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The Panic of 1907

The Panic of 1907 was a financial crisis in the United States in which the collapse of speculative investments triggered a series of runs on banks and trusts financing those investments. Various causes of the Panic can be traced to easy money policies propagated by the U.S. Treasury years prior. "The U.S. Treasury...engaged in large-scale purchases of government bonds and eliminated requirements that banks hold reserves against their government deposits…[increasing] the supply of credit and stock market speculation" (Boyle). As a result, banks and trusts "held a low percentage of cash reserves relative to deposits, around 5 percent, compared with 25 percent for national banks" (Moen & Tallman). These conditions were coupled with "a stock market [that] had been in decline since early 1907" (See Fig. 1) and the lack of a "central bank or reliable lender of last resort during the National Banking Era" (Moen).

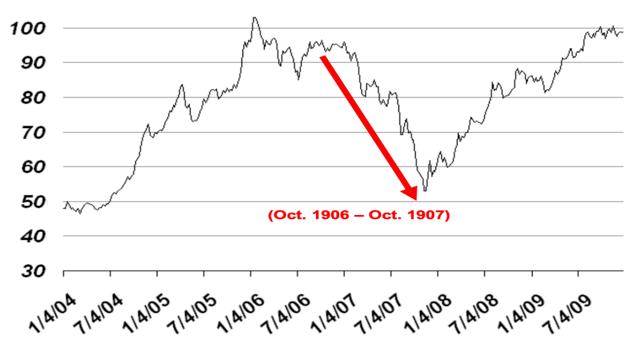

Fig. 1 "Equity prices were in a steady decline for the entirety of 1907" (Simon)

Conditions were already unfavorable when Fritz Augustus Heinze and Charles W. Morse decided to buy up shares of a copper mining firm to corner the market. This resulted in a "run on banks that had financed their speculative attempt to corner the copper market" (Boyle). A run on trust companies followed, particularly in the case of the "Knickerbocker Trust, which had previously dealt with Heinze" (Boyle). It ultimately failed, and the panic spread to other economic hubs in the U.S.

In a closer examination of the Panic, an investor would have been most struck by the ability of only two speculators (Heinze and Morse) – and the news about their attempt to corner the market – to trigger irrational fear and bank/trust runs on a massive scale. The run on Knickerbocker intensified so much that, "depositors had withdrawn nearly $8 million [from the trust]" and "36 percent of deposits from New York City trust companies between August 22 and December 19, 1907" (Moen and Tallman).

A successful investor during the time would have likely taken note of one particular indicator – a low cash-to-deposit ratio at trusts. "They held a low percentage of cash reserves relative to deposits, around 5 percent, compared with 25 percent for national banks" (Moen and Tallman). Because trust deposits were demandable in cash like banks, trusts were equally as susceptible to runs. Fig. 2 below illustrates the massive amounts of deposits.

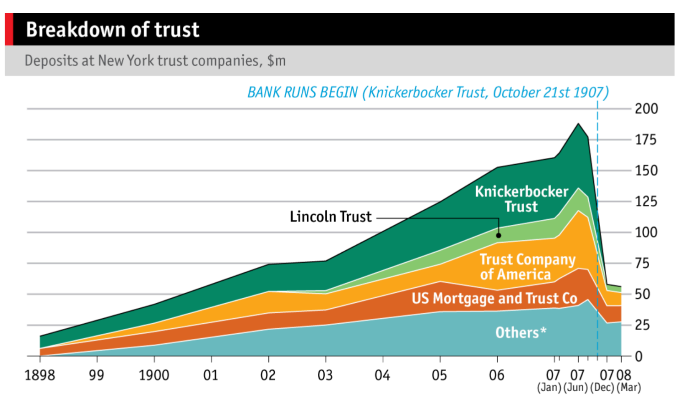

Fig. 2 "Deposits at New York trust companies steadily rose until the Panic of 1907" (The Economist).

During the onset of the Panic, an investor would have responded by remaining cautious of declining equity prices in contrast to GDP growth, a lack of liquidity in the market, low cash-to-deposit ratios, and the lack of a central bank. They would have held a margin of safety to classify the most rational asset purchases and minimize losses in the eventual bear market. Given the aforementioned asset purchases by the Treasury and falling stock prices prior to the Panic, an investor would have hedged their equity investments with a healthy amount of bond purchases.

During the peak of the Panic of 1907, the private response was almost exclusively handled by one 70-year old gentleman by the name of J.P. Morgan. He “suddenly functioned as America’s Central Bank” and met with the Secretary of Treasury to support a line of $25 million to failing trusts in New York City (Simon). Inspired by Morgan, other prominent individuals such as J.D. Rockefeller and Secretary of Treasury Cortelyou followed suit and deposited large sums of money to trusts and banks (Moen). The private response to the Panic was formidable – they did everything in their capacity in order to save the American economy.

The public response to the Panic also proved to be one of the most important decisions moving forward. The federal government enacted the Aldrich-Vreeland Act in 1908, which would lay the groundwork for the “Federal Reserve Act of 1913 and the Federal Reserve System that it would create” (Boyle). The newly formed Federal Reserve would act as a lender of last resort and bail out insolvent institutions, as well as control the money supply. Like the private response, the public response was very significant, and not much more could have been done at the time.

Many lessons stemmed from the Panic of 1907, namely the importance of liquidity, the presence of “one or more outstanding individuals,” and how “triggering events can wreak havoc” (Simon). The Panic most likely would have been avoided had there been a central bank in place already, which might have eased public fear of insolvency issues. Adequate governmental regulation would have also helped avoid a Panic, since “trust companies were much less regulated than national or state banks in New York” (Moen).

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