

BOOK REVIEW

Mitchell, Lawrence E. *The Speculation Economy: How Finance Triumphed over Industry*. San Francisco: Berrett-Koehler, 2007.

In *The Speculation Economy*, Lawrence E. Mitchell argues that the American financial system underwent a radical change at the start of the twentieth century as finance went from being a servant of industry to dominating it. “The speculation economy,” he writes, “is one in which business management focused on production is replaced with business management focused on stock price” (x). In his earlier book *Corporate Irresponsibility*, Mitchell—a law professor at George Washington University—analyzed how a concern with maximizing shareholder returns in the short term eroded corporate management’s commitment to the long-term health of their businesses and society at large. Here he examines the historical roots of twentieth-century corporate capitalism and its dysfunctional relationship with the “modern stock market.”

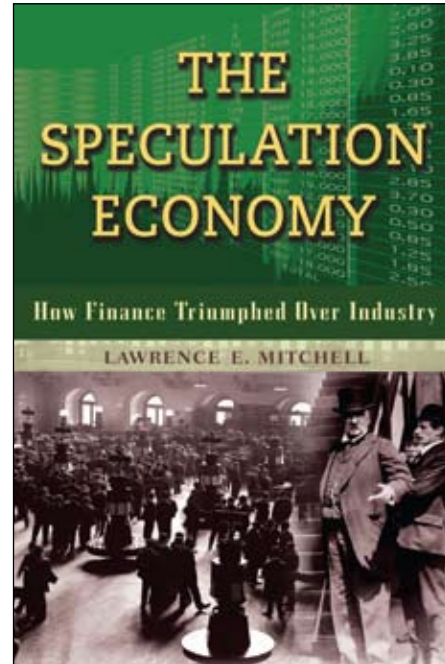
Mitchell weaves together strands of business, political, legal, and cultural history to explain the rise of the stock market to its central position in the American economy and society. The industrial economy had gradually evolved over the course of the nineteenth century, but the “speculation economy” emerged suddenly during the merger wave of 1897–1903, when large corporations took over much of American manufacturing. In the last decade of the nineteenth century, large

industrial businesses sought new ways to cooperate and suppress competition, state laws loosened controls over corporate finance, and prosperity returned after years of depression to produce a growing pool of capital seeking new investments. Most importantly though, according to Mitchell, a cadre of promoters and financiers took advantage of these conditions to create the “giant modern corporation,” an institution primarily intended to enrich its creators. Businesses organized to produce goods were replaced with new corporations designed only to produce shares of stock—shares that were foisted upon a growing population of middle class investors.

As Mitchell recounts, critics charged that the corporations were overcapitalized or had issued “watered stock.” Overcapitalization makes little sense in light of modern financial theories, but it was the major point of contention for almost three decades during the corporation’s rise to dominance. A corporation was considered overcapitalized when it issued shares of stock with a total par value far in excess of its tangible assets. Industrialists sold their businesses to new corporations in exchange for this so-called watered stock; promoters profited by issuing themselves large blocks of watered shares and selling them on the open market. Critics argued that in the absence of publicly available financial information, watered stock masked monopoly profits and contributed to market speculation by adding to the mystery of what a corporation was “really worth.” Defenders of the practice countered that the value of these shares depended not on the underlying physical property of a corporation, but on the profits management produced using that property.

Most importantly, they argued, the value of shares depended on the expectations of investors and speculators buying and selling in the open market—a market that historians have found was rather adept at discounting the water present in corporate shares. Though Mitchell claims to be agnostic about whether overcapitalization was the problem critics believed it to be, he clearly sympathizes with them.

Overcapitalization was central to the political debate over regulating corporations and finance at the start of the century. For over a decade, Congress considered federal incorporation and licensing measures that would have required financial disclosures from corporate managers and promoters and uncovered overcapitalization. The rationale behind the federal incorporation movement was not to protect innocent investors, Mitchell emphasizes, but rather to give the government a tool for identifying monopolistic corporations that charged high consumer prices and generated exorbitant profits for shareholders. After the Panic of 1907 demonstrated that institutional investment in corporate securities threatened the stability of banks and trust companies during market slumps, regulatory proposals focused on curbing speculation. Ultimately, Mitchell's story is about what the federal government failed to do, as public fear of centralized governmental power left the modern corporation and its financial machinations to evolve largely unimpeded. When the federal government did finally act during the Great Depression, regulation was mostly about protecting individual investors and maintaining stability in financial markets. Mitchell argues that the fundamental questions about the power of large corporations, and the moneyed



elite that benefitted most from them, faded after 1914; if anything, New Deal disclosure laws contributed to the legitimacy of the corporate financial economy and the growth of the investing public.

Mitchell demonstrates that the rise of the stock market was a social and cultural transformation as well. As stock issues multiplied, a growing number of economists, politicians, and Wall Street boosters depicted stock ownership as the source of a new middle class independence in an era when farming and small business ownership were on the decline. They argued that the stock market represented a stake for the ordinary citizen in the corporate economy and offered a way to counteract growing wealth inequality; widespread stock ownership could defuse class warfare and erect a barrier to “creeping socialism.” While Mitchell concedes that the number of shareholders before World War I was still very small by mod-

ern standards, he argues that these political and cultural ideas were more powerful than those numbers would suggest and contributed to the rapid rise of small investors in the 1910s and 1920s.

Mitchell ends his story in 1919, a decade before the dramatic boom and bust of 1929. The end point might seem a strange one, but Mitchell has chosen it carefully. The key, he tells us, is that after 1919, watered stock ceased to be a subject of public or political debate. The government's wartime Liberty Bond drives had introduced millions of Americans to investing, and serious talk of market regulation ended. The "speculation economy" arrived as the investing public focused less on the safety of principal and predictability of returns, tuned out concerns about watered stock, and purchased the common stock of major American corporations in large numbers. By speculation, Mitchell does not mean to single out practices like short selling or margin trading, designed to make quick profits on rapid changes in stock prices. Rather, he argues that the purchase of common shares is inherently speculative because it is, at best, a bet on rising corporate profits over the long term. At worst, investors participate in a "guessing game" that leads to unreasonable expectations about a company's future value and forces managers to do whatever they have to do to meet the market's expectations, prop up stock prices, and keep their jobs.

Mitchell has crafted an important and ambitious study on the timely issue of the financial sector's role in American society. However, the framework in which he places his impressive research oversimplifies the complexity of his narrative. Mitchell repeatedly asserts that the

corporation served no other purpose than to enrich promoters and bankers at the expense of business and investors. More attention to business and social history would be necessary to substantiate such a broad claim. After his introduction to the problems of business competition in the 1890s, Mitchell does not consider how the corporate form might have addressed legitimate business challenges, or how changes in financial practice and theory grew from changes in business conditions. For example, investors shed their aversion to watered stock in the 1920s not necessarily because they were duped, but because corporation value largely came to depend not on physical assets, but on intangibles like branding, managerial innovations, and developing technologies that are legitimately difficult to value. To Mitchell, new middle class investors were largely manipulated by promoters who "dumped" stock on the market and opinion-makers who convinced them that buying it was a good investment and a path to independence. Mitchell writes that "the history of the speculation economy is a history of choice" (279), but his depiction of investors as victims overshadows how they made their choices and how their investment decisions were not just reactions to financial changes but actually helped to create them.

While Mitchell sees investors as passive in the face of powerful financial interests and a timid federal government at the birth of the large corporation, he emphasizes that today's broad market participation is the key to making it a truly social institution. He urges investors to abandon their drive for short-term market gains and use their collective power to demand responsible corporate

management, by which he means a commitment to high wages, investment in research and development, long-term strategic planning, and honest financial disclosure. But if investors have not been simply run over by the market, neither do they possess the collective free will to change it on their own. The real strength of *The Speculation Economy* is how it details the complex web of economic, political, and social processes that have produced modern financial markets. Any radical change in the way the corporate economy operates will require fundamental changes in the underlying business and political institutions that gave rise to it in the early twentieth century.

Daniel Holt recently received his Ph.D. in history from the University of Virginia. He is currently working on a history of American securities law and regulation from the Civil War to the New Deal.