INTRODUCTION

The Legacy of 1914

The Great War threatened the United States with financial disaster. During the last week of July 1914, Europeans began to liquidate their Wall Street investments and transfer gold to Europe to pay for the war. Foreign investors owned more than 20 percent of American railroad securities, the largest category of securities traded on the New York Stock Exchange.[1] Under the gold standard, they could demand the precious metal in exchange for the proceeds of their stock sales. The biggest gold outflow in a generation imperiled America's ability to repay its debts abroad. Fear that the United States would abandon the gold standard pushed the dollar to unprecedented depths on world markets.

The European assault on American finance brought danger and opportunity. In 1914 the United States was a debtor nation with a history of financial crises. Failure to meet its foreign obligations could sink American dreams of world monetary leadership. If it passed the test, however, the United States could jump to the head of the class.

Less than three weeks after the outbreak of the European conflict, Woodrow Wilson reviewed a road map for America's march to world financial supremacy. Henry Lee Higginson, an investment banker in Boston, wrote to the president on August 20, 1914, that "England has been the exchange place of the world, because of living up to every engagement, and because the power grew with the business. Today we can take this place if we choose; but courage, willingness to part with what we don't need at once, real character, and the living up to all our debts promptly will give us this power; and nothing else will. I repeat that it is our chance to take first place."[2] Wilson sent Higginson's letter to Treasury Secretary William G. McAdoo with the following covering message: "Here is a letter which is no doubt worth your reading whether you think the suggestions are practicable or not."[3]

McAdoo had, in fact, launched a plan to defend American financial honor before he received Higginson's letter from Wilson. This book traces William G. McAdoo's battle for American financial credibility during four months in 1914, from the end of July through the middle of November, a brief period that changed the course of U.S. financial history. McAdoo's strategy turned the financial crisis into a monetary triumph, and the story of his success provides a blueprint for crisis control that merits attention today.

In 1914 most developed countries—including Austria, Belgium, Britain, France, Germany, Italy, Japan, and Spain—could rely on central banks to fight their financial battles.[4] Even Czar Nicholas II had the Imperial Bank of Russia. The United States, without a central bank since 1836, after Andrew Jackson scuttled the Second Bank of the United States, resembled a headless financial giant. The Federal Reserve System, authorized by Congress on December 23, 1913, remained on the drawing board. It could have been a classic power vacuum, especially with President Woodrow Wilson distracted by his wife's fatal illness.

McAdoo seized the opportunity to confront the panic. He maintained America's commitment to the gold standard while every other country of the world, save for Britain, abandoned it because of the war. The boost to the dollar's credibility helped America challenge Britain as the financial capital of the world. November 11, 1914, the day the dollar's discount disappeared on world markets, and four years to the day before the Armistice, marks the turning point in America's battle for international financial leadership. In January 1915 the New York capital market replaced London as money lender to the world. Argentina, Canada, and China, traditional British clients, visited Wall Street to raise capital.[5] By the time America entered the world conflict in 1917, foreign governments issued more than $2.5 billion of dollar-denominated securities in New York.* A decade would pass before the transfer of financial power was complete, but a tectonic shift in monetary supremacy had begun.

How important was the gold standard at the outbreak of the Great War? John Maynard Keynes said that London's position as the world's leading financial center would surely be jeopardized if Britain suspended gold payments. He advised the British government that "we should not repudiate our external obligations to pay gold until it is physically impossible for us to fulfill them."[6] Keynes knew that capital markets forgive a country that suspends specie payments during wartime as long as it resumes its obligation after the emergency has passed.[7] But a financial superpower must meet a higher standard.[8]

Britain ruled world finance in 1914. Two characteristics—the pound sterling as international money and London as global moneylender—qualified Britain for the world financial crown. The pound served as the currency of choice for international transactions, just as the dollar does today, and borrowers throughout the world visited the City of London,

* Chapter 9 shows that America's role in world finance between 1915 and 1917 compares favorably with Britain's record immediately prior to 1914.

rather than Wall Street, to raise capital. The war would force London, at least temporarily, to stop supplying capital abroad but, according to Keynes, it could continue as king of international finance by insuring that sterling remained as good as gold. Britain signaled its intention in August 1914 to continue as the world's financial superpower by following Keynes's advice.

Treasury Secretary McAdoo recognized America's opportunity to shine by remaining true to gold, just like the world's monetary superpower. The United States had hoped to join the international financial elite since the turn of the twentieth century. McAdoo's entrepreneurial skill would turn the dream into reality.

William Gibbs McAdoo was born in Marietta, Georgia, in 1863.[9] He moved to Knoxville, Tennessee, in 1877, when his father became a professor of history and English at the University of Tennessee. McAdoo entered the University of Tennessee in 1879 and joined the debating society. The upperclassmen saddled McAdoo, a freshman with "a chip on his shoulder," with defending the unpopular side of every issue.[10] He enjoyed the limelight and knew that he wanted to be a lawyer. His heart settled on studying at the University of Virginia in Charlottesville, the best law program in the country from where McAdoo sat. That was before he discussed it with his father, William G. McAdoo Sr.

During the Christmas holidays in 1881 young Will McAdoo worked in the U.S. Circuit Court at Knoxville. He was then offered a permanent job as deputy clerk in the U.S. Circuit Court at Chattanooga. His father urged him to take the job "to learn law from actual contact with the courts."[11] In May 1882 McAdoo left Knoxville for Chattanooga, one year shy of his college degree. He never got to Charlottesville.

McAdoo was admitted to the bar in Chattanooga but did not practice law for very long. His father's advice to study law by apprenticeship imprinted a pragmatic gene deep inside his brain. It altered his life.

William McAdoo abandoned his fledgling legal career for the business world. To overcome his abbreviated academic training, McAdoo mastered the details of every prospective venture. At age thirty, before launching a plan to electrify the Knoxville Street Railroad, he learned how to calculate electric power and how dynamos are set up. Despite McAdoo's preparation, the venture failed and wiped out his life savings.[12] Ten years later, before he undertook to build a railroad line under the Hudson River, he investigated an abandoned tunnel dressed in rubber hip boots and yellow oilskins and brandishing an oil lantern. This time McAdoo's groundwork succeeded. As president of the Hudson & Manhattan Railroad Company, he inaugurated passenger rail service between Manhattan and New Jersey in 1908. After McAdoo became Woodrow Wilson's treasury secretary in 1913, his practical bent helped to avert the monetary crisis that began with the outbreak of war in the summer of 1914.

How did McAdoo manage the crisis?

The absence of a central bank hampered America's defenses. McAdoo tried to get the Federal Reserve System up and running to combat the danger. Benjamin Strong, governor-elect of the powerful Federal Reserve Bank of New York and a leading figure during the formative years of the central bank, wanted to protect the new currency system from the crisis. He blocked McAdoo's push for an early opening of the Federal Reserve Banks. The reversal, however, set the stage for McAdoo's improvisational skills. He rushed tons of gold to treasury offices around the country to trumpet America's commitment to redeem dollars in the precious metal.[13] He orchestrated a rescue of New York City from the brink of bankruptcy, introducing the "Too Big to Fail" doctrine in American finance.* McAdoo's pragmatism could have produced a jigsaw puzzle of confusion. Instead, his entrepreneurship created a formula for crisis control that belongs in every policy maker's playbook.

Failure to respond promptly to a crisis spells disaster. A financial panic spreads like an epidemic. On July 31, 1914, McAdoo shut the New York Stock Exchange for an unprecedented four months to hamper British sales of American securities. The British could not drain American gold without the dollar proceeds from sales of U.S. stocks and bonds. On August 3 he flooded the country with paper currency to prevent a repetition of the bank runs that had embarrassed America only a few years earlier, during the Panic of 1907. Banks had been forced to suspend the convertibility of their deposits into currency when they could not meet depositor demands for cash during October 1907. Banks avoided suspending their obligations in 1914 by offering depositors the emergency currency dispensed under McAdoo's orders.†

William McAdoo knew, however, that these finger-in-the-dike measures could not remain in place forever. Shutting the stock exchange immobilized the capital market, and unlimited supplies of emergency currency tempted inflation. McAdoo recognized that he needed an exit strategy to replace these powerful weapons before they disrupted the economy. He understood that the gold drain could be reversed by promoting American exports of agricultural goods to offset European sales of U.S. securities. On August 14, 1914, McAdoo met with businessmen

* Chapter 7 describes how McAdoo helped New York City meet its maturing bond obligations to British and French investors.

† McAdoo implemented the emergency currency provisions of the Aldrich-Vreeland Act. The legislation had been passed in May 1908 to avoid a repetition of the Panic of 1907. This is the only time the Aldrich-Vreeland Act was used. Chapters 3 and 4 provide a detailed explanation.

at the Treasury to arrange for "sufficient ships to move our grain and cotton crops to European markets."[14] The conference created the Bureau of War Risk Insurance, which supported the dollar's redemption in the foreign exchange market. As 1914 drew to a close, the flood of emergency currency receded and the New York Stock Exchange reopened. McAdoo had tamed the crisis without inflicting collateral damage.

How did the summer of 1914 change history?

A suspension of the gold standard in 1914 would have been a setback to American dreams of international financial leadership. The Panic of 1907 had already damaged U.S. credibility. A panic in 1914 would have been the second act in an American financial tragedy. Alexander Noyes, the contemporary business editor of the *New York Times*, appropriately highlighted the drama: "It is not too much to say that as a matter of financial history, the United States stood during those two or three weeks of August at the parting of the ways."[15] Suspending the gold standard would have relegated the dollar to second-class status, and sterling would have remained the undisputed money of choice for international finance.

Europe needed American capital to fight the Great War, but excess capital does not equate to a new monetary standard. Oil-rich Saudi Arabia helped finance American deficits during the 1970s, but the Saudi riyal never challenged the U.S. dollar as the international medium of exchange. Moreover, Britain did not need an abundance of capital after the war to retake first place as moneylender to the world. Financial institutions, such as banks and insurance companies, lend money by mobilizing the savings of others, committing only a few cents of their own in the process. Britain had the financial machinery and expertise to do the same.

America would have dominated world finance during the last half of the twentieth century even if it had abandoned gold in August 1914. The financial burden of the Second World War and the erosion of the British Empire doomed sterling. However, the 1920s and the 1930s would have evolved quite differently had William G. McAdoo not enhanced American financial credibility at the outbreak of the Great War.

With New York wounded by failure in 1914, London could have avoided setting a timetable for restoring a fully operational gold standard after the war. Britain could have followed Keynes's advice in 1925 and not pushed sterling into its prewar parity with the dollar.* Keynes felt that battling New York for world financial supremacy in 1925 imposed too great a cost on the British economy. He wrote to a director of the Bank of England: "Are you sure that you want London to be at any

* Keynes did not oppose the gold standard per se but wanted to avoid the deflationary consequences of forcing a return to the prewar parity of $4.8665 per pound sterling. Chapter 9 discusses Keynes's position in detail.

time the dumping ground of unlimited cheap American money liable to be withdrawn at a day's notice?"[16] Keynes was right. Sterling's return to gold forced Britain into a deflationary straightjacket that exacerbated the Great Depression.[17]

What can 1914 teach us about crisis management?

McAdoo succeeded in August 1914 because he did not hesitate to bludgeon the crisis with a sledgehammer. He wielded powerful weapons—suspending stock trading for four months and flooding the country with emergency currency—that could have injured America. His exit plan, stimulating agricultural exports with the Bureau of War Risk Insurance, avoided lasting damage to the economy. McAdoo could apply massive force because he had implemented a plan to restore normal functions. Failure to include a strategy for withdrawal either promotes toothless emergency weapons, like a placebo to treat a serious disease, or imposes unnecessary costs.

McAdoo brought more than a blueprint and sledgehammer to the crisis. Walter Lippmann, the political commentator and nationally syndicated columnist, described McAdoo as someone who is "swift to note and swift to move. He picks his course quickly, moves fast upon it and with great audacity. . . . Instinctively he prefers the bold and the decisive to the prudent and the tepid course."*

Not everyone has the courage to act, even when they know what to do. Leadership matters. The 1970s witnessed the greatest peacetime inflation in the United States. The Federal Reserve System had been in operation for more than half a century when inflation spiraled out of control. Arthur Burns, a former Columbia University economist and president of the National Bureau of Economic Research, sat at the helm of the Federal Reserve System for nearly the entire decade. He had been appointed chairman of the Federal Reserve Board by President Richard Nixon in 1970. Economists knew how to stem the inflation that threatened to destroy American economic stability. According to Milton Friedman, the problem was not lack of knowledge but, rather, lack of leadership:[18] "The explanation for [the Great Inflation] is fundamentally political, not economic. . . . I believe that Arthur Burns deserves a lot of the blame, and he deserves the blame because he knew better."[19]

The American financial system could have survived the summer of 1914 even if McAdoo had done nothing. The gold drain would have disappeared as the war forced Britain to America's doorstep for provisions.

* Lippmann's description (1927, 113) first appeared in an essay dated June 1920, when McAdoo's name was bandied about as the Democratic Party's presidential nominee. McAdoo withdrew his name from consideration, in part, out of deference for the ailing incumbent, Woodrow Wilson; see "A News Report, June 20, 1920," *Papers of Woodrow Wilson* (1991, 438–39).

But the clarity of hindsight ignores contingencies that failed to materialize. Alexander Noyes, in his retrospective a decade later, emphasized the point: "It should not be forgotten that the financial outlook for the United States seemed desperate, even to a great part of the banking community, at the time when maintenance of gold payments was agreed on. . . . [I]t is impossible to be sure that a decision in August 1914 to suspend gold payments, even with the purpose of subsequently resuming them, would not have given to at least our immediately subsequent financial history a very different turn from that which it actually took."[20]

McAdoo's imprint—decisive leadership combined with a road map for crisis control—turned a potential financial disaster into a monetary triumph.