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The Panic of 1907

by Fred E. Foldvary

One hundred years ago, there was a financial panic in the United States. There were runs on the banks as depositors rushed to take out their money before they ran out of currency. The stock market dropped to half its peak 1906 average.

The financial crisis began in New York City, home of most of the financial "trust" companies. The panic induced Congress to create the Federal Reserve System (the "Fed") in 1913 to prevent any more such financial crises. But the Fed failed to prevent the even worse bank failures of the Great Depression.

The main cause of the crash was stock market and real estate speculation. Also contributing were attempted company takeovers and the San Francisco earthquake of 1906. Much of the real estate of San Francisco was insured by companies in London. Payouts to San Francisco drained money from the U.K., which raised interest rates there and in the U.S. But interest rates mostly rose due to borrowing for speculation, and the high rates and real estate prices then halted investment in capital goods. The U.S. stock market crashed on March 14, 1907 and then again after a failed attempt on October 16, 1907, of a scheme to corner the stock of the United Copper Company, which highlighted the close connections then among banks, trusts, and brokers. The panic began on October 18, 1907, following the collapse of United Copper share prices. On October 21, there was a run on the large Knickerbocker Trust Company, which then shut down.

To restore confidence, the banker chief J. P. Morgan, working



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together with the Secretary of the Treasury, organized some bank executives and the U.S. Treasury to transfer money to troubled banks and buy stocks. That soon ended the panic. Banking chiefs, led by J. P. Morgan, later met at the Jekyll Island Club off the Georgia coast to concoct the central-banking scheme that became the Federal Reserve Act of 1913.

Land speculation had caused a previous panic, in 1893, followed by the severe depression of 1893. Land values had peaked in Chicago and elsewhere in 1890, and construction peaked in 1892. This was the last of a series of 19th-century depressions in the US, which occurred every 18 years on the average, following peaks in land value and construction. The next peak in land value after 1890 was in 1907, and the U.S. economy had already been slowing down already in 1906 as interest rates rose.

In banking history, the years from the Civil War to 1913 are called the "National Banking Era." Prior to the Civil War, the banks were controlled by the state governments. During the Lincoln presidency, the U.S. government printed national currency, and the major banks fell under federal regulation.

There were three types of financial institutions during the National Banking Era: state banks, national banks, and trust companies. Most of the panic focused on the trusts, whose assets and activities grew rapidly after the depression of the 1890s. A trust is an organization like a corporation, which has legal status as an artificial person, having title to assets in its name. The financial trusts managed money for estates, held stocks and other assets, and accepted deposits like banks. Many of their loans used real estate and stocks as collateral. When these price of these assets fell and loans were not repaid, the trusts became bankrupt, which in turn ruined the investors' wealth.

President Theodore Roosevelt initiated an active policy to break up

some of the large trusts and also to bring them under federal control. The Anti-Trust Act of 1890 had been intended to break up companies with near monopoly control over an industry. But Roosevelt's aggressive policy ended up contributing to the panic of 1907.

The fundamental causes of the Panic of 1907 were the flawed monetary and fiscal systems of the United States. The federal government's control of the money during and after the Civil War created a rigid money supply that did not respond to the demand for money. During that era, agriculture dominated the economy, and the inflexible money supply created a crunch and a spike up in interest rates whenever farmers and others need to borrow funds.

Federal taxes fell mostly on the sale of goods, with high tariffs and excise taxes on goods. The great expansion of state-subsidized infrastructure such as canals, railroads, and highways, along with other government services, pumped up land values, subsidizing land ownership. Economic booms were accompanied with land speculation as land values rose, and the speculation was financed with borrowed money. Real estate was a major asset of companies such as the railroads, whose shares rose in value as real estate prices escalated, and speculators also borrowed to buy the shares of stock. The stock market bubble rested on the real estate bubble, and then high interest rates and high real estate prices dried up investment, causing a recession and fall in stock market shares, resulting in bank failures as loans turned bad. Depositors would then panic and rush to take out their money.

The same story happened again and again, but after 18 years, new speculators had no experience with the previous panic, and older investors kept hoping to recover past losses and make a killing before the crash. The establishment of the Fed did create a more flexible money supply, as the Fed can expand the money without

limit. Federal deposit insurance, starting in 1933, ended bank panics, but this only shifted the financial risks to the government and thus to taxpayers and bond owners. The fundamental policy of federal control of the money remained, and the fiscal system of taxing production while subsidizing land value also has remained.

The Panic of 1907 shook confidence in the U.S. financial system, but the people and the government officials learned the wrong lessons. The problem with the banking system was the federal control of the money supply, and the effective remedy would have been free market banking, where the banks and other private firms would issue private currency backed by gold. With competitive banking, the private bank notes and deposited funds would expand flexibly in accord with the demand for money and borrowing, while the redemption into gold would prevent inflation. That is how the Scottish free banking system worked previously. But instead, Congress moved towards greater federal control of money and banking, a policy which failed to prevent the Great Depression and which led to the continuous inflation since World War II and also to more recessions.

The effective policy to end panics and depressions is free banking and land-value tapping, the tapping of land value and rent for public revenue, which would prevent speculative excess. The institutional details are different today than one hundred years ago, but the fundamental structural causes of depression have not changed. The current real estate boom has peaked out, and with much of financial collateral based on real estate loans, the economy is headed towards the same end, a crash. This time, rather than a panic focused on financial institutions, federal policies have spread the risk to the entire economy, so the next crash will be much worse than the brief panic of 1907, and this time, a clique of bankers will not save us.

The ancient Mayan Indians of Central America predicted the end of the world on December 21, 2012, when their calendar closes on the present era. Perhaps a severe global economic crisis, combined with escalating global warming and the baby-boomer retirement explosion will wreak the world's money and tax systems so badly that by default, truly free enterprise will emerge in a new era. It's little wonder that since 2002, the price of gold has risen from US \$280 to \$680 per ounce as those perceptive in financial affairs realize that fiat money can fall to its price of production, zero, and the market value of land also can ultimately fall to its cost of production, zero, while gold has been and always will be positive wealth independent of governments and banking.

We live by fictional delusions, but reality ultimately governs the world.

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