</sup> but by the early part of the nineteenth century the official government figures placed it at 275,839.<sup>47</sup>

A similar popularization of investment holdings occurred in the new field of corporate securities. The head of Barings, in a speech to Parliament in 1825, noted that "the gambling mania that was at present abroad had seized upon all classes, and was spreading itself in all parts of the country."<sup>48</sup> By the forties, it was said that:

In every street of every town persons were to be found who were holders of Railway Shares. Elderly men and women of small realised fortunes, tradesmen of every order, pensioners, public functionaries, professional men, merchants, country gentlemen — the mania had affected all.<sup>49</sup>

According to the *London Times*, even the clergy were forsaking the scripture for script.<sup>50</sup>

If the demand and the supply of capital are compared, it would seem that throughout this period the latter generally exceeded the former. A vivid demonstration of the strength of the supply of capital is illustrated by an episode in 1818 when the popular demand for an issue of Treasury notes was so insistent that a mob of subscribers, assembled in front of the Bank of England at two o'clock in the morning before the books were opened, crashed the gates off their hinges, and later the entire issue was subscribed by the first ten persons in line.<sup>51</sup> Statistical evidence of the greater rate of saving over the rate of investment throughout the second quarter of the nineteenth century is seen in the decline in the yield on government bonds from 4.42 percent in 1820 to 3.11 in 1850.<sup>52</sup>

#### CRISES UNDER EARLY SECURITY CAPITALISM

In the second quarter of the nineteenth century British security capitalism experienced two severe speculative crises. The crisis of 1825 was brought about by the flotation of unsound and highly speculative securities of foreign governments and of domestic corporations. The promoters of one company stated that it was formed "to drain the Red Sea, in search of the gold and jewels left by the Egyptians, in their passage after the Israelites."<sup>53</sup> Also a company was organized, with the unconsciously true purpose of exploiting "the immense mineral wealth in Ireland which is almost unknown."<sup>54</sup> In a satirical novel of the day, "The Gold, Wine and Olive Joint Stock Company" is organized by a promoter who says: "Why, you talk as if we had any real business to transact. All we have to do is to puff our shares up to a premium, humbug the public into buying them, and then let the whole concern go to ruin."<sup>55</sup> All the elements of thin margin trading were present in this first speculative excess of the new security capitalism. The speaker of the House of Parliament saw fit to warn shareholders that they were liable on the full amount of their subscription, even though the initial deposit which they had made was only one pound of deposit for every hundred pounds of full subscription.<sup>56</sup>

The inevitable crash came in the autumn of 1825. The provincial banks were the first to be affected and a number failed.<sup>57</sup> These bank failures accompanied a sharp collapse of security prices on the London Stock Exchange and losses on securities were placed at approximately £16,000,000. Thus the new system of security capitalism experienced its initial reverse, and society faced the melancholy sight of security losses resulting from a general security panic.

The next serious maladjustment in British security capitalism came in 1846. However in this case the new speculative medium was the stock of the domestic railway corporations. The leading figure in the railway development of these years was George Hudson who was characterized as "The Railway King."<sup>58</sup> Even in these early days Hudson developed advanced methods of railway financing, for he "maintained his popularity with the shareholders by serving them up dividends paid out of their own capital."<sup>59</sup>

Herbert Spencer, at that time a sub-engineer on the London and Birmingham Railway, made the following note on the rising tide of railway speculation :

During the thirties speculative local magnates and far-seeing capitalists, having projected railways which would obviously be advantageous, thereupon chose their engineers, and subsequently let portions of their work to contractors ; but, as fast as there grew up considerable classes of wealthy contractors, and of rich engineers accustomed to co-operate with them, it became the habit for these to join in getting up schemes, forming companies, and practically appointing boards—a policy in all ways beneficial to themselves. Thus, by 1845, there had arisen many and various interests uniting to urge on railway enterprise ; and anyone who took a broad view of the causes in operation, might have seen that great disasters were certain to ensue.<sup>60</sup>

Spencer's father invested in a Derby railway but his philosopher son had sufficient foresight to take him out before the crash came.<sup>61</sup> According to a contemporary comment : "Every nook and avenue of England which, with any shew of decency, could be described in a public print as 'an important district', abounding in traffic of a certain description, was forthwith occupied by an incipient railway company."<sup>62</sup>

Every symptom of a speculative security boom was present, with increasing public optimism, with rising stock prices of existing companies and with the formation of new companies. The particularly serious aspect of this speculative movement was that the investment in railways locked up large amounts of capital in fixed assets and so absorbed the liquid capital of the money market.<sup>63</sup> The reaction finally came in 1846 and railway securities fell sharply. The total losses on railway securities were estimated at over £100,000,000 thus far exceeding the losses in 1825.<sup>64</sup>

#### CRITICISM OF SECURITY CAPITALISM

The new system of security capitalism was subject to bitter criticism. There was considerable public opposition to stock exchange operations and particularly to speculation in government bonds

which constituted the preponderant bulk of securities in this early period. The leading critic was William Cobbett who stated that :

Such indeed, is the operation of all great capitals of credit which enable the capitalist by means of banks to multiply the natural power of his stocks even three and fourfold; to grasp, monopolize and control everything . . . Large capitals and credit . . . have a tendency to monopolization and to form a kind of bourgeois and upstart aristocracy with all the faults of the former and without any of its virtues.<sup>65</sup>

Cobbett's attitude has been well etched by G. K. Chesterton in the following words:

He would have been as ready as any merchant or trader to face the fact that man, as God has made him, must make money. But he had a vivid sense that the money must be as solid and honest as the corn and fruit for which it stood, that it must be closely in touch with the realities that it represented; and he waged a furious war on all those indirect and sometimes imaginary processes of debts and shapes and promises and percentages which make the world of wealth today a world at the worst unreal and at the best unseen . . . what he was at once predicting and denouncing, like a small cloud that had not yet become a universal fog, was that vast legal fiction which we call finance.<sup>66</sup>

The investment bankers were frequently pilloried in the public press, especially because of their loans to foreign governments. These loans were criticised particularly on the basis of their economic disadvantage for they were considered as injuring rather than helping the foreign trade of Great Britain as the funds were applied to build up competing industries. In the House of Lords it was urged that the owner of capital should be restricted by law from sending his capital out of the country.<sup>67</sup> "The profitable employment of our own," it was argued "and not foreign people nor slaves, constitutes the wealth and prosperity of the British Empire."<sup>68</sup> Foreign loans were also scored on political grounds that they were "a mere prop for military despotism."<sup>69</sup>

This opposition to the foreign loan operations of the investment bankers came from varied sources. At times objection came from particular classes, as the Jews and the Quakers who in 1845 bitterly opposed the loans to Russia. The *Westminster Review* declared that "it was the duty of the inhabitants of Western Europe to endeavor to prevent further loans being made to Russia." The article was prophetic, but about eighty years too early, in forecasting that "the spirit of Freedom has gradually but steadily marched eastward until it has at last reached the frontiers of Russia," and concluded with a forecast of a "complete revolution and a repudiation of the Russian debt tomorrow."<sup>70</sup> At a meeting in the London Tavern in 1849, William Cobden, bitter opponent of the belligerent

policies of Lord Palmerston, introduced a resolution that the current Austrian loan was not safe and that armament loans were "unsound in principle and injurious to the interests of nations."<sup>71</sup> The provincial commercial bankers as the financiers of individual capitalism also were loud in their criticism which found vent in their "Circular to Bankers," the official organ of the Association of Country Bankers. These banking critics expressed the resentment of the entrenched though passing individual capitalism in its opposition to the rising security capitalism.

#### EARLY FINANCIAL JOURNALISM

A necessary institution of security capitalism is its own journalism, and this institution was developed in England in the first half of the nineteenth century. The newspapers of the day, such as the *London Times* and the *Morning Herald* began their "city" article or financial column in 1825.<sup>72</sup> By the thirties there was a well developed financial press, and not only the London but also the provincial newspapers carried regular "city" articles. In time came publications devoted entirely to financial subjects, but they were written mainly for bankers and primarily from the professional viewpoint. A little later the financial press made a broader appeal, and catered to the general public. The *Economist*, founded in 1843 as a journal to sponsor free trade principles, gave increasing space to financial data and attained a high level of journalism.

The new security capitalism had need of developing additional journalistic aids to reach the ever-widening range of individual investors. As long as securities consisted mainly of the bonds of the national government, there was little need of an intensive system of security journalism. However, when corporate securities were first introduced in the market, it became necessary to "educate" the investing public, and thus the art of prospectus writing was born.<sup>73</sup> The educational work of these prospectuses was often reinforced by brief pamphlets which supposedly gave impartial economic and financial information concerning investments. A typical brochure was one entitled "An Enquiry into the Plans, Progress and Policy of the American Mining Companies," written in 1825 by Benjamin Disraeli. This pamphlet was written mainly for the purpose of keeping up the price of certain mining shares.<sup>74</sup>

#### LACK OF GOVERNMENTAL CONTROL

Notwithstanding the abuses of the rising security capitalism in issuing unsound foreign government and later over-capitalized domestic railway securities, practically no effort was made to place the

system under government control. So strong was the prevailing classical philosophy of individualism and of laissez-faire in the eighteen twenties that a member of Parliament in commenting on a bill to charter a fraudulent foreign mining company, said that Parliament "had no right to take upon itself to prevent the citizens of London or the people of England, from disposing of their money in any way they might please."<sup>75</sup>

Opposition in Parliament to the new security capitalism came largely from the Tory members, who, however, were unable to bring about any restrictive legislation.<sup>76</sup>

In the forties there was a feeble effort to control the expansion of security capitalism. In 1844, Gladstone, then a Tory and President of the Board of Trade, became Chairman of the Select Committee on Joint Stock Companies. This Committee in its final report concluded that "periodical accounts, if honestly made and fairly audited, cannot fail to excite attention to the real state of a concern; and by means of improved remedies, parties to mismanagement may be made more amenable for acts of fraud." The Committee thus accepted the principle of disclosure that protection of the investor in corporate securities rested in giving him the truth about the securities which were offered to him.<sup>77</sup> The Committee's report formed the basis of the Companies Act of 1844 which required the registration of prospectuses. This Act marked the beginning of legislative protection of security purchasers in England. The Committee, in general, took a narrow view of the necessary extent of governmental control in the conclusion that "the imposition of statutory regulations and prohibitions calculated not merely to put a stop to the activities of the wrong-doer but to place quite intolerable fetters upon private business."

Gladstone attempted to extend a degree of regulation over the railroads in the Railroad Bill of 1844. The original bill contained a provision giving the government a limited right to purchase the railways then being constructed, but this provision was rejected by Parliament. Probably one reason for the elimination of this and other regulatory provisions of the bill was the fact that 157 members of Parliament were listed on the registers of the new railway companies.<sup>78</sup> Economic self interest as well as economic reasoning thus explains the parliamentary support for a laissez-faire policy in relation to British security capitalism throughout the second quarter of the nineteenth century.

#### CONCLUSION

Thus throughout the eighteenth century the origins of security capitalism may be traced in the growing volume of government

securities, in the increase in the number of holders of such securities and in the formation of the London Stock Exchange. Over these years individual capitalism still prevailed. However, in the period from the close of the Napoleonic wars until the middle of the nineteenth century, under favorable political and economic conditions, security capitalism made its appearance along with declining individual capitalism. At the beginning of the period the latter system was still dominant and continued to finance the economic transformation of England with capital supplied by the individual entrepreneurs and credit furnished by the commercial banks.

However, the institutional characteristics of the new system of security capitalism were taking definite shape. First came the rise of public security investment when Europe and South America floated bond issues in London. Then with the growth of corporations came private securities particularly for financing railroads, and this development of transportation with the exception of banking was the only important phase of the industrial revolution which was financed by security capitalism. Coterminously came the accumulation of funds seeking such security investment. For the first time in English history came the widespread diffusion of security holdings which is one of the fundamental characteristics of security capitalism. In order to bring together these forces of the supply of and the demand for security investment, there developed the necessary machinery in the form of investment banking houses organized to place new securities, stock exchanges operated to facilitate the purchase and sale of outstanding securities and a security journalism conducted to disseminate financial information to the investing public. The supply of capital at first exceeded the demand, and the presence of this surplus capital led to an increase in demand for new securities. The volume of these new securities increased temporarily and overinvestment led to the crises of 1825 and of 1846. In both cases the increased volume of new securities was accompanied by a decline in the quality of these securities, and eventually brought losses to the holders. However, over this period there was little governmental control of security capitalism with the exception of the adoption of the disclosure principle in the Companies Act of 1844.

## CHAPTER 3

### *TRIUMPH OF BRITISH SECURITY CAPITALISM*

THE period from the end of the forties until the early nineties marked the triumph of British security capitalism. This period, which falls within the Victorian era, was the high tide of England's economic prosperity. The knowledge of her scientists, the shrewdness of her business men and the intelligence of her bankers brought to her shores a material prosperity and a social well-being never before attained in any country up to that time with the possible exception of the United States. Agriculture entered its "golden age," for farming under advanced methods of cultivation was conducted with satisfactory results. Over these years England became the manufacturer, the merchant and the banker for the world. The power which drove the wheels of industry in this period was steam, and for this purpose England possessed the richest coal deposits in all Europe.<sup>1</sup> The output of coal, pig iron, and steel expanded.<sup>2</sup> Although the output of England's factories increased, there was no oversupply of goods, as new foreign markets were continually developed. True, the Continent was also becoming industrialized, and Western European countries were now largely satisfying their needs for finished goods from their own factories and mills. England, however, found markets in other parts of the world, including her own colonies, as well as in the Far East and in the new countries in South America.

The population of England in the latter half of the nineteenth century grew rapidly and provided an ever-increasing domestic demand for British goods. The economic, financial and social system of the Victorian era thus was flexible, and was capable of adapting itself to the changes taking place in a dynamic society.

### PHILOSOPHIC INTERPRETATION OF SECURITY CAPITALISM

The second half of the nineteenth century was marked by rapid intellectual progress, and there was a growing reliance on pure ratiocination as a means of solving the problems of the day.<sup>3</sup> Particularly was this true in the field of economic theory. A leading interpreter of developed British security capitalism was Walter Bagehot who, as a banker, was a successful practitioner and, as editor of the *Economist*, was also a keen student of the system. Another close observer

was Viscount Goschen who grasped the significance of the institutions of the new system. John Stuart Mill, writing in the middle of the century, was naturally more conscious of the meaning of the new system than the earlier classicists. The growing importance of the corporation over these years may be seen by contrasting the economic views of Adam Smith and of Mill. While the former failed to foresee the future position of the corporation, the latter fully recognized its significance particularly in the field of large scale operations.<sup>4</sup> Mill likewise sensed the importance of capital in the new economic system.<sup>5</sup> He accepted the classical theory of the value of saving, but with certain qualifications. In commenting on "The Tendency of Profit to a Minimum," he observed that in developed countries capital could tend to become so great that it might threaten the extinction of profits.<sup>6</sup>

In general the Victorian period was an age of economic self-satisfaction and the favorable attitude of the general public to security capitalism was reflected in the following contemporary article on the growth of capital:

Millionaires benefit mankind more than themselves. In their search for new millions, they lead to universal enrichment; in themselves attaining leisure, they win it for others. They are ranged on the side of peace and good-will among men; and however greedy of wealth personally, are allied with the practical moralists of the age. The ministers and servants of economy, they throw down the ramparts erected by barbarism against the intellectual and ethical progress of our species, and proclaim the fraternity of mankind. They drag the savage from his cave and make him share in the gains of civilisation; they lift the felon from his lair and bid him toil at honest work; they bid labour economise *its* capital, and place it in the general reservoir of wealth, thereby to share yet more largely in the triumphs of trade. Thus war, pestilence, and famine disappear, and peace, health, and plenty prevail.<sup>7</sup>

#### ABSENCE OF FINANCIAL IMPERIALISM

The Continent was disturbed by a series of conflicts which had ominous political effects for the future, but in which England was not a direct participant except the Crimean War. It engaged in a number of "little" wars, and in the second half of the nineteenth century gained additional overseas territory. With the exception of the Egyptian War, these conflicts and this expansion had little relation to banking security capitalism. In fact, the Marxian charge, that security capitalism leads to "imperialistic" wars waged to advance or to protect the interests of bankers and bondholders, is not justified by the actual facts of England's financial and political history. In spite of the extensive political power and the vast economic strength of the British holders of foreign securities, they rarely

forced their government into a policy of collecting unpaid debts by battleships or by bayonets. Defaults by foreign governments on the bonds floated and held in England were numerous in these years, and the circumstances of these repudiations were often exasperating. Nevertheless, the British government did little to protect the interests of British holders of foreign securities.<sup>8</sup>

This passive attitude of the government was severely criticised by the financial press which felt that the government was not giving sufficient protection to the holders of foreign securities.

#### GROWTH OF CORPORATIONS

In the previous period the corporate form of organization had grown by fits and starts. In the boom years of 1824-1825 and of 1844-1845, the number waxed considerably only to wither in the lean years which followed. Now the growth of corporate organization was continuous and sustained. The number rose from 700 in 1855 to 2,000 in 1864 and to 7,900 in 1883.<sup>9</sup> The impetus for this increase came in 1855 when the limited liability feature of corporate organization was definitely specified in the Companies Act of that year.<sup>10</sup> This statute marked the passing of the dominance of individual capitalism and the beginning of the supremacy of security capitalism. The single owner and partnership forms of business organization were at last replaced by the corporation, and the personal element in business now gave way to the impersonal character of corporate organization.<sup>11</sup> So reckless was the formation of many of these new companies that the master of the rolls declared: "no doubt many companies were started for the purpose of being wound up."<sup>12</sup> This unsatisfactory result of the new Companies Act cast serious doubt on the advantages of limited liability which was in consequence characterized as a "pestilential principle."<sup>13</sup>

#### DEVELOPMENT OF FINANCIAL ORGANIZATION

These years witnessed a rapid development of financial institutions such as the Bank of England, the commercial banks, the overseas banks, the investment banks, the investment trusts and the stock exchange. The Bank of England continued its passive policy toward security capitalism. However, in one important respect the new system was recognized by the Bank and that was in granting loans on marketable securities listed on the London Stock Exchange except mining shares, and even on unlisted securities if they were sound and if their value could be ascertained.<sup>14</sup>

For a number of years the large commercial banks developed branches throughout the country, and absorbed many of the private















































































































































































































































































































































































































