

The NBER Digest

NATIONAL BUREAU OF
ECONOMIC RESEARCH, INC.

November 1990

Did Morgan's Men Add Value?

The fees earned by investment bankers always have stirred controversy. The calumny heaped upon the profession in recent years, however, is mild by comparison with the attacks it suffered in the early years of the 20th century. In that era, a handful of powerful investment houses, led by J. P. Morgan & Co., dominated stock and bond underwriting and seated directors on the boards of companies that owned 40 percent of the nation's capital stock.

This so-called "money trust" was accused of exacting a "tribute" from U.S. business through exorbitant underwriting fees. For example, the investment bankers who managed the creation of U.S. Steel in 1900 received commissions worth more than 10 percent of the value of shares floated in that deal. These commissions were as large a share of the American economy then as \$15 billion would be today. Morgan's men also were accused of using interlocking directorates to exert control over the entire economy.

However, according to NBER researcher **J. Bradford De Long**, the "money trust" provided real value to shareholders in return for their high fees. In **Did J. P. Morgan's Men Add Value? A Historical Perspective on Financial Capitalism** (NBER Working Paper No. 3426), De Long suggests that the involvement of the House of Morgan increased shareholder value in two ways. First, Morgan engineered the creation of monopolies, such as U.S. Steel and International Harvester, that were able to charge higher prices than their predecessors could. Morgan also may have helped firms to extract monopoly rents from the public by having directors sit on the boards of competitors, such as General Electric and Westinghouse.

Second, Morgan directors may have increased stock values by assuring investors that a firm was well managed. At a time when there was little public disclosure of corporate information and investor protections were weak, the involvement of a firm such as J. P. Morgan signaled a company's soundness as a potential investment. The firm's reputation thus carried over to its clients.

De Long analyzes financial data for 1911-2 for 20 companies that had a Morgan partner on their boards and for 142 other companies selected at random. He calculates that the presence of the Morgan partner significantly raised the value of the company's common stock—perhaps by enough to justify Morgan's high underwriting fees. Although stockholders had reason to be concerned that Morgan was involved both in a company's management and in its securities underwriting, "perhaps conflicts of interest . . . have been outweighed, at least for shareholders, by the advantages of having Morgan and Co. watching over firm managers," De Long suggests.

"The 'money trust' provided real value to shareholders in return for their high fees."

The influence of the "money trust" began to decline after World War I, De Long notes, as competing firms began to sell stocks and bonds to the general public, reducing the importance of the Morgan reputation for corporations trying to raise new financing. The dissolution of the "money trust" and the

separation of banking and corporate finance in the 1934 Glass-Steagall Act were among the most significant achievements of the populist opposition to financial capitalism. It is ironic, De Long observes, that so many modern-day populists call for investors to take a long-term view of corporations and become more involved with corporate management—precisely the roles for which the “money trust” was so soundly criticized three-quarters of a century ago. ML

New Products and Inflation Measurement

When totally new products are introduced, their benefits to society can be enormous. But those benefits generally are not reflected in measures of economic output, or in price changes, in industries that are undergoing rapid technological change. In fact, standard measures may show that prices are rising over time, while quality-adjusted prices actually are falling.

According to NBER Research Associate **Manuel Trajtenberg**, the CT scanner is just such a product. CT scanners produce highly accurate images of such vital organs as the brain, which previously could not be seen at all. They were developed in Britain in the early 1970s, and soon there were about 20 firms producing them worldwide. According to Trajtenberg, “The fierce competition that ensued brought about a breathtaking pace of technical advance.”

The first CT scanner was sold in the United States in 1973 for \$310,000. Fifteen additional scanners were sold here that year. By 1985, nearly 60 percent of U.S. hospitals with more than 100 beds had at least one CT scanner.

In **Product Innovations, Price Indices, and the (Mis)measurement of Economic Performance** (*NBER Working Paper No. 3261*), Trajtenberg estimates that the “real,” or quality-adjusted, price of CT scanners declined by 92 percent during the first year after their introduction. During the first five years that CT scanners were available, their quality adjusted prices fell a staggering 80 percent *per year*.

The pace of technical progress, and hence the rate of real price reductions, was much faster during the first half of that period than in the last half, though. Trajtenberg estimates that the quality-adjusted price of CT scanners fell by an additional 53 percent between 1977 and 1982. While still dramatic, that is

nonetheless far slower than the price decline and quality improvements that followed in the years immediately after their introduction in 1973.

“Standard measures may show that prices are rising over time, while quality-adjusted prices actually are falling.”

Trajtenberg uses a two-step process to come up with his quality-adjusted prices. First, he gathers detailed data on the attributes, prices, and individual sales of all brands of scanners marketed each year. With that data, he can estimate the market values of the year-to-year innovations in speed and accuracy, and then can construct quality-adjusted price indexes. Although in nominal terms the price of scanners actually increased by 175 percent in a decade, their real price fell drastically because of technological improvements in speed and accuracy. Trajtenberg concludes that government inflation measures may overstate price changes substantially if adjustments to price indexes in high tech sectors do not address product innovation “up front.”

Trends and Cycles in Foreign Lending

By now it is almost a cliché that the “globalization of financial markets” is a revolutionary new development of 20th-century society. But a new study by NBER Research Associate **Barry Eichengreen** shows that international capital movements have yet to attain the relative size they reached at the turn of this century—and are unlikely to attain that size until well into the next.

In **Trends and Cycles in Foreign Lending** (*NBER Working Paper No. 3411*), Eichengreen finds that current account balances (both surpluses and deficits) for a sample of nine major countries averaged 4 percent of GNP between 1900 and 1913, compared with only 1.7 percent from 1973 to 1981. For the intervening period, international capital flows were even smaller.

Eichengreen reports that between periods of very high international lending there have been periods of busts. This boom-and-bust pattern in international finance goes back to the early 19th century. Every 40 years or so, investors seem to be caught up by a financial innovation—railroad bonds in the 1880s; stock promotions in the 1920s; bank loans to the

Third World in the 1970s—that pushed international lending to unsustainable heights.

Eventually, there is a crisis (we currently are suffering through an example). Excessive enthusiasm gives way to extreme pessimism. The crisis usually begins when real interest rates suddenly rise, or when the export prices of borrowing nations fail, and the borrowers no longer can obtain new loans to meet their interest payments. This crisis lasts until all the individuals with firsthand experience have retired, and a form of collective amnesia sets in among international bankers. Then the game can begin anew.

Eichengreen considers three possible explanations for these debt cycles. The first captures the boom-and-bust character of lending, but does not explain why the booms sometimes are more pronounced, more extended, and more frequent than the busts.

“Between periods of very high international lending there have been periods of busts. This boom-and-bust pattern in international finance goes back to the early 19th century.”

The second predicts that the volume of lending should be greatest when international divergences in the stage of economic development, and hence in the incentives for domestic savings and investment, are greatest. Unfortunately, the historical evidence does not support this explanation.

Analyses that focus on the international monetary and financial regime come closest to providing a satisfactory explanation for differences in the volume of lending across periods, Eichengreen finds. He considers the argument that the stability and certainty provided by the fixed exchange rates of the gold standard led to the exceptional volume of international capital flows prior to 1913. But there was a much lower volume of lending under the gold standard of the 1920s, Eichengreen asserts.

He suggests that the fact that periods of extensive lending were characterized by a remarkable absence of interest rate and commodity price shocks is more important than the gold standard. The kind of disturbances that interfere with a debtor country's ability to service its debt have become much more pervasive in recent decades. This has created an environment that is more susceptible to financial crisis and to repeated disruptions in the lending process. The gold standard might have contributed to the remarkable absence of interest rate and commodity price shocks before 1913, Eichengreen concludes, but so may have a host of other features of the international economic environment. LB

Immigrants on Welfare

Over the last 30 years, the number of immigrants arriving in the United States has increased considerably, and there has been a major shift in their countries of origin. Before 1950, over 60 percent of immigrants to the United States came from Europe, and less than 4 percent came from Asia or Africa. Between 1971 and 1980, less than 18 percent of immigrants came from Europe, while over 35 percent came from Asia. Now, a study by **George Borjas** and **Stephen Trejo** estimates that changes in the national origin of immigrants between 1950–9 and 1975–80 led to an increase of more than 2 percentage points in the fraction of immigrants on welfare.

In **Immigrant Participation in the Welfare System** (*NBER Working Paper No. 3423*), the authors report that in 1980, the welfare rolls included 29 percent of immigrants from Vietnam; 26 percent of immigrants from the Dominican Republic; 18 percent from Cuba; 12 percent from Mexico; and so on, down to 2.3 percent from Iran; 2.4 percent from India; 3.9 percent from Switzerland; 4 percent from Denmark; and 4.7 percent from West Germany. However, Borjas and Trejo note that welfare participation rates in the United States increased between 1970 and 1980 for both immigrants and natives. In 1970, the proportion of immigrant households receiving welfare was slightly lower than that of native households—5.9 percent versus 6.1 percent. By 1980, welfare participation of immigrants was almost a full percentage point higher than for natives—8.8 percent versus 7.9 percent.

Borjas and Trejo also find that welfare participation increases more rapidly with the age of an immigrant than it does for natives. For instance, 5.2 percent of natives aged 18–34 were on welfare in 1970 versus 6.5 percent of that same group in 1980. This represents an increase in welfare participation of 1.3 percentage points over the decade for natives. But for immigrants in the same group who arrived in this country between 1965 and 1969, the analogous increase was 4.3 percentage points. For all immigrant groups arriving after 1960, welfare participation rates were at least 3 percentage points higher than those of natives over the age of 50.

“Changes in the national origin of immigrants between 1950–9 and 1975–80 led to an increase of more than 2 percentage points in the fraction of immigrants on welfare.”

Using data from the 1970 and 1980 Censuses, Borjas and Trejo find that the pattern of increasing wel-

fare dependency among immigrants is true for both male- and female-headed households.

In addition, more recent arrivals are more likely to receive welfare than earlier immigrants were at the same stage of the assimilation process. For example, immigrant households who arrived between 1965 and 1969 had an overall welfare participation

rate of only 5.5 percent in the 1970 Census. However, the immigrant households who came between 1975 and 1979 had a welfare participation rate of 8.3 percent in the 1980 Census. This increase of 2.8 percentage points exceeds the corresponding increase—1.8 percentage points—among native households for the same decade. DRF

NBER

The National Bureau of Economic Research is a private, non-profit research organization founded in 1920 and devoted to objective quantitative analysis of the American economy. Its officers are:

Chairman—George T. Conklin, Jr.
Vice Chairman—Paul W. McCracken
Treasurer—Charles A. Walworth

President and Chief Executive Officer—Martin Feldstein
Executive Director—Geoffrey Carliner
Director of Finance and Administration—Sam Parker

Contributions to the National Bureau are tax deductible. Inquiries concerning contributions may be addressed to Martin Feldstein, President, NBER, 1050 Massachusetts Avenue, Cambridge, MA 02138.

The NBER Digest summarizes selected Working Papers recently produced as part of the Bureau's program of research.

Working Papers are intended to make preliminary research results available to economists in the hope of encouraging discussion and suggestions for revision. The Digest is issued for similar informational purposes and to stimulate discussion of Working Papers before their final publication. Neither the Working Papers nor the Digest has been reviewed by the Board of Directors of the NBER. Preparation of the Digest is under the supervision of Donna Zerwitz. The articles indicated by ML, LB, and DRF were prepared with the assistance of Marc Levinson, Lewis Beman, and David R. Francis, respectively.

Individual copies of the NBER Working Papers summarized here (and others) are available free of charge to Corporate Associates. For all others, there is a charge of \$3.00 (\$4.00 outside of the U.S.) per paper requested. Advance payment is required on orders. Please do not send cash. For further information, please contact: Working Papers, NBER, 1050 Massachusetts Avenue, Cambridge, MA 02138; (617) 868-3900. Abstracts of all current National Bureau Working Papers appear in the NBER Reporter.