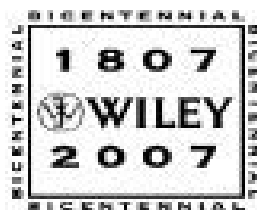


THE PANIC OF 1907

Lessons Learned from the Market's
Perfect Storm

**ROBERT F. BRUNER
SEAN D. CARR**



John Wiley & Sons, Inc.

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RFB:

For Bobbie

*“Treasure is in knowing that you are loved and that you love
because
you are loved, and that knowledge of self and relationship
and
purpose is what treasure is all about.”*

—Peter J. Gomes

SDC:

For Ladi

*“The salvation of this human world lies nowhere else than in
the
human heart, in the human power to reflect, in human
meekness and
human responsibility.”*

—Vaclav Havel

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RFB and SDC

Charlottesville, Virginia
June 2007

Prologue

These are troublous times.

*—Charles T. Barney
Knickerbocker Trust Company
October 21, 1907*

Around 10 A.M. on November 14, 1907, Lily Barney and a friend were chatting in the Barneys' second-story bedroom overlooking Park Avenue when they heard the crack of a gunshot echo through the house. The women bolted toward the other bedroom across the hall. Stepping inside, they saw Lily's husband, Charles, lying on the floor near his bed in his pajamas. Beside him was a revolver containing three loaded cartridges and one empty shell. The Barneys had kept pistols on every floor of the house for protection, and this one clearly belonged to Charles.^{[1](#)}

As Lily Barney came near, her husband raised himself slightly but slumped in pain to the floor. She knelt beside him, cradled his head in her lap, and attempted to ease his discomfort. Ashbel Barney, one of the Barneys' two sons, had been downstairs and had also heard the shot. Running to the bedroom and seeing his mother and her friend bending over his wounded father, he raced to telephone George Dixon, the Barneys' family physician. Then, with the help of his mother and servants the 20-year-old Ashbel lifted his father to his large, brass, canopy-covered bed. Charles T. Barney remained conscious, but silent.

Dixon reached the Barney house in Manhattan's fashionable Murray Hill neighborhood 10 minutes after receiving the call. After administering an anesthetic he began an operation in which he discovered that a .38-caliber bullet had entered the upper left quadrant of Barney's abdomen; it had taken an upward course, torn through the intestines, traveled lengthwise through the left lung, and embedded in the left shoulder just behind the collarbone. Despite their ministrations, around 2:30 in the afternoon Charles Barney was pronounced dead from shock and severe hemorrhaging. Within hours newsboys were bellowing "extras" about the incident all along Park Avenue.

Over the coming days, rumors and innuendoes about Barney's death reverberated throughout the city. Stories appeared about previous suicide attempts (though none could be confirmed)² and there were indications, later denied by Lily Barney, that she and her husband had become acutely estranged in recent months and that she had initiated a divorce.³ One leading newspaper even reported that the letters of "two women, one a Parisian, long a favorite of a French prince," had been found among Charles Barney's papers.⁴ Close associates called the man's morals into question. "Mr. Barney was not a God-fearing man," said A. Foster Higgins. "He could not live happily because his life was not moral. He lived a lie to his wife and children."⁵

Whatever his personal faults, though, the death of Charles T. Barney aroused extreme public interest and suspicion for one reason only: Barney had presided over New York's famed Knickerbocker Trust Company when its dramatic failure in October 1907 became the tipping point for a financial crisis of monumental proportions.

Charles Tracy Barney was truly a man of the Gilded Age. The son of a prosperous Cleveland merchant, he had married into the prominent Whitney family when he wed Lily Whitney, the sister of the financier and former U.S. Secretary of the Navy, William C. Whitney. Barney pursued a career in banking, and his Whitney connections ensured him lucrative business opportunities in New York real estate development and speculation. By 1907 Barney had become a director of at least 33 corporations, and he was among the founding investors of New York City's new subway system.

Barney's ascent to New York's financial firmament coincided with his association with the Knickerbocker Trust Company. By the 1890s, he had become its vice president, and in 1897 he was elected to the firm's top office. The handsome but high-strung Barney emerged as one of the leading figures in New York's financial community, and he had developed a reputation as "one of the most imperious of Wall Street's bankers, who ruled every undertaking that he had anything to do with."⁶

Such a man, at the height of his wealth and power, could scarcely have foreseen how swiftly and ignominiously his downfall would come. In early October 1907, two unscrupulous (and colorful) speculators, F. Augustus Heinze and Charles W. Morse, had contrived an elaborate scheme to corner the market in the stock of a copper mining company. The attempt failed miserably. Such a scheme would hardly have bothered the members of New York's financial elite, such as Charles Barney, but Heinze and Morse had convinced several New York trust companies, including the Knickerbocker, to fund their venture.⁷

As word spread that the Knickerbocker—and perhaps even Charles Barney himself—was embroiled in the Heinze-Morse scheme, the 18,000 depositors of the trust company

panicked. Simply an association with the speculators was more than most depositors could bear. On Friday, October 17, a “run” on the Knickerbocker was under way, and dozens of depositors clamored at the trust company’s doors to claim their funds.

Given the close financial relationships among all the banks and trust companies in New York City, panic gripped investors and depositors alike. In an attempt to quell this spiraling hysteria, on October 21 the directors of the Knickerbocker Trust convinced Charles Barney to tender his resignation. In a statement issued later that night, Barney said humbly, “I resigned to give my associates in the company a free hand in the management.” But when he was asked about the financial condition of the Knickerbocker, Barney laughed at any suggestion that the institution might be in trouble. “Nothing could be more absurd,” he said. “The company was never in a stronger position. It remains the next to the largest in the city and as sound as any. There is not the slightest question of its entire solvency.”⁸

A few days after his resignation from the Knickerbocker Trust Company, Barney drafted a statement in which he boasted of his role at the bank. “I built the Knickerbocker up from a company with eleven million dollars in deposits to one with over sixty-five million dollars,” he said. “I am willing to take responsibility for anything pertaining to the condition of the company.” Nonetheless, he steadfastly refused to accept that he should be culpable for the trust company’s failure. “So far as the suspension is concerned,” he said, “if there is any institution in New York that could without aid have withstood the run that the Knickerbocker experienced last Tuesday [October 22], I do not know it.”⁹ Less than a month later Charles Barney would be dead.

Many surmised that Charles Barney's death was caused by his fears of personal financial failure, but reports indicate he was nowhere near insolvency. In October 1907, Barney's assets exceeded his liabilities by more than \$2.5 million, mostly represented by equities in real estate.¹⁰ Moreover, most of Barney's creditors were bank and trust companies, including the Knickerbocker itself. Just a week before his death Barney's attorneys had worked out an arrangement that would have enabled him to stay afloat. "There was every reason why Mr. Barney should have been feeling encouraged," Barney's physician, Dr. Dixon, said. "Daylight had begun to break ahead financially. He had begun to see his way clear. If he was [sic] going to commit suicide, two weeks ago would have been the most likely time. But now, when things had begun to look up, was a time when he should have been feeling in better spirits than for two weeks."¹¹

Friends of Charles T. Barney believed that neither financial crisis nor a professional reversal was his downfall. It was the loss of confidence that hurt him most. "Mr. Barney's heart was broken by the cruel treatment of his associates; that is the cause of his death," said Charles Morse, the man whose association most likely led to Barney's undoing. "It is absurd to talk of financial ruin as a cause of his act, for though he had lost money, he was by no means ruined. Mr. Barney was always an honorable man of business, and it was grief at being abused in the newspapers and suspected by his business associates that caused his death."¹² Another family friend said, "Had there been a little leniency on the part of those who were forcing him to the wall, Charles T. Barney would be alive today and in a position to revive his business standing."¹³

The failure of the Knickerbocker Trust Company was but the beginning, not the end, of a panic that would engulf a turbulent and rapidly growing nation as it entered the twentieth century. The run on other banks and trust companies, some of which were associated with the Heinze-and-Morse scheme, continued unabated even after the Knickerbocker closed its doors. Lines in front of banks in New York and elsewhere extended for blocks, and Wall Street was gripped by a paroxysm of fear. In the coming days, money would become scarce, banks would fail, the stock market would plummet, and the city of New York itself would reach the precipice of bankruptcy. Only a small cadre of astute and cool-headed financiers and government officials could steer a course through the oncoming gale. Like Charles Barney, the nation had lost its confidence. It would take leadership and courage to bring it back.

Introduction

*History may not repeat itself, but it rhymes.*¹

—Attributed to Mark Twain

Why do market crashes and banking panics happen?¹ Conventional wisdom on this question has gathered, like iron filings, at two intellectual poles. At one extreme, we find explanations that are highly detailed and idiosyncratic to a particular event—often comprised of a hodge-podge of period-specific causes.² At the other extreme are conclusions that might be broadly described as “one big idea”: a sole cause large enough to cover a multitude of sins. A favorite big idea among some economists, for example, is that financial crises follow a lack of liquidity in the financial system.³ Another popular big-idea explanation is simple greed or venality.⁴

Unfortunately, the one big idea often ignores the considerable richness of detail that the recounting of a single crisis can reveal, and thus produces simplistic conclusions and inappropriate recommendations for decision makers. One wants more, an explanation that is neither too much nor too little; neither too idiosyncratic nor too simplistic. Therefore, by drawing on a detailed history of the crash and panic of 1907 and on an extensive body of research about financial crises, we offer an alternative view that is as applicable to the past as to the future.

From 1814 to 1914, the United States saw 13 banking panics—of these, the panic of 1907 was among the worst.² The panic had coincided with a series of major market downturns, culminating in a 37 percent decline in the value of all listed stocks. Triggered by the literal and figurative shock of a massive earthquake and a rash of fires that destroyed the city of San Francisco in 1906, the financial crisis of 1907 had global implications, and it called forth the leadership of a small group of powerful financiers. Though the duration of the crisis was relatively brief, the repercussions proved far-reaching, resulting in the formal establishment of a powerful central bank in the United States through the Federal Reserve System.

To understand fully the crash and panic of 1907, one must consider its context. A Republican moralist was in the White House. War was fresh in mind. Immigration was fueling dramatic changes in society. New technologies were changing people's everyday lives. Business consolidators and their Wall Street advisers were creating large, new combinations through mergers and acquisitions, while the government was investigating and prosecuting prominent executives—led by an aggressive young prosecutor from New York. The public's attitude toward business leaders, fueled by a muckraking press, was largely negative. The government itself was becoming increasingly interventionist in society and, in some ways, more intrusive in individual life. Much of this was stimulated by a postwar economic expansion that, with brief interruptions, had lasted about 50 years. Bring, then, a sense of irony informed by the present to an understanding of 1907.

Stock market crashes and banking panics had surfaced periodically in the United States and elsewhere throughout the nineteenth century. Market crashes often sprang from occasional bubbles in asset prices: extreme speculations in land and new securities would “correct” when investors’

expectations failed to be realized.³ Banking panics were often the consequence of these corrections as adjustments in asset valuations sent shock waves through the young country's financial system. The nation's banks, realizing that the value of pledged collateral had impaired the creditworthiness of their loans, would call in their credits. Borrowers, unable to repay their debts, would default and declare bankruptcy. Consequently, nervous bank depositors would fear for the survival of the bank and rush to withdraw their funds. If one institution failed in the process, then a panic would spread—a classic “run on the banks.”⁵ Unlike France, Germany, and Britain, the United States lacked a central banking authority that could supply extra liquidity in such times of credit anorexia.

By 1907, economic growth in America had lifted business expectations; a cataclysmic disaster in California would shatter them. How the effects of an external shock to the economy would wend their way into violent price changes a year later tells a story of how complex systems process information. The markets for stocks, debt, currency, gold, copper, and other commodities form such a complex system—they are interrelated in the sense that fundamental changes in one can affect prices in the others. Common factors such as inflation, real economic growth, liquidity, and external shocks can affect them all. How we make meaning of crashes and panics, then, is fundamentally a question of information: its content, how it is gathered, and how the complex system of the markets distills it into security prices.⁶

Over the years the occurrence of large and systemic financial crises has been the focus of considerable research—both directly and through varied intellectual streams: macroeconomics, game theory, group psychology, financial economics, complexity theory, the economics of

information, and management theory. The following detailed account of the events of 1907 draws upon this rich literature to suggest that financial crises result from a convergence of forces, a “perfect storm”⁴ at work in the financial markets. Throughout the dramatic story of the panic of 1907, we explore this metaphor as we highlight seven elements of the market’s perfect storm:

1. **System-like architecture.** Complexity makes it difficult to know what is going on and establishes linkages that enable contagion of the crisis to spread.
2. **Buoyant growth.** Economic expansion creates rising demands for capital and liquidity and the excessive mistakes that eventually must be corrected.
3. **Inadequate safety buffers.** In the late stages of an economic expansion, borrowers and creditors overreach in their use of debt, lowering the margin of safety in the financial system.
4. **Adverse leadership.** Prominent people in the public and private spheres implement policies that raise uncertainty, which impairs confidence and elevates risk.
5. **Real economic shock.** Unexpected events hit the economy and financial system, causing a sudden reversal in the outlook of investors and depositors.
6. **Undue fear, greed, and other behavioral aberrations.** Beyond a change in the rational economic outlook is a shift from optimism to pessimism that creates a self-reinforcing downward spiral. The more bad news, the more behavior that generates bad news.
7. **Failure of collective action.** The best-intended responses by people on the scene prove inadequate to the challenge of the crisis.

This pluralistic approach affords a framework through which the alert observer can make sense of unfolding events; we

invite reflection on their application to the crisis of 1907, and we return to them at length in the final chapter.

Interpreting and even anticipating future financial crises requires insights into the forces suggested here—not merely individually, but also collectively—how they *interact* to produce a crisis. This approach may lead us, perhaps, to a more complicated explanation of financial crises than pundits and politicians want to hear, yet the metaphor of the perfect storm reveals a possible outlook for decision makers—one that suggests that the way to forestall a financial crisis is to anticipate the storm’s volatile elements and, perhaps, even to fight their potential convergence.

Chapter 1

Wall Street Oligarchs

A man I do not trust could not get money from me on all the bonds in Christendom.

—J. Pierpont Morgan¹

In 1907, the young American economy was roaring. Between the mid-1890s and the end of 1906, the nation's annual growth rate was a stunning 7.3 percent, which had doubled the absolute size of all U.S. industrial production during a relatively brief period. The volatility of this growth also leaped from just over 6.5 percent to 8.0 percent per year—although, relative to the high rate of growth, this economic volatility was slightly lower than what it had been during much of the nineteenth century. Even so, compared with previous periods of major industrial expansion, the U.S. economy in 1907 was larger and growing faster than ever (see [Figure 1.1](#)).²

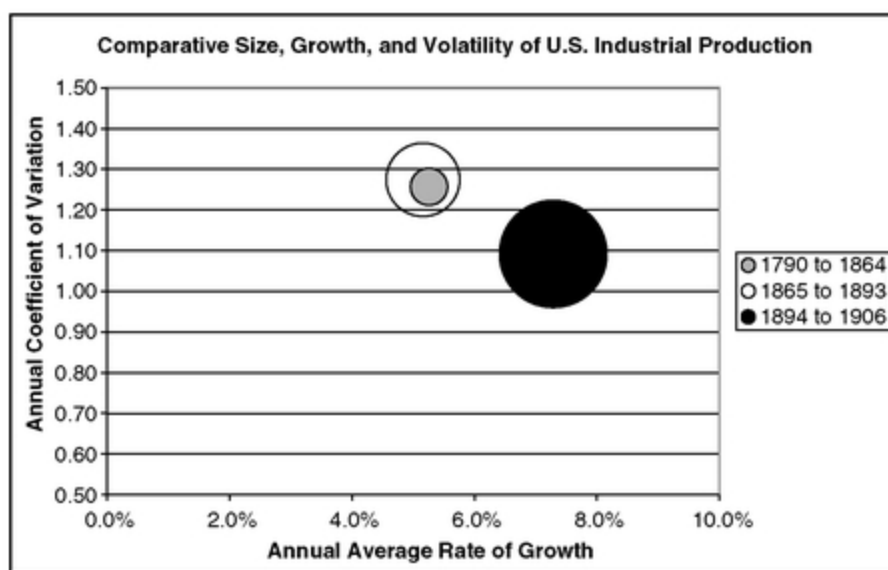
With the dramatic growth and economic development of the United States at the turn of the century came an enormous demand for capital. In 1895 the U.S. economy added \$2.5 billion to its fixed plant and inventories, and by 1906 the annual rate of capital formation was running at nearly \$5 billion, a blistering pace (see [Figure 1.2](#)). Much of this was financed by the country's exports, which appeared as a bulging current account surplus after 1895. But even exports were insufficient to finance the very large growth

rate in the formation of capital in 1905 (12.7%) and 1906 (21.8%).

Figure 1.1 Comparative size, growth, and volatility of U.S. industrial production.

NOTE: The size of the circles indicates the relative size of the U.S. industrial production at 1864, 1893, and 1907 respectively. The growth rate is the compound average over each period. The coefficient of variation is a measure of relative volatility of growth (calculated as the standard deviation of growth rates divided by the compound average rate of growth for the period).

SOURCE: Authors' figure based on data from NBER, David Industrial Production Index.

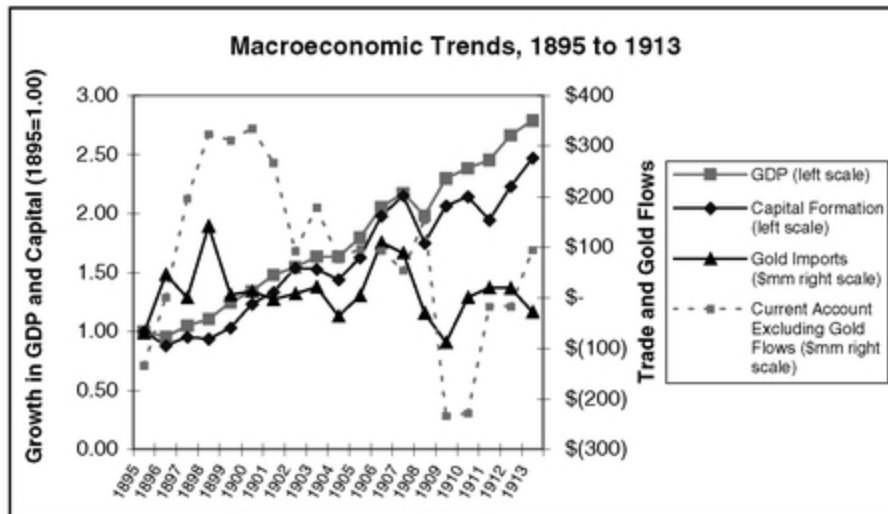


Into this prodigious vacuum moved a tightly knit network of financiers in New York and London who possessed the sophistication and credibility to raise the necessary funds for America's factories and infrastructure in the world's capital markets.⁷ Their success in attracting foreign capital to America's "emerging market" was reflected in the immense importations of gold in 1906:⁸ the inflow of gold to the United States spiked sharply upward to \$165 million,

dwarfing all gold flows after the Civil War, except during the year of a significant economic downturn in 1893.

Figure 1.2 Macroeconomic trends, 1895 to 1913.

SOURCE: Authors' figure based on data from NBER Macro History Database.



America's rapid industrialization during this period also hastened the emergence of business entities of unprecedented scale, complexity, and power. Between 1894 and 1904, more than 1,800 companies were consolidated into just 93 corporations.³ Some of these large firms had grown by buying up smaller competitors during times of economic distress, while others were organized by financiers seeking to control competition and build efficiencies of scale.⁹ Much of the volume of new debt and equity financing for these large corporations again flowed through a relatively small circle of financial institutions in New York, including J. P. Morgan & Company; Kuhn, Loeb & Company; the First National Bank; the National City Bank; Kidder, Peabody & Company; and Lee, Higginson & Company.⁴

In 1907, the informal but undisputed leader of this financial community in the United States was J. Pierpont Morgan, known to his family and friends simply as

“Pierpont.” A complex man, biographers have found unusual clues to Morgan’s personality. Historian Vincent Carosso characterized him as a devoted family man, a “strong-willed, affectionate, protective, and generous paterfamilias.”⁵ Biographer Jean Strouse divined that Morgan was estranged (but not divorced) from his wife, that he had amorous relations with other women, and at the same time was a prominent figure in the Episcopal church in New York City. Strouse also determined that Morgan suffered from periods of clinical depression—indeed, business and family letters are replete with open references to his bouts with the “blues.” But all biographers are agreed that Morgan was a forceful personality.

Historian William Harbaugh wrote of Morgan, “What a whale of a man! There seemed to radiate something that forced the complex of inferiority . . . upon all around him, in spite of themselves. The boldest man was likely to become timid under his piercing gaze. The most impudent or recalcitrant were ground to humility as he chewed truculently at his huge black cigar.”⁶ Morgan’s nickname in the street was “Jupiter,” suggesting godly power. Once he reputedly dismissed the threat of a government inquiry with a comment to President Theodore Roosevelt that, “If we have done anything wrong, send your man [the attorney general] to my man [one of Morgan’s lawyers] and they can fix it up.”⁷

J. P. Morgan operated within a circle of talented professionals and influential figures in the New York and European financial communities, and he demonstrated great faith in their collective abilities to “fix things up.” Biographer Frederick Lewis Allen described vividly Morgan’s attitude about the role of the Wall Street oligarchs, of which he was the most prominent:

Morgan seemed to feel that the business machinery of America should be honestly and decently managed by a few of the best people, people like his friends and associates. He liked combination, order, the efficiency of big business units; and he liked them to operate in a large, bold, forward-looking way. He disapproved of the speculative gangs who plunged in and out of the market, heedless of the properties they were toying with, as did the Standard Oil crowd. When he put his resources behind a company, he expected to stay with it; this, he felt, was how a gentleman behaved. His integrity was solid as a rock, and he said, "A man I do not trust could not get money from me on all the bonds in Christendom." That Morgan was a mighty force for decent finance is unquestionable. But so also is the fact that he was a mighty force working toward the concentration into a few hands of authority over more and more of American business.⁸

Two of the leading figures in Morgan's circle were George F. Baker, president of First National Bank of New York, and James Stillman, president of New York's National City Bank. Though Stillman and Baker were direct competitors of Morgan for securities underwritings, the three men commanded great mutual respect having worked together in business and on charitable boards. Morgan's son once told a biographer, "Mr. Baker was closer to my father than any other man of affairs. They understood each other perfectly, worked in harmony, and there was never any need of written contracts between them."⁹ Baker and Pierpont Morgan were indeed warm friends; they respected each other and shared similar views on business matters. With Stillman, the relationship was perhaps more distant: "[T]hey did not always see eye to eye," wrote a biographer.

“Their mutual attitude, however, was one of respect and a certain degree of friendship.”¹⁰

Morgan’s preference for the consolidation of power was matched by a record of consistent leadership in times of crisis and advocacy on behalf of investors. In 1893 Morgan stepped into the breach to help President Grover Cleveland raise gold in Europe as a means of resolving the deepening liquidity crisis facing the country. He was instrumental in the consolidation and reorganization of failed companies, most importantly railroads that had overexpanded prior to the depression of the mid-1890s. In the process, Morgan introduced firm discipline and an investor-oriented point of view. In one prominent exchange with a resistant railroad executive, J. P. Morgan, said, “*Your* railroad? Your railroad belongs to my clients.”¹¹

Morgan also sought actively to avoid what he viewed as “ruinous competition” by merging competitor firms to produce corporations whose names remain memorable a century later: American Telephone and Telegraph, International Harvester, American Tobacco, National Biscuit (Nabisco), to name a few.¹⁰ In 1901, Morgan played a central role in the formation of U.S. Steel, the largest corporation in America. Capitalized at a value of \$1 billion dollars, U.S. Steel was twice the size of the entire budget of the U.S. government in 1907. Carosso thus described J. P. Morgan’s general approach to business consolidation:

Conservatism . . . stood at the center of Morgan’s general business views. If he had any fundamental, guiding business policy at all, it was to promote stability through responsible, competent, economical management, and to be aware of his obligations to an enterprise’s owners and bondholders. There was nothing he disliked more than unrestricted competition and aggressive expansionism, which he

considered wasteful and destructive. Morgan believed in orderly industrial progress, and he endorsed policies aimed at promoting cooperation. Large enterprises, he affirmed, should adhere to the principle of community of interest, not the Spencerian doctrine of survival of the fittest.¹²

Morgan was more than just a consolidator of existing businesses; he also played the role of venture capitalist. Not only were several Morgan partners investors in Thomas Edison's company, but Drexel, Morgan (the precursor to J. P. Morgan & Company) also served as the depository for the cash of Edison's firm, arranged loans for the company, facilitated foreign transactions, and helped to manage Thomas Edison's private wealth.¹¹ Morgan even helped Edison with mergers and acquisitions and underwrote the initial public offering for the Edison General Electric Company.¹³

By 1906, J. Pierpont Morgan was disengaging slowly from the day-to-day activities of his firm to attend to his passion for collecting art and literature, serving on boards of charitable institutions, and touring Europe. He relied heavily on his son, J. P. "Jack" Morgan Jr., to manage his firm's daily affairs, as well as his "right-hand man," George W. Perkins, a partner in J. P. Morgan & Company. On April 17, 1906, the aging Morgan turned 69 years old. By this time, he was unquestionably, according to one biographer, "the most powerful figure in the American world of business, if not the most powerful citizen of the United States. His authority was vague, but it was immense—and growing."¹⁴ On the morning after his birthday, an historic catastrophe devastated the city of San Francisco, California, setting in motion a chain of events that would eventually call for all the power, wisdom, strength, and influence that Old Jupiter could muster.

Chapter 2

A Shock to the System

General affairs here are about as bad as they can be.

—J. P. “Jack” Morgan Jr.

August 8, 1907

The earthquake that destroyed San Francisco in April 1906 was unprecedented in scale and scope. In the wake of the temblor itself, broken gas mains ignited massive fires throughout the city. Disruptions to municipal water lines prevented fire suppression, and San Francisco’s mostly wood-framed architecture only fueled the flames. The conflagration eventually engulfed the city, leveling over four square miles, or about half of San Francisco, such that most historical accounts speak of both the earthquake *and* the fire as the source of the city’s destruction. San Francisco’s damages were reported to range between \$350 and \$500 million, or 1.2 to 1.7 percent of the U.S. gross national product in 1906.^{[1](#)}

The strains from the catastrophe in California rippled instantly through the global financial system. At the time, San Francisco was the financial center of the West and home to the western branch of the U.S. Mint, so anything that disrupted business in San Francisco threatened the entire western region economically.