

# J. P. MORGAN, THE PANIC OF 1907, & THE FEDERAL RESERVE ACT

IN 1907, J.P. MORGAN AND OTHER WALL STREET BANKERS RESCUED BANKS, THE STOCK MARKET, AND NEW YORK CITY FROM FINANCIAL RUIN. IN 1913, CONGRESS PASSED THE FEDERAL RESERVE ACT, WHICH PUT THE GOVERNMENT IN CHARGE OF MANAGING FUTURE FINANCIAL CRISES.

In 1900, more than 20,000 banks operated in the United States (compared to fewer than 8,000 today). When people deposited money in a bank, it did not just store the cash in a vault. The bank made its profits by lending most of these funds to businesses and individuals and charging interest on these loans.

Banking regulations required most banks to keep a certain percentage of their deposits, called reserves, in ready cash or easily available. Small town banks often deposited some of the reserves in larger city banks to earn interest there, but they could quickly call back their reserves as needed.

The city banks in turn usually deposited part of their required reserves in the biggest city banks. A large percent of the reserves that flowed up this chain of banks ended up in New York City's Wall Street financial institutions, the largest banks of all.

Wall Street banks made loans to railroads, huge corporations, and even to the U.S. government. They also invested in stocks and bonds. In this way, Wall Street financed much of America's booming industries.

When things went smoothly, money from bank reserves flowed up the chain of banks to Wall Street and then down the chain in the form of profitable interest. But things did not always go smoothly.

## Bank Panics

One problem was the frequent shortage of money in circulation.



J.P. MORGAN (1837-1913), left, walks with his son, John Jr., in 1912.

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To meet an increase in the demand for loans, local banks sometimes had to call back reserves they had deposited in city banks. In turn, these banks then often had to call back their reserves from up the chain of banks.

The United States did not have a central bank. In 1836, President Andrew Jackson had refused to re-charter the Bank of the United States. Thus, no national central bank managed the supply of money or acted as a "lender of last resort" to keep banks in business when they temporarily ran short of cash.

Repeated bank panics broke out during the 19th century. Such

events occurred suddenly when depositors, acting on real or imagined fears, ran to their banks to demand their cash deposits back.

People panicked easily because if their bank failed, they would lose all the money they had deposited. Unlike today, no government insurance program guaranteed bank deposits.

"Bank runs" quickly wiped out the reserves of banks and often caused them to fail even though they might still hold solid assets such as profitable loans. A panic could start among small rural banks and spread up the chain of banks. It could also go down the chain after the failure of banks on Wall Street.

The financial markets could also cause bank panics. If banks recklessly speculated their reserves on land, when the value of land fell, a bank panic might follow. If the stock market crashed, a bank panic could result. During the 1800s, at least five major bank panics erupted followed by economic depressions of varying lengths and severity.

Without a central bank to rescue the banking system during a panic, the bankers themselves had to try to stop the financial meltdown. No banker was better at this than J.P. Morgan.

## J.P. Morgan

Born in 1837, John Pierpont Morgan was the son of a successful bank financier. Pierpont, as he preferred to be called, was educated in private New England schools and studied art history at a German university. After his first wife died, Morgan married Frances Tracy in 1865. They had four children.

At age 24, Morgan entered New York finance as the Wall Street agent for his father's banking company. In 1871, Morgan's father arranged for his son to form a partnership with an older banker. Drexell, Morgan and Co. soon emerged as the main source of loans to the U.S. government.

Over the next decades, Morgan became the dominant figure on Wall

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Street. He was more than six feet tall with a deformed purplish nose caused by a skin condition. He hated pictures taken with his nose in profile, and he once assaulted photographers with his walking cane.

Morgan believed American capitalism should be under the control of bankers like him. His Wall Street peers saw him as their natural leader, who was known as honest and fair.

Morgan viewed the wild cut-throat capitalism of the late 19th century as wasteful and destructive. He hated “ruinous competition,” such as the rate wars that drove many railroads into bankruptcy. Morgan believed the best way to create business stability was for competitors to regulate themselves with private agreements based on trust. In the 1880s, Morgan started to organize mergers of competing railroads.

### **‘Jupiter’**

In 1893, a stock market crash triggered a bank panic and the worst depression in U.S. history up to that time. During this depression, the money supply shrank as people and businesses hoarded cash. Scarce money caused high interest rates on borrowing, which led to a drop in spending and mass unemployment.

The gold standard worsened the crisis. The U.S. Treasury could only print paper money that was backed by its reserves of gold. The money crisis worsened when European nations demanded payment in gold to settle trade imbalances. This threatened to shrink the money supply further.

In February 1895, Morgan and other bankers met with President Grover Cleveland. Morgan proposed a plan for his financial firm to coordinate the U.S. purchase of gold from world sources in exchange for government gold bonds payable in 30 years.

Cleveland approved Morgan’s plan. It worked, and the U.S. money supply stabilized. Morgan and the other bankers who carried out the plan made a nice profit as well.

In effect, Morgan acted in place of a central bank that the U.S. did not have. Wall Street nicknamed him “Jupiter,” after the chief Roman god.

When his bank partner died, Morgan renamed the firm J.P. Morgan & Co. Morgan’s bank financed the merger of numerous railroads into six huge systems. He traded his financing for the majority of stock in the merged railroads and a place on their boards of directors. Wall Street called this process “morganization.”

Morgan also merged competing industrial companies into gigantic

*He assembled the city’s commercial and trust company bankers, put them in separate rooms, locked the front door, and kept the key in his pocket until he could negotiate a deal.*

corporations. In 1901, he merged steel companies he owned with Carnegie Steel plus nine others to form U.S. Steel. This became the world’s first billion-dollar corporation, which controlled about half the American steel business.

Morgan donated millions of dollars to museums, the opera, hospitals, schools, and his Episcopal Church. His passion was collecting fine art, manuscripts, and other rare objects. To contain his vast collection, he built the Morgan Library next to his home.

### **The Panic of 1907**

In 1901, Vice President Theodore Roosevelt became president following the assassination of President William McKinley. Roosevelt quickly signaled that he sympathized with

reformers, called progressives, who demanded vigorous enforcement of antitrust (anti-monopoly) laws.

During the summer of 1907, a pair of minor Wall Street bankers devised a scheme to capture the stock of the United Copper Co. and drive up its price. But the scheme fell apart, and the company’s stock plunged in value.

One investor in the scheme was the president of the Knickerbocker Trust Company. This was a new type of bank that was only lightly regulated.

Trust companies did regular banking but also made risky loans and speculated in the stock market. By taking risks, they made greater profits and could offer higher interest rates to depositors than the more common commercial banks did. Also, trust companies did not have to hold as much in reserve as commercial banks.

Early in October, Knickerbocker depositors learned that their bank’s president had invested in United Copper stock. This caused a run on the trust company by depositors who feared it had lost money and would fail. Actually, Knickerbocker itself had not invested in the scheme and was stable.

But Knickerbocker still ran out of cash to pay off its panicked depositors, and it closed. A panic began. Depositors in other New York trust company banks started withdrawing their money. Banks down the banking chain were calling back their reserves from Wall Street to guard against a run on their deposits.

Wall Street bankers turned to 70-year-old J.P. Morgan, the one man they trusted. When a new run on the Trust Co. of America bank occurred, Morgan and two of his banker friends raised \$3 million to save it. But the bank runs continued, especially on the trust companies.

Then New York City’s mayor reported to Morgan that the financially stressed city needed a loan to cover its payroll and pay contractors.

Fearing the city's financial collapse would worsen the panic, Morgan and his banker friends purchased \$30 million in city bonds.

Brokerage firms, which handled stock market transactions, were also in danger of failing. They were paying skyrocketing interest rates on loans to meet their obligations. Morgan put together a \$25 million "money pool" for making lower interest loans to them, avoiding an almost certain stock market crash.

But the largest brokerage firm on Wall Street, Moore & Schley, was \$25 million in debt. The bankruptcy of this key firm could still set off a stock market crash.

Morgan called a meeting at the Morgan Library. He assembled the city's commercial and trust company bankers, put them in separate rooms, locked the front door, and kept the key in his pocket until he could negotiate a deal.

The meeting went well into the night. Trust company bankers resisted pooling their reserves to stop the panic, but negotiations wore on. At 4:30 a.m., Morgan finally bullied them into signing an agreement. It called for the trust company bankers to bail out their brother bankers who were struggling with runs on their deposits. For his part, Morgan promised to save the Moore & Schley brokerage.

Morgan then devised a plan to erase the debt of Moore & Schley. It would sell a steel company it owned to U.S. Steel, a company that Morgan held stock in and was a member of its board of directors. The only problem with this deal was that by buying a competitor, U.S. Steel would monopolize the steel industry even more. This could trigger an antitrust prosecution by the Roosevelt administration.

Morgan immediately sent trusted advisers to Washington to persuade President Roosevelt to approve the deal. Roosevelt agreed that the circumstances of the Wall Street panic warranted U.S. Steel's purchase of a competitor.



A CROWD GATHERED in front of a failed bank in New York City. Before federal deposit insurance (created in the 1930s), if a bank went under, its depositors lost all their money.

Library of Congress

## The Fallout

Morgan's deal-making finally stopped the Wall Street panic. Much economic damage, however, had already spread across the country. The resulting depression of 1907–08 was severe, but probably would have been greater if the bank panic had continued.

Wall Street cheered Morgan as a hero. But progressives attacked Morgan and Wall Street for all the profits they made from their deals. Some even accused them of causing the panic so they could make money from it, but this was never proved.

It also turned out that the steel company purchased by U.S. Steel had been underpriced. This made the purchase even more profitable for U.S. Steel (and Morgan).

Progressives criticized the president for being hoodwinked by Morgan into undermining his own trust-busting campaign. In addition, progressives claimed that a "money trust" of Wall Street bankers, headed by Morgan, conspired to monopolize the nation's financial investments.

In December 1912, Morgan testified before a congressional banking committee hearing chaired by Rep. Arsene Pujo. At age 75, Morgan was

semi-retired with his son, John Jr., in the process of taking over the family bank.

When the committee's chief counsel questioned Morgan whether he commanded any power over the economy, he replied, "Not the slightest." He denied that any money trust existed. He also disagreed that his mergers of railroads and industries had created an unhealthy concentration of economic power.

The Pujo committee, however, concluded that a "community of interest" existed on Wall Street that concentrated "the control of money and credit in the hands of a comparatively few men." The committee's report identified six Wall Street banks, including Morgan's, which made it nearly impossible for large companies to sell their corporate bonds without the group's cooperation. The six banks had agreed not to compete against one another in handling new issues of bonds. The Pujo report also revealed that Morgan's bank along with two others held voting seats on the boards of directors of corporations worth an astounding \$25 billion (between 2 and 9 trillion in today's dollars).

Morgan sailed to Europe early in 1913. He died in his sleep in Rome on March 31. Morgan's partners ►

publicly blamed his death on the stress of the Pujo hearings. Morgan's estate was valued at more than \$100 million. That figure was much smaller than the fortunes of industrial barons like Carnegie and Rockefeller. Carnegie commented, "And to think, he was not a rich man." Morgan's only son, John Jr., inherited control of his father's financial empire.

## The Federal Reserve Act

After the Panic of 1907, there was widespread agreement that a central bank was needed to manage the money supply and to be the "lender of last resort" to stop bank panics. Sharp disagreement arose, however, over who should run this bank.

Most of the nation's bankers, including Morgan, wanted a private central bank controlled entirely by bankers. The progressives wanted a central bank under the control of the federal government.

After Democrat Woodrow Wilson won election as president in 1912, he sided with the progressives. Wilson insisted that the central bank be a public agency directed by government officials appointed by the president.

Bankers and Republicans objected to Wilson's demand for federal control of the central bank. They argued that the bank would be controlled by politicians who would follow the policies of whichever party was in power. They also complained such a board would mean major government interference in private banking and the free enterprise system. They much preferred that any "capstone" board, as Wilson called it, should be in the hands of expert bankers alone.

The progressives used the findings of the Pujo hearings to justify the need for a government-controlled central bank to counter Wall Street's dangerous concentration of economic power. For many years, farmers and populist politicians had complained that the New York

banks had too much control over the cost of borrowing. It was time, the progressives argued, to stop relying on Wall Street bankers, like J.P. Morgan, to end bank panics themselves and make big profits in the process.

With the Democrats in control of Congress, the Federal Reserve Act was passed by strong majorities in the House and Senate. President Wilson signed it into law on December 23, 1913. These were the act's key features:

- A seven-member Federal Reserve Board, appointed by the president with the consent of the Senate, was to coordinate money supply policy with 12 banks designated as Federal Reserve Banks. Each of the banks would be located in a different region of the country.
- The Federal Reserve Banks were to be "lenders of last resort" for U.S. banks.
- The Federal Reserve Banks could issue Federal Reserve Notes, paper currency redeemable in gold, to make the money supply more "elastic" or expandable, if needed.

The Federal Reserve Act of 1913 has been changed a number of times, most notably to centralize power from the 12 regional banks to the Federal Reserve System's policymakers in Washington. One major flaw in the 1913 banking reform effort was the lack of a government bank deposit insurance system to

protect people's money when banks failed. Congress finally enacted this reform in 1933, creating the Federal Deposit Insurance Corporation. Today, the FDIC insures every depositor up to at least \$250,000 in an insured bank.

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In 2000, J.P. Morgan & Co. merged with Chase Manhattan Corp. to form the JPMorgan Chase Bank. This bank participated in the 2008 U.S. bailout of banks. It borrowed \$25 billion, which it has since repaid to the U.S. Treasury. JP-Morgan Chase is currently the largest U.S. bank by assets held.

## For Discussion and Writing

1. Why did bank panics often lead to the failure of banks and economic depressions?
2. President Theodore Roosevelt condemned the "predatory man of wealth." Was J.P. Morgan such a man? Why or why not?
3. How did the Federal Reserve Act attempt to stop the destructive bank panics?

## For Further Reading

Bruner, Robert F. and Carr, Sean D. *The Panic of 1907: Lessons Learned from the Market's Perfect Storm*. Hoboken, N. J.: John Wiley & Sons, 2007.

Chernow, Ron. *The House of Morgan: An American Banking Dynasty and the Rise of Modern Finance*. New York: Atlantic Monthly Press, 1990.

## ACTIVITY

### Control of the Federal Reserve System

In 1913, J.P. Morgan and other bankers disagreed with President Woodrow Wilson and the progressives over who should control the Federal Reserve System. *Should it be directed by private bankers like Morgan or by government officials appointed by the president?*

1. Form small groups that will first list arguments for each side of the question above based on information in the article.
2. The groups will then discuss the arguments on each side and decide who should control the Federal Reserve System.
3. The groups will then report their conclusions and reasons to the class.