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.

On the New York and London stock exchanges, news of the quake led to an immediate sell-off in stocks and a significant drop in share prices. Economists Kerry Odell and Marc Weidenmier have estimated that the disaster led directly or indirectly to about a $1 billion (or a nearly 12.5 percent) decline in the total market value of New York Stock Exchange securities. Prices of railway stocks fell more than 15 percent, and those of insurance companies declined between 15 and 30 percent during the two weeks after the cataclysm.[2]

Relief funds were drawn into the city from around the country and the world: England supplied $30 million; Germany, France, and the Netherlands collectively provided another $20 million. Such international effects of the earthquake were further amplified because many foreign insurers had provided San Francisco's underwriting protection. What most severely hurt the insurance industry was that most people were insured against fire but not earthquakes. British insurance firms, for instance, had accounted for about half of the city's fire insurance policies; after the quake, they faced losses of close to $50 million. In fact, several insurers were overwhelmed by the claims and could not meet their insurable obligations; Fireman's Fund Insurance Company, for example, faced liabilities of $11.5 million, exceeding its total assets by $4.5 million.[3] Consequently, some underwriters imposed lengthy delays in paying for damages, while others discounted their claims, insisting that any earthquake-related fire damage was not explicitly covered in their policies. The Hamburg-Bremen Insurance Company demanded a discount of 25 percent for all San Francisco claims. Only six companies fully honored their obligations.[4]

While some British insurers funded their payments by selling their holdings of American securities, others liquidated assets heavily in foreign markets. This liquidation prompted major shipments of gold from London to the United States—$30 million in April and another $35 million in September 1906, amounting to a 14 percent decline in Britain's stock of gold—the largest outflow of gold from Britain between 1900 and 1913. Eventually, these outflows of gold created liquidity fears for the Bank of England.[5] The declining liquidity of the London capital market sparked the spread of rumors in New York that British financial houses were in trouble and required support from the Bank of England.*

At the time of the earthquake in the spring of 1906, the global market for capital was dominated by London. The British Empire was at its zenith, and London was the locus of immense flows of capital. Charged with the responsibility of maintaining liquidity for the Empire, the Bank of England—the "Old Lady of Threadneedle Street"—held reserves of gold with which to meet the liquidity demands of banks and trading partners. Keeping the British mills, factories, and shops supplied with goods from the commonwealth was a fundamental premise of England's economic system.

In an attempt to stanch the depletion of the country's gold supply, the Bank of England raised its benchmark interest rate from 3.5 to 4.0 percent. Fearing further demands for gold with the coming Egyptian cotton crop,[6] the Bank raised its rate again on October 19, 1906, from 4.0 to 6.0 percent—the highest rate posted by the Bank of England since 1899.[7] Central banks in France and Germany followed suit and sharply raised their interest rates as well.[8] Panic had not yet set in, but telegrams flew across the Atlantic between the world's leading financiers, reflecting a growing anxiety within the financial community about liquidity and the likely actions of the Bank of England.[9]

In New York City, capital was becoming scarce, too, as its gold reserves also migrated to San Francisco. The timing of these relief shipments to the West Coast was particularly unfortunate since they coincided with the ordinary demands for funds induced by the U.S. agricultural cycle: The harvesting and shipment of crops required credit until the crops reached the consumer. As a result of the capital shortage, the price of money in New York grew dear, and other sectors of the American economy started to feel the pinch. By the winter of 1906–1907, severe credit shortage had set in.

On December 18, 1906, Jack Morgan, writing to his affiliate partners in London, offered stark language about these stringent credit conditions: "Things here are very uncomfortable owing to the tightness of money . . .

* To the queries from J. P. "Jack" Morgan Jr. about these rumors, Edward "Teddy" Grenfell, a partner in J. S. Morgan & Company in London, the British affiliate of J. P. Morgan & Company, denied any basis in fact.

we are likely to have a stiff money market for some time to come."[10] A few days later he wrote with a clarification: "There is plenty of money in the country everywhere except in New York, and the only really alarming thing about the situation appears to be a very undefined feeling that there is something wrong in New York. This feeling extending to the large centres in the West has interfered with the natural flow of money to this centre to take advantage of the high rate."[11] As the year 1907 began, there was a deep sense of foreboding among the nation's money men.

Complicating the capital scarcity problem was a bull market in stocks, which had been spurred by the buoyant economic growth of the American economy through 1905. A "mammoth bull movement," in the words of one observer, was running its course on the New York Stock Exchange. Jack Morgan, under whose direct supervision J. Pierpont Morgan had left J. P. Morgan & Company, noted a speculative sentiment prevailing in the stock market:

> For the first time in three years the public—with stocks at their present high prices—have begun to come in and buy heavily with the result that the so called market-leaders are no longer in charge, and that the stock market is running away in a fashion which I must say suggests to me possible trouble in the future although not in the immediate future.[12]

Meanwhile, enormous new issues of securities, particularly by railway and industrial companies, placed further demands on the resources of the money market. Henry Clews, a contemporary Wall Street authority, said, "Indeed, the year 1906 from beginning to end witnessed a continuation of those inordinately heavy demands for money from Wall Street and corporations, and these led to the disturbed monetary conditions."[13]

While the equity market was attracting popular attention, the debt markets (i.e., bonds and loans) overshadowed stocks in both volume and significance. During 1906, debt market conditions diverged sharply from equities: While stock prices rose, bond prices fell (and thus, interest rates increased). The price movement in the debt markets coincided with the increasing demand for credit driven by the continued real economic growth in the United States, the agricultural cycle that drew financing to bring the bumper crop of 1906 to market, and the shock of the San Francisco earthquake. Alexander Dana Noyes, a leading observer of Wall Street, wrote in 1909, "Beginning about the middle of 1905, a strain on the whole world's capital supply and credit facilities set in, which increased at so portentous a rate during the next two years that long before October, 1907, thoughtful men in many widely separated markets were discussing, with serious apprehension, what was to be the result."[14]