MANAGED BY THE MARKETS

How Finance Reshaped America

GERALD F. DAVIS

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PREFACE

In the fall of 2008, financial institutions in the United States underwent a period of upheaval not seen since the wave of bank failures that led off the Great Depression. Dozens of private mortgage companies had gone under during the previous year, when the housing bubble burst. The trouble had spread throughout the financial sector, and the US government was on a takeover binge to prevent failing financial grants from bringing down the rest of the economy. Fannie Mae and Freddie Mac, the corporations standing behind half of the American mortgage market, were placed under the control of the Federal Housing Finance Agency in early September. The following week the Federal Reserve acquired 80% of AIG, the nation's largest insurance company. A few days after that, Washington Mutual, America's largest savings and loan, became the biggest bank failure in US history when it was seized by the Office of Thrift Supervision and sold to JP Morgan Chase.

In the meantime, investment bank Lehman Brothers had gone bankrupt—the largest bankruptcy in US history—while its distressed competitor Merrill Lynch sold itself Bank of America. Goldman Sachs and Morgan Stanley, the two remaining major investment banks, converted to bank holding companies under the supervision of the Fed. And in October the Treasury Department compelled the nine largest US commercial banks (which now included Goldman and Morgan Stanley) to sell stakes in themselves to the government, drawing on a vast new bailout fund authorized by Congress a few days earlier. In a period of just over a month, a conservative presidential administration devoted to free markets and financial deregulation had engineered a level of direct government control over the nation's financial institutions undreamed of by V. I. Lenin a century before.

The frequent comparisons of the economic crisis of 2008 to the Great Depression of the 1930s were not misplaced. Like the first Great Depression, GDII was a crisis of economic institutions, not simply a financial crisis, because finance permeated the economic lives of American households. From college and retirement savings invested in equity mutual funds, to monthly credit card payments tied to LIBOR, to refinanced mortgages and lines of credit that allowed homeowners to extract cash from nominal changes in the value of their dwellings, Americans' economic security was lashed to financial markets to an unprecedented degree. The crisis itself had been precipitated by an unlikely nationwide bubble in housing prices. Demand for "safe" mortgage-backed securities among global financial institutions had turned homes into a peculiar form of stock option, increasingly available to buyers with sketchy documentation of their income. This drew speculators, who found that the returns available from buying and flipping houses surpassed those available on the stock market, and without the downside risk—if the house declined in value, one could just walk away from the mortgage. The result was a run-up in prices unprecedented in American history.

The housing bubble had partially masked weaknesses in the real economy, from the long-term stagnation of wages to death throes of much of the manufacturing sector. Homeowners had extracted hundreds of billions of dollars in equity from their homes, much of which went to finance personal consumption that outstripped their wage income. The bubble was thereby responsible for many of the new jobs created in housing and retail. Meanwhile, the deindustrialization of America gathered steam for its final push, as more than 4 million jobs in manufacturing evaporated during the eight years of the Bush presidency.

With home prices in free fall and credit tight after the housing bubble burst, consumers avoided major purchases. The result was an existential threat to the American auto industry, a keystone of the production economy. It appeared that without a government bailout, one or more of the "big three" (General Motors, Ford, and Chrysler) would end up in bankruptcy, or perhaps even liquidation, along with dozens of their suppliers. The financial crisis was like the meteor that wiped out the dinosaurs—in this case, America's largest remaining manufacturers.

The financial crisis further accelerated the decline of the peculiar American system of social welfare, in which health care and retirement income were tied to corporate employers. Economic pressures had led many firms, such as GM, to abandon their commitments to health insurance for retirees and their families, and now financial distress was causing employers to cut back on coverage for their current employees. Retirement security was also threatened by collapsing stock prices. For two decades, companies had shifted employees from company pensions to individual 401(k) plans invested in the stock market. Workers had been encouraged to think of themselves as investors responsible for their own economic destiny. Millions had taken the bait, leading to a nation in which half the population had their economic security tied to the stock market.

Finance had become the new American state religion. Its converts adhered to a shared creed: Index funds were a safe and remunerative place to put your savings. House prices always went up, so it made sense to buy the biggest one for which you could get a mortgage. And most importantly, trust the market: it speaks with wisdom greater than any of its participants. Even the way people talk had been transformed. Getting an education became "investing in human capital," and getting to know your neighbors was "investing in social capital." A home was not so much a tie to a community as a tax-advantaged option on future price increases. Shakespeare wrote, "All the world's a stage, and all the men and women merely players." Now, all the world was a stock market, and we were all merely day traders, buying and selling various species of "capital" and hoping for the big score.

The mortgage meltdown and the resulting global financial crisis shattered the creed of the new investor-citizens. American stock indices at the end of 2008 were well below where they had been a decade before, meaning that average investors would have been better off putting their funds into a government-insured savings account than into the stock market. Perhaps one-quarter of homeowners with mortgages—and half of homeowners in "bubble" states like Nevada—found themselves trapped by houses worth less than they owed, and many of them were compelled to abandon their homes and move on. Entire neighborhoods from Southern California to Florida to Detroit were dotted with empty houses in foreclosure. Meanwhile, villagers in Narvik, Norway, found that their municipal budget had been sacked by collapses in the value of bonds that their local government had bought from Citigroup, backed by mortgage payments owed by American property speculators. Citigroup in turn had to seek capital from the sovereign wealth funds of Abu Dhabi, Kuwait, and Singapore due to its own multi-billion dollar losses and ultimately required a vast Federal bailout.

Banks around the world found themselves holding securities that were effectively impossible to value because their markets had disappeared. And their governments tried a variety of methods to deal with the problems that American mortgage securities had precipitated in their local financial sectors. The UK, facing a similar situation to the US, adopted a bold bailout plan that partially nationalized three of its biggest banks—Lloyds TSB, Royal Bank of Scotland, and HBOS (slated to be acquired by Lloyds), with the latter two losing their CEOs as a result. The fifteen members of the Eurozone collectively agreed to a similar plan. And leaders of the G20, which included both rich countries and large emerging markets such as China, India, and Brazil, met in Washington to create a coordinated response to the global economic crisis.

Observing the financial crisis unfold was like watching a game of cricket: the action didn't make any sense, it never seemed to end, and it was impossible to keep track of all the players. Who was to blame—bonus-obsessed Wall Street bankers, an overly cautious Federal Reserve, rapacious mortgage brokers, lax regulators, greedy speculators (some of which were pension funds or Norwegian villagers), homeowners who borrowed too much? Indeed, who was *not* to blame? And how were we going to get out of this mess?

- The early years of the previous century had also seen large-scale economic upheaval and financial crisis. The United States at the turn of the twentieth century was in the midst of a generation-long transition from an agrarian to an industrial economy. Industry was becoming concentrated in a few dozen manufacturers, railroads, and utility companies, and a handful of New York banks held privileged positions in the new corporate power structure. Through a massive merger engineered by Wall Street in 1901, US Steel became America's first billion-dollar company, to be joined by other giants such as General Motors, General Electric, and AT&T. Big companies had the jobs, the assets, and the power; their executives and bankers were in charge. In this new corporate system, populists knew whom to hold accountable—J. P. Morgan, John D. Rockefeller, Henry Ford. To understand the plotline of American society, one had to understand the newly corporatized economy and its workings.

- My grandfather's life encompassed the shift from an agrarian to an industrial society in the early twentieth century. After growing up on a family farm in Indiana and mustering out of the army in 1919, he migrated to Detroit to work at Ford Motor Company's Highland Park factory making Model Ts. He moved on to be a welder at the River Rouge, Ford's massive complex in Dearborn, where he worked at various points until the 1960s—retiring with a gold watch, a company pension, and health care coverage. His home in Dearborn—Ford's company town—was a storehouse of Ford products, from cars and old tractor parts to Ford Philco radios, kitchen appliances, and a color television. For him, Ford was not so much a company as a way of life, reflected in the local custom of calling the company "Ford's." He and his colleagues had all seen old Henry on the shop floor at one point or another.
- The Rouge was an entire industrial economy in two square miles, bringing iron ore, coal, rubber, and sand in one end and sending cars out the other. In the 1930s over 100,000 people worked at the Rouge in the most vertically integrated factory the world had ever seen, with its own fire department, police force, and hospital. A factory tour I took as a child was both terrifying and enlightening, as I saw slabs of

glowing orange steel rolling out to be pounded into door panels for Ford Mustangs.

- Today, the idea of moving to Detroit to work for Ford as a young man—and retiring forty-five years later with a company pension—is as remote as the idea of carving a family farm out of the wilderness of Nebraska, or heading to Wisconsin to be a fur trapper. Most of the Rouge's components are now run by a handful of multinationals, not Ford, and its bankrupt steel mill was bought by Russia's SeverStal in 2004. The strategy of vertical integration has fallen into disrepute in manufacturing, as has the idea of a company town. Ford has since sold its Jaguar division to the Tata Group, an Indian conglomerate whose Tata Steel company still operates a company town around its primary plant in Jamshedpur. By 2008, the centenary of the Model T, the company that had invented the $5 workday was selling for less than $2 per share, and Ford's entire North American workforce was smaller than that of the Rouge during the Great Depression. Meanwhile, in January 2008 Ford had offered to pay off its remaining hourly workers to leave the company so that it would not have to look after them in retirement.

Sociologist C. Wright Mills wrote that "Social science deals with problems of biography, of history, and of their intersections within social structures." The sociologist was like a mapmaker, describing large-scale historical changes—such as the transition from an agrarian to an industrial society, or large-scale migrations from the rural south to the urban north, or the Great Depression—and the social structures through which they affected individual lives—say, large manufacturers like Ford and its Rouge complex. That was where individual biographies took place; that is how we can link one man's move from farm to factory to the larger currents of social change. In the mid-twentieth century, management theorist Peter Drucker observed that "In the industrial enterprise the structure which actually underlies all our society can be seen." In a sense, the Rouge was a map of the American economy, making the connections among the parts tangible and revealing how individuals fit into the larger enterprise of industrial society. Moreover, the Rouge's mass-production model for making cars had spread far beyond manufacturing: farms, stores, insurance companies, research labs, governments, armies, and even the Gilbreth family of *Cheaper by the Dozen* had adopted the operating logic of the Rouge.

It is clear now that the map of society represented by the Rouge no longer gives us an accurate view of post-industrial America. Most Americans do not live their lives through careers in organizations; far more work in retail and other services than growing food or making tangible objects like cars. What we need is a new map, a new way to understand biography, history, and their intersection in social structure.

This book is a sketch of such a map. Drawing on the past twenty years of my own and others' research, I aim to provide an understanding of how large-scale changes in the economy have influenced the organization of American society. My basic argument is that twentieth-century American society was organized around large corporations, particularly manufacturers and their way of doing things. It is now increasingly organized around finance—not just particular Wall Street banks, but finance as a model of how things are done. If the Rouge was a map of American society in 1950, then Nasdaq was a representation of American society circa 2000. And if the Gilbreths saw child-rearing as a form of mass production, today's sophisticated parents had come to see their children as an investment in their social capital. The consequences of tying the well-being of society to financial markets have become starkly evident due to the global financial crisis.

The argument unfolds over seven chapters. The first lays out the broad terrain in the shift from an industrial to a post-industrial economy. The second describes the hyperactive growth of finance over the past twenty-five years and the system of corporate governance that grew up in the US to guide its publicly traded corporations. I then describe how corporations grew to predominance in the US over the twentieth century and how they came to be social institutions, fulfilling many of the social welfare functions done by states in Europe. This model collapsed through the takeover wave of the 1980s and the subsequent triumph of the "shareholder value" movement; together, these two trends moved corporations toward a vertically dis-integrated network model that became widely adopted in both manufacturing and service. Chapter 4 describes how the financial services industry has been altered by a shift from the model of banking in *It's a Wonderful Life*—taking in deposits and making loans—toward a Wall Street model in which assets (mortgages and other kinds of debt) were turned into tradable securities. Banks largely became portals to financial markets, which changes their basic mode of operation and the nature of their connections to local economies. In Chapter 5, I argue that many governments have increasingly followed the lead of shareholder value-oriented corporations, by conceiving of their role as business service providers—"vendors" of laws—and through the widespread use of outsourcing, particularly in the US. Thanks to changes begun in the Clinton Administration and accelerated under George W. Bush, the American government has increasingly come to resemble Nike, relying on contractors for much of the basic work of government. Chapter 6 assesses the effects of post-industrialism, corporate restructuring, and the spread of financial thinking to households. Here I survey the effects of widespread stock ownership on people's perceptions of their political interests and analyze the causes and consequences of the mortgage crisis as examples of how finance has penetrated basic social processes. Finally, Chapter 7 gives a more speculative view of what comes next for American society in the wake of the financial implosion of 2008.

This is a lot of terrain to cover in one book. In a limited space, my hope is not to provide a detailed topographic map of North America, but something closer in spirit to the London Underground train (Tube) map. The Tube map strips away a great deal of detail and follows a few simple rules—most notably, all train lines are portrayed as horizontal, vertical, or diagonal lines. On the one hand, this level of simplification is in flagrant violation of reality, as the Tube's lines twist and turn in all kinds of unlikely ways. On the other hand, a Tube map is the single most useful piece of paper a visitor to London can have for navigating his or her way around a buzzing and complicated city. I hope

I've succeeded in making a financial tube map for the contemporary United States that helps readers navigate our new economic and social terrain.

A note on sources

My aim in writing this book is to provide a text that is as reader-friendly as possible within the constraints of the subject matter. In many cases I am drawing on research areas with very large literatures. The reference section at the end of the book provides an entry point into these literatures. The attentive reader will note that a suspiciously large number of the works listed in the references are written by me and my co-authors, on topics such as corporate boards of directors, bank consolidation in the US, proxy voting by mutual funds, American Depository Receipts, corporate social responsibility among multinationals, activism by institutional investors in corporate governance, and so on. This is not because I single-handedly wrote 10% of the relevant literature, but because the literature reviews on each of these particular topics is generally contained in my prior articles. The intrepid user of search engines is likely to find many of these prior works available over the Web.

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ACKNOWLEDGMENTS

Managed by the Markets has had a very long gestation. After almost a decade of mulling a book about finance and society, I wrote a basic outline while spending a sabbatical at the London Business School in early 2006 and managed to persuade a delightful editor, David Musson of Oxford University Press, that the idea for the book was good (true) and that I would complete it by March 2007 (false). Fortunately for the book, and unfortunately for the rest of the world, subsequent events have borne out the thesis of the book about the effects of finance on American society. As I wrote, banks failed, executives were fired, bankruptcies surged, home foreclosures skyrocketed, neighborhoods were blighted with newly abandoned houses, and unemployment leapt. There was broad agreement that the world was on the precipice of a second Great Depression brought about by financial excesses, and that only massive yet deft intervention by governments—including a new American administration led by Barack Obama—could avert global economic Armageddon. Presumably, the wisdom of my glacial writing pace is now evident.

My family has been an almost constant delight as I wrote the manuscript, and I thank my wife, Christina Brown, and our children Ben Davis and Gracie Davis for their endless support. I imagine there is a point when family members tire of hearing fascinating factoids while they are trying to do something else ("Yes, Dad, I know that Wal-Mart employs more Americans than the dozen largest manufacturers combined, that insurance contracts on the terminally ill can be securitized, and that Liberia's ship registry is actually a business in Virginia—but I'm late for practice"); fortunately, they did not let on too often.

I have been fortunate to work at the world's greatest university for interdisciplinary research, the University of Michigan, in a school with an unparalleled combination of collegiality and rigor, the Stephen M. Ross School of Business. My colleagues among the graduate students and faculty in Management & Organizations have provided a stimulating milieu for thinking deeply (or at least as deeply as I am capable of). Current and recovering students have been particularly helpful through their conversations about the ideas in this book: Adam Cobb, Natalie Cotton, Dan Gruber, Olenka Kacperczyk, Chris Marquis, Eric Neuman, Weber, Melissa Wooten, and Mina Yoo. And Rena Seltzer provided wise guidance on making enough time to complete the book without letting everything else fall apart.

I haven't managed to securitize my intellectual debts, so here is a partial repayment. Many people read portions of the book and gave useful comments. These include Ben Davis, Fabrizio Ferraro, Anne Bowers Fleischer, Mike Lounsbury, Joshua Margolis, Chris Marquis, Eric Neuman, Charles Perrow, Sarah Quinn, Cathy Shakespeare, Marina Whitman, Mayer Zald, and seminar participants at the University of California at Berkeley Sociology and Organizational Behavior departments and at IESE. I am especially grateful to Christina Brown and J. Adam Cobb for reading the entire manuscript end-to-end and giving me excellent suggestions for improvement.

All remaining errors are my own. In fact, for the more pedantic readers, I have purposely inserted a small handful of minor factual, grammatical, and spelling errors—its the least I could do to keep their interest up.

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