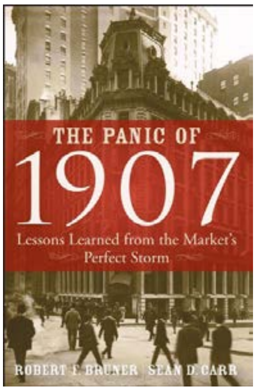
The Panic of 1907



Lessons Learned from the Market's Perfect Storm

By RT Bruner and SD Carr

This book was recommended to me by a friend at a time when I was keen to increase my study of past market crashes. In particular, I was looking to better understand what causes crashes, so I will be better able to anticipate them and act accordingly.

This book tells the story of one of the worst crashes in US history. It reads like a novel, but has been solidly based on records from the time. The story carries the reader along from crisis to crisis through the panic.

What makes the book especially interesting is that, although the markets and their regulation were different then, the similarities to 2008 were striking. In 2008, the rescue was led very much by the Federal Reserve and the Treasury. In 1907, the situation was largely saved by the intervention of JP Morgan, even though he was at the time quite ill with a heavy cold or flu, with some help from the Treasury.

The story is brought to life through the characters of the time, many of whom were quite colourful. Above all, the story reveals the root causes of the panic, which like 2008, lay in the misuse of debt mixed liberally with some dubious business practice and reckless risk taking. Readers are taken through an extraordinary chain of events which show that even in 1907, the whole financial system was interconnected more heavily than most people understand. It was in many ways a rehearsal of 2008. Indeed this book is an excellent example of my policy of reading a book about the markets every month. It is only by understanding history that we can avoid or at least learn better to deal with crises in our own time.

The other remarkable aspect of the 1907 story was the way in which financial institutions were prepared to club together to avert a worse crisis, albeit at one point JP Morgan locked all the bankers in his library until they agreed to assist.

Today, the Federal Reserve and the Government would be responsible for doing what Morgan achieved. Indeed, this crisis led to the formation of the Federal Reserve. Prior to 1907, the US did not have a central bank. The book also explains clearly the very real differences in the US banking system which are still there today.

Then, when the story has been told, the authors draw some lessons, which for me were the most valuable part of the book. These are the key issues which led to the panic, many of which can still arise today:

The financial industry is actually a giant system with tentacle-like links everywhere. This aspect rather than size of the firms was the key reason the crisis became a panic as it was impossible to quarantine a failure in one firm. So, the failure of a speculation by Otto Heinze & Co, who tried unsuccessfully to corner the copper market. This brought down their broker Gross & Kleeberg (broker) and spread quickly to several banks and was implicated in the spectacular failure of the Knickerbocker Trust. This in turn put pressure on other trust companies and banks. It then spread across the country and overseas.

The precursor was a period of buoyant growth, with ill-advised lending and risk-taking. Always, a crisis like this is preceded by a relaxation of standards in lending and borrowing, which flows into wild speculation. *Easy credit amplifies the boom, and tight credit amplifies the contraction*. In a situation where there was simply a shortage of money supply, we had the recipe for a financial Armageddon. The parallels with 2008 when banks were afraid to lend even to other banks are striking. The basic concepts are consistent and only the details are different.

There were inadequate safety buffers. Some developments as a result of the crisis and since have helped, but this factor was also evident in 2008 when the problem was so large that an extraordinary global effort was needed lest we again slip into a 1930's scenario.

Adverse leadership was a factor in 1907, with a US President who had taken a verbal stick to large companies. This did nothing to help when panic developed and in fact was a factor in increasing fear and loathing. The book makes very clear how little things can provoke a run on a bank or trust company, an eerie shadow that again fell over us in 2008.

Crises and panics always tend to have some triggers. From the 1906 earthquake in San Francisco through financial scandals, adverse court rulings, rising regulation and outlandish rhetoric from the President was anathema to business confidence and public confidence in their financial institutions. The scene was set for crisis in much the same way as the 2008 crisis had its antecedents in the sub-prime mortgage scandal in the US which emerged from mid-2007. The authors point to four key ingredients in the situation which seem to be common to other similar crises:

- A real event or events which affect the economy
- The trigger event was large and costly
- The trigger event was an unambiguous signal to investors
- The situation was surprising in the sense that it came as a shock to most investors

There tends to be a strong emotional element in the panic situation. The authors point to undue fear, uncontrolled greed and other behavioural aberrations.

Although there was considerable collective action led by JP Morgan, there was not enough similar action in and especially outside New York. The key was the action of the famous prisoner's dilemma from games theory which is well explained in the book.

The book was written in 2007. In the Lessons chapter the authors ask whether it could happen again and take us through the key issues as they saw them at this time. This is especially valuable, because they were in the same position then as every ordinary investor, except that they had a better conceptual model of what to look for.