The Panic of 1907: Lessons Learned from the Market’s Perfect Storm  
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Why the Story is Worth Knowing

It is an odd coincidence of history that the current financial crisis that threatens the U.S. economy began one hundred years after a financial crisis that nearly collapsed the banking system and disabled a growing U.S. economy. Had the banking system not “gotten its act together” to avoid more significant withdrawals of deposits, the United States might not have been in a position to provide financing and export necessary goods during the two World Wars of the following decades and create the economic engine that it has today. The financial crisis of 1907 caused the government of the United States to acknowledge that it must play a role in maintaining a stable banking system, leading to the creation of the Federal Reserve System as its regulator and lender of last resort. But many of the banking system’s vulnerabilities still exist today and are worth investigating.

The Panic of 1907 is both researched and written well. The authors do a very good job of comparing the structure and development of the financial system in 1907 to that of 2007. This book provides helpful context to those who seek a fuller understanding of how banking works, how it has changed, and how it remains the same.

The Context of 1907

In many ways, the U.S. economy and financial markets in 1907 resembled what we experienced in 2007 leading up to the financial crisis of the recent era. The decade from 1886 to 1906 was a period of high economic growth in which banks
located in New York City raised capital from abroad to finance industrial trusts that consolidated industries such as the oil, steel and railroad sectors, not unlike what private equity funds aspire to accomplish in the present. The President at the time, Teddy Roosevelt, believed in the productivity of large companies, yet pushed against the consolidation of industry because of his concern for the imbalance between the equity investor and the consumer of goods – a position very similar to that taken by President Obama today in the opinions he has expressed and policies he has proposed for the banking industry.

But in two ways, the period leading to the events of 1907 were dramatically different. First, the United States did not have a central bank. The banking system of the day had over 16,000 banks, twice the number in the banking system today. The U.S. Treasury controlled the supply of currency in this period and banks that were considered “national banks,” mostly located in New York City, could receive deposits of dollars from the Treasury when the U.S. Government chose to provide liquidity to the economy. The supply of currency and credit filtered through the rest of the economy through a system of state-chartered banks that created correspondent relationships with the New York banks where they kept deposits and from which they could borrow.

Second, the supply of money in the U.S. and United Kingdom was fixed to the quantity of gold. When economies around the world needed liquidity, banks needed to attract deposits of gold in order to write currency against it and they needed to ship the physical commodity from place to place. This institutional arrangement constrained the amount of capital available to the banking system and subjected the transition of currency to long delays.

Two events set the stage for the financial panic of 1907. The first event was the need for the Bank of England to finance the harvest and sale of cotton in Egypt in 1906. The Bank of England needed to attract gold deposits in order to provide enough credit, and it therefore increased interest rates. The second event was the earthquake in San Francisco in April of 1906. The damage to property was immense and required a significant amount of credit beyond what was needed to finance agriculture in the United States. The British property and casualty insurers suffered heavy losses and shipped gold to pay claims on the damaged property. The sudden shortage of gold caused interest rates to double from 3 ½% to 7%.
The Cascade of Events that Caused the Panic

Credit crises often begin with a single seemingly innocuous event that tips the delicate balance of the financial system and causes a disorderly tripping of the pillars. In the case of the Panic of 1907, the first domino was a speculator in copper, Augustus Heinz, who sold his interest in the metal to The Standard Oil Company for a rich sum and decided to use the proceeds to make two investments: an investment in the shares of a bank in New York City and an investment in a stock pool that his brother Otto managed. Otto took loans from his broker and a local bank in Montana and tried to corner the stock of a publicly-traded copper company using the stock as collateral for the loan. He was wrong about the value of the company, the price of the shares declined, and he was unable to pay back the loans. Otto’s investment pool collapsed, the broker quickly folded, and the loss to the bank caused it to close its doors to depositors. A rumor suggested that the busted bank in Montana had deposits in the money center bank owned by Augustus and panic ensued. Soon depositors in banks and investors in trust companies grew concerned about the web-like connections between banks and trusts and began lining up to withdraw their funds. A single leveraged equity bet on a copper mine turned into a full-blown financial panic.

The rest of the book describes how J. Pierpont Morgan, in the absence of a central bank, persuaded and cajoled the club of bankers in New York City to pool their scarce resources to provide loans to banks, trust companies and market brokers to keep them solvent and return confidence in the ability of the financial market to provide the financing required to support the national economy. This narrative describes the immense complexity of a financial crisis and the unusual leadership skills that are required to persuade competing financial concerns to collaborate to prevent the financial markets and economy from dissolving.

What Hasn’t Changed Since 1907?

Financial crises have many common elements that enable the cascade of events that create panic, but five are prominent in a comparison between the financial crisis of 1907 and the crisis that we have been addressing since 2007:
Leverage - a high level of debt relative to the sources of wealth in the economy. In 1907, the banks, trust companies and investment pools relied on borrowed money to operate. In 2007, most sources of organized capital, such as private equity funds, hedge funds, businesses and commercial banks, used leverage. Governments, commercial businesses and households continue to have debt in high proportion to their assets or revenues.

The business model of banking and the asymmetry of information. The model for banking, then as now, involves two primary risks. First, banks borrow money with short tenor but lend money with much longer tenor. Second, banks offer liquidity to their creditors but use the capital to invest in relatively illiquid assets. The bet of this banking model is that creditors keep their chips in the poker game and that the bank will manage the cards well. Despite increasing requirements for banks to disclose their activities, investors in banks still know less than the managers of the banks themselves. This “asymmetry of information” becomes apparent to investors when they suspect that the bank has made strategic errors in their selection of assets or management of liabilities. They believe that someone knows more and will quickly withdraw their funds and cause a run on the bank. In 2008, such a run from the withdrawal of commercial paper loans and hedge fund custodial arrangements caused the quick demise of Bear Stearns and Lehman Brothers.

Interconnectedness between financial intermediaries. In the absence of a Central Bank in 1907, the banking system was organized as a “club” of well-capitalized banks that supported each other’s activity with short-term funding and to which regional banks around the country affiliated as correspondent banks for short-term financing. A failure of one part of the link threatened the entire chain. In 2008, while commercial banks could rely on the Federal Reserve for short-term emergency funding, their practice was to borrow from each other in the market for overnight funds and to swap credit exposures between each other in the credit default swap market. In addition, private investment funds such as hedge funds and private equity funds participated in the market for funding the banks. Also, public companies like GE created large financing companies that relied upon short-term funding from this market. Again, a failure of one link caused the whole chain to fall apart.
(4) **Decline in the prices of property and collateral.** In a recent meeting with Alex Weber, former head of the Bundesbank, he stated that all financial crises are caused by a decline in property that is offered as collateral for loans. In 1907, the cascade began with the decline in the market price of shares of stock that the investment pool operator used to secure a loan. In 2007, the cascade began with the decline in values of residential properties that secured mortgage loans.

(5) **The behavior of investors.** Humans are gregarious and, like most mammals, they look to the behavior of others to inform themselves how they should behave. In other words, they act as a herd and the collective decisions of the many cause the rapid cascade in a financial crisis.

**What is Different Today from 1907?**

The market for money has changed in a few meaningful ways since the market crisis of 1907. Examples include:

(1) **High degree of disintermediation.** Due to the significant increase in wealth in the United States during the last 100 years, a significant pool of savings has accumulated in pension plans, endowments and mutual funds. These pools of capital have encouraged the development of credit markets that exist outside of the banking system. Governments and corporations freely borrow from these investors without the involvement of commercial or savings banks, and the investors can sell on any day with the help of middlemen who routinely match buyers and sellers of bonds. Banks are no longer the only alternative for investors to place their savings.

(2) **Federal Deposit Insurance prevents runs on banks.** In response to the Panic of 1907 and the Great Depression that followed years later, the Federal government established an insurance program that protected up to $100,000 that investors placed in banks, thus protecting depositors from the information disadvantage from which they suffered. As a consequence, depositors no longer cause the run on the bank.

(3) **Shadow banking system that existed outside of the official banking system.** Large pools of highly leveraged capital in private investment funds and Special Investment Vehicles allowed banks to borrow off-balance sheet and beyond the vision of the regulator of the banking system. When the
equity from these vehicles either evaporated or withdrew, the bottom cards of the banking system of 2007 began to fall.

(4) **Consolidation of banking has left the system with fewer banks.** In 1907, the banking system had 16,000 financial institutions. By 2008, consolidation in the industry cut that number to little more than half, with large banks that were too big to be allowed to fail.

(5) **Federal Reserve System.** Recognizing that the economy of the U.S. could not rely upon the unusual leadership skills of J. P. Morgan to sort out another banking crisis, Congress created the Federal Reserve System of banks in 1913 to ensure a stable banking system.

**Final Comment**

We are now five years on in the credit crisis that began in late 2007. We are not past it yet. The excessive leverage that made the financial system fragile has not subsided but has shifted from private sector to public sector as governments in the U.S. and Europe have committed public funds to keep the banking system solvent and operating. As participants in the financial system negotiation through the Dodd-Frank legislation in the U.S. and Basel III internationally, I believe that it is a productive investment of time to study financial crises of the past – their causes, their solutions, their outcomes and the behaviors and innovations that the system required to advance to the next and more complicated stage of development. *The Panic of 1907: Lessons Learned from the Market’s Perfect Storm* is a helpful account of one of the more violent financial crises that the U.S. has endured. The complexity of the system, the interrelatedness of the participants and the asymmetric nature of information continue as problems that will not be solved this time around.