Written by Steven J. DuBord on October 14, 2008

The Panic of ’07

The ongoing financial crisis, with its welter of high-profile bank failures and fearsome swings in stock valuations, may seem to those of us perched on the leading edge of the 21st century like an unprecedented calamity, a contagion of turmoil that threatens to sweep the orderly, more or less civilized world of our lifetimes into a dark abyss of political, economic, and even social collapse. At long last, the direst predictions of decades past seem to be nearing fulfillment, and worldwide confidence in what we glibly call "the system" is being shaken as never before in recent experience.

Yet this, or something very much like this, has happened before, although not within living memory. Parallels have already been drawn to the obvious, the Great Depression of the 1930s. But a more exact comparison — at least, from the complexion of events as they have so far unfolded — is a much less familiar but, in its day, equally calamitous event, the brief but tumultuous financial upheaval known to posterity as the Panic of 1907 (or, perhaps more aptly, the Banker’s Panic).

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The economic landscape of a century ago was not terribly different in its essentials from what we have today, except that the scale was much smaller, and communication and evaluation of market activity was far less efficient. In those days, the Dow Jones Industrial Average was just transitioning from double to triple digits for the first time (it raced from about 50 in the summer of ’04 to just over 100 less than two years later), and many stocks were traded on outdoor tables along Wall Street. The money supply in New York City — America’s banking center then as now — was dictated by the harvest cycle. When harvested crops went on the market each fall, money tended to leave New York banks, who in turn raised interest rates to attract it back. Foreign investors often took seasonal advantage of these high interest rates, just one facet of a burgeoning international trade. In that comparatively halcyon decade before the First World War ruined the West, the economy was more global and interconnected than ever in the past, and many optimists were predicting the dawn of a new age of world prosperity, free trade and open borders, and a cessation of the petty territorial wars of past centuries.

A severe economic contraction from late 1906 into 1907 was the first hint that the optimists were not to be vindicated. By summer of 1907, stocks had fallen more than 20 percent from their highs of the previous year (ultimately, stocks lost roughly 50 percent of their value by early 1908, before the markets turned around and, by the summer of ’09, regained almost all of their lost ground).

In the spring of ’06, the great San Francisco earthquake had caused considerable monetary disruption, but the financial earthquake of ’07 was to prove far worse. As the long 1907 summer wore on, the stock market decline took its inevitable toll, and a stream of bad economic news became a flood. In July copper prices collapsed, and in August, the Roosevelt administration, in one of the first federal government intrusions into the free market in the name of "trust-busting," levied a $29 million dollar fine against Rockefeller's Standard Oil Corporation. This latter action, though not a consequence of market instability, added fuel to the financial fire by further eroding confidence.

The panic that erupted in October of 1907 was certainly not the first such episode in American history. There had been many such, especially since the National Bank Act of the Civil War period put an end to the free banking of the antebellum period. But the Panic of '07 was the most severe and, like many other such episodes, was set in motion by the imprudent actions of a few wealthy and well-connected men.

The match that started the conflagration on Monday, October 14, 1907, was an ill-conceived attempt by Augustus and Otto Heinze, successful copper magnates, to corner the copper market. Their scheme was fairly simple in theory; already in control of what they believed to be a majority stake in the shares of United Copper, they embarked on an aggressive buying spree that Monday morning, expecting to drive up the price of the remaining shares and force the holders of United Copper shares who had been expecting to sell short to sell instead to the Heinze brothers. However, the Heinzes' plan was insufficiently capitalized, and the bonanza of cheap stocks did not materialize. Instead, shares of United Copper skyrocketed and then collapsed by midweek, ruining the Heinze brothers.

Unable to meet its obligations, Otto Heinze's financial company, Gross and Kleeberg, went bankrupt, and was followed by the State Savings Bank of Butte, Montana, which was owned by Augustus and which had used large amounts of United Copper stock as collateral.

Augustus was also the president of the Mercantile National Bank in New York City. When the bank's board of directors learned of his shenanigans, they forced his resignation on Thursday morning. Depositors at the bank, uncertain of the institution's exposure to the copper stock collapse and fearing for its insolvency, panicked and rushed to withdraw their money. Runs also occurred at the National Bank of North America and New Amsterdam National, institutions run by a close associate of the Heinzes, Charles Morse.

The real panic started early the following week, when Charles T. Barney, president of the Knickerbocker Trust Company, was forced by his board to resign because of ties with Morse and the Heinzes. Ironically, Knickerbocker Trust had declined to underwrite the Heinzes' stock purchasing scheme, believing them to be undercapitalized and the plan too risky. Nevertheless, the firing of Barney (who died a few weeks later) triggered a massive run on Knickerbocker Trust on Tuesday, October 22, which brought down the institution in a few hours.

By Thursday, the nation's finances were in complete disarray. Many prominent banks and trusts had failed as a result of bank runs all over the city, and capital everywhere was drying up. In those days, when government intervention in market activity on the scale of Roosevelt's New Deal or the current administration's massive bailout (not to mention the machinations of the Federal Reserve) was unthought of, Wall Street seemed to be running out of options.

But influential banker J.P. Morgan, who was caught as flat-footed as everyone else by the panic, kept a level head. He had helped keep the U.S. Treasury solvent during the Panic of 1893, and intended to survive again. He first managed to convince the heads of a number of trust companies to provide emergency assets to help one crippled trust, the Trust Company of America, survive a run. The following day (Thursday, October 24, two days after the failure of Knickerbocker Trust), Morgan arranged for a number of bankers to provide the then-colossal sum of $23 million to allow the New York Stock Exchange to continue operating. The U.S. Treasury also agreed, under pressure from Morgan and his associates, to deposit federal money in New York banks to give them extra assets. The bankers also worked hard to convince clergymen (that era's equivalent of today's mass media) to reassure their congregations over the weekend and to counsel against further panic.

Out of the public eye, the City of New York was on the brink of bankruptcy. Accordingly, Morgan quietly contracted to buy $30 million in city bonds, averting yet another potentially lethal crisis.

The final problem weighing on the markets was the near-insolvency of Tennessee Coal, Iron, and Railroad Company (TC&I), to whose depreciating assets a major brokerage company, Moore and Schley, was critically exposed as a result of borrowing heavily against TC&I stock. To stave off bankruptcy at Moore and Schley, TC&I would have to be rescued and, in a time before federal bailouts, that meant a private buyout.

Fortunately, Morgan and company found a willing suitor, the U.S. Steel Corporation. Unfortunately, such a transaction was no longer permissible under new "trust-busting" legislation (the Sherman Antitrust Act) without the president's approval. Morgan and his associates worked feverishly with representatives from U.S. Steel to hammer out an acquisition plan, then dispatched representatives to Washington to persuade President Roosevelt to approve the deal before markets opened on Monday, November 4. After some difficulties, the president finally granted them an audience and reluctantly gave the deal the go-ahead. Within two days, the takeover was complete, and the market turmoil subsided.

The Panic of 1907 lasted only a few weeks, but its political fallout lingers to this day, writ large. For in the wake of the panic, many leading financial men like J.P. Morgan and financier Jacob Schiff, and prominent political leaders like Senator Nelson Aldrich, decided that the time had come for America to have a central bank along European lines. While European countries, central banks and all, were just as susceptible to financial crises as the United States, a central bank could provide liquidity by creating money out of thin air. That this procedure guaranteed inflation and monetary hardship imposed on the middle class was of no consequence to the mandarins of high finance; with a central bank assuming control of finance, the responsibility for bailouts would no longer be theirs. Senator Aldrich spearheaded an effort to begin designing a central bank; the result was the creation of the Federal Reserve in 1913.

However, the Panic of 1907 suggests that, left to its own devices, the free market can and will solve such crises on its own. In 1907, it was J.P. Morgan — certainly no champion of free markets but with a strong vested interest in keeping the market afloat _ who provided the leadership and much of the liquidity. The biggest hitch was persuading the federal government to permit a major free-market transaction — the buyout of TC&I — which unwise and unconstitutional legislation was hindering. As a result of comparatively limited government involvement, the Panic of 1907 ran its course quickly. The same might still happen now in the unlikely event that the United States and other governments back off and let market processes solve what government interference will only make worse.

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