

WINNER OF THE PULITZER PRIZE FOR HISTORY 2010
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'COMPELLING AND CONVINCING ... HUMANISES THE WORLD'S
DESCENT INTO ECONOMIC CHAOS' ROBERT PESTON



LORDS OF FINANCE

1929, THE GREAT DEPRESSION, AND
THE BANKERS WHO BROKE THE WORLD

LIAQUAT AHAMED

Lords of Finance

Liaquat Ahamed has been a professional investment manager for twenty-five years. He has worked at the World Bank in Washington, D.C., and the New York-based partnership of Fischer Francis Trees and Watts, where he served as chief executive. He is currently an adviser to several hedge fund groups, including the Rock Creek Group and the Rohatyn Group, is a director of Aspen Insurance Co., and is on the board of trustees of the Brookings Institution. He has degrees in economics from Harvard and Cambridge universities. *Lords of Finance*, which was shortlisted for the BBC Samuel Johnson Prize for Non-fiction and which won the *Financial Times*/Goldman Sachs Business Book of the Year Award, the *Spear's* Financial History Book of the Year Award, and the 2010 Pulitzer Prize for History, is Liaquat Ahamed's first book.

Praise for *Lords of Finance*

'Magisterial . . . A brilliantly readable history of an earlier era of economic implosion: the 1929 crash and those who caused it.' *Observer*

'[Ahamed] provides a compelling and convincing narrative of bungling, tortured bankers vainly trying to reconcile their conflicting duties to their countries and to the global economy. The strength of his book is in humanising the world's descent into economic chaos.'

Robert Peston, *Sunday Times*

'A brilliant and timely book . . . Today's policy makers have learned from these dreadful mistakes, but they still have more to do to restore economic stability and bring down unemployment. They need to read this book.'

Richard Lambert, *Guardian*

'One of those rare books – authoritative, readable and relevant – that puts the "story" back into history . . . a spellbinding, richly human [and] cinematic narrative.'

Strobe Talbott

'[Ahamed's] book has immense importance to modern policymaking. It is voluminous history of the Great Depression seen through the actions of central bankers. The principal figures in the story are the governors of the central banks of the US, Great Britain, France and Germany. This is a fascinating and even a great book.'

The Times

'A major work of scholarship which offers vivid portraits of the central bankers of the day.'

Daily Telegraph

'A magisterial work . . . A grand, sweeping narrative of immense scope and power . . . A beautifully written book; Ahamed has a gift for phrasemaking and storytelling that most full-time writers would envy – the decision to build *Lords of Finance* around these four men is a brilliant conceit . . . You read Ahamed's sections on reparations with a growing sense of horror, knowing how it all turns out. But you also read this book with a growing sense of recognition . . . you can't help thinking about the economic crisis we're living through now.'

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New York Times

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Daily Mail

'Fascinating . . . a brisk, original, incisive and entertaining account of a crucial time in the world's economic history that continues to affect us all today. Anyone who wants to understand the origins of the economic world we live in would do well to read this book.'

Michael Beschloss

Absorbing [and] provocative, not least because it is still relevant.'

The Economist

'A great read.'

George Soros

Lords of Finance

LIAQUAT AHAMED



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TO MEENA

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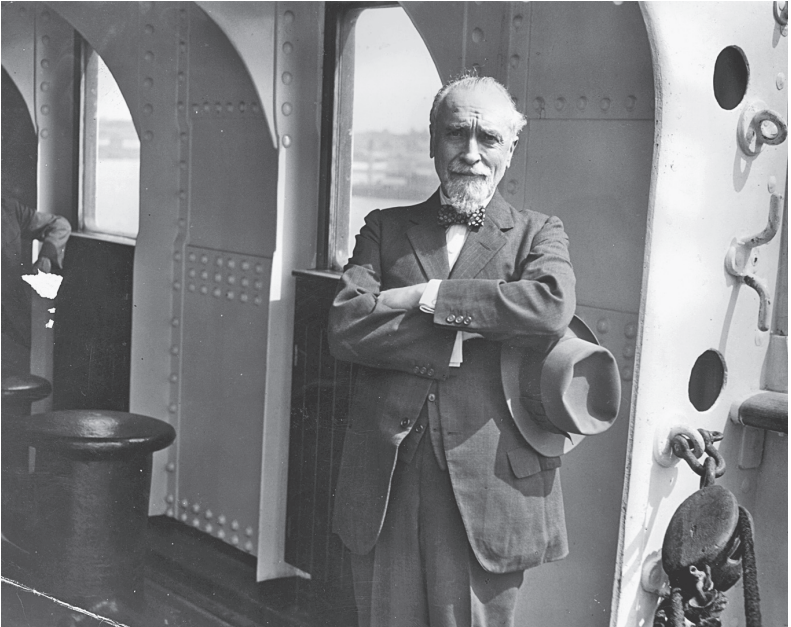
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*Read no history—nothing but biography,
for that is life without theory.*

—BENJAMIN DISRAELI



Montagu Norman on the Duchess of York, August 15, 1931

INTRODUCTION

ON AUGUST 15, 1931, the following press statement was issued: "The Governor of the Bank of England has been indisposed as a result of the exceptional strain to which he has been subjected in recent months. Acting on medical advice he has abandoned all work and has gone abroad for rest and change." The governor was Montagu Collet Norman, D.S.O.—having repeatedly turned down a title, he was not, as so many people assumed, Sir Montagu Norman or Lord Norman. Nevertheless, he did take great pride in that D.S.O. after his name—the Distinguished Service Order, the second highest decoration for bravery by a military officer.

Norman was generally wary of the press and was infamous for the lengths to which he would go to escape prying reporters—traveling under a false identity; skipping off trains; even once, slipping over the side of an ocean vessel by way of a rope ladder in rough seas. On this occasion, however, as he prepared to board the liner *Duchess of York* for Canada, he was unusually forthcoming. With that talent for understatement that came so naturally to his class and country, he declared to the reporters gathered at dockside, "I feel I want a rest because I have had a very hard time lately. I have not been quite as well as I would like and I think a trip on this fine boat will do me good."

The fragility of his mental constitution had long been an open secret within financial circles. Few members of the public knew the real truth—that for the last two weeks, as the world financial crisis had reached a

crescendo and the European banking system teetered on the edge of collapse, the governor had been incapacitated by a nervous breakdown, brought on by extreme stress. The Bank press release, carried in newspapers from San Francisco to Shanghai, therefore came as a great shock to investors everywhere.

It is difficult so many years after these events to recapture the power and prestige of Montagu Norman in that period between the wars—his name carries little resonance now. But at the time, he was considered the most influential central banker in the world, according to the *New York Times*, the “monarch of [an] invisible empire.” For Jean Monnet, godfather of the European Union, the Bank of England was then “the citadel of citadels” and “Montagu Norman was the man who governed the citadel. He was redoubtable.”

Over the previous decade, he and the heads of the three other major central banks had been part of what the newspapers had dubbed “the most exclusive club in the world.” Norman, Benjamin Strong of the New York Federal Reserve Bank, Hjalmar Schacht of the Reichsbank, and Émile Moreau of the Banque de France had formed a quartet of central bankers who had taken on the job of reconstructing the global financial machinery after the First World War.

But by the middle of 1931, Norman was the only remaining member of the original foursome. Strong had died in 1928 at the age of fifty-five, Moreau had retired in 1930, and Schacht had resigned in a dispute with his own government in 1930 and was flirting with Adolf Hitler and the Nazi Party. And so the mantle of leadership of the financial world had fallen on the shoulders of this colorful but enigmatic Englishman with his “waggish” smile, his theatrical air of mystery, his Van Dyke beard, and his conspiratorial costume: broad-brimmed hat, flowing cape, and sparkling emerald tie pin.

For the world’s most important central banker to have a nervous breakdown as the global economy sank yet deeper into the second year of an unprecedented depression was truly unfortunate. Production in almost every country had collapsed—in the two worst hit, the United States and

Germany, it had fallen 40 percent. Factories throughout the industrial world—from the car plants of Detroit to the steel mills of the Ruhr, from the silk mills of Lyons to the shipyards of Tyneside—were shuttered or working at a fraction of capacity. Faced with shrinking demand, businesses had cut prices by 25 percent in the two years since the slump had begun.

Armies of the unemployed now haunted the towns and cities of the industrial nations. In the United States, the world's largest economy, some 8 million men and women, close to 15 percent of the labor force, were out of work. Another 2.5 million men in Britain and 5 million in Germany, the second and third largest economies in the world, had joined the unemployment lines. Of the four great economic powers, only France seemed to have been somewhat protected from the ravages of the storm sweeping the world, but even it was now beginning to slide downward.

Gangs of unemployed youths and men with nothing to do loitered aimlessly at street corners, in parks, in bars and cafés. As more and more people were thrown out of work and unable to afford a decent place to live, grim jerry-built shantytowns constructed of packing cases, scrap iron, grease drums, tarpaulins, and even of motor car bodies had sprung up in cities such as New York and Chicago—there was even an encampment in Central Park. Similar makeshift colonies littered the fringes of Berlin, Hamburg, and Dresden. In the United States, millions of vagrants, escaping the blight of inner-city poverty, had taken to the road in search of some kind—any kind—of work.

Unemployment led to violence and revolt. In the United States, food riots broke out in Arkansas, Oklahoma, and across the central and southwestern states. In Britain, the miners went out on strike, followed by the cotton mill workers and the weavers. Berlin was almost in a state of civil war. During the elections of September 1930, the Nazis, playing on the fears and frustrations of the unemployed and blaming everyone else—the Allies, the Communists, and the Jews—for the misery of Germany, gained close to 6.5 million votes, increasing their seats in the Reichstag from 12 to 107 and making them the second largest parliamentary party after the Social Democrats. Meanwhile in the streets, Nazi and Communist gangs

clashed daily. There were coups in Portugal, Brazil, Argentina, Peru, and Spain.

The biggest economic threat now came from the collapsing banking system. In December 1930, the Bank of United States, which despite its name was a private bank with no official status, went down in the largest single bank failure in U.S. history, leaving frozen some \$200 million in depositors' funds. In May 1931, the biggest bank in Austria, the Creditanstalt, owned by the Rothschilds no less, with \$250 million in assets, closed its doors. On June 20, President Herbert Hoover announced a one-year moratorium on all payments of debts and reparations stemming from the war. In July, the Danatbank, the third largest in Germany, foundered, precipitating a run on the whole German banking system and a tidal wave of capital out of the country. The chancellor, Heinrich Brüning, declared a bank holiday, restricted how much German citizens could withdraw from their bank accounts, and suspended payments on Germany's short-term foreign debt. Later that month the crisis spread to the City of London, which, having lent heavily to Germany, found these claims now frozen. Suddenly, faced with the previously unthinkable prospect that Britain itself might be unable to meet its obligations, investors around the world started withdrawing funds from London. The Bank of England was forced to borrow \$650 million from banks in France and the United States, including the Banque de France and the New York Federal Reserve Bank, to prevent its gold reserves from being completely depleted.

As the unemployment lines lengthened, banks shut their doors, farm prices collapsed, and factories closed, there was talk of apocalypse. On June 22, the noted economist John Maynard Keynes told a Chicago audience, "We are today in the middle of the greatest catastrophe—the greatest catastrophe due almost to entirely economic causes—of the modern world. I am told that the view is held in Moscow that this is the last, the culminating crisis of capitalism, and that our existing order of society will not survive it." The historian Arnold Toynbee, who knew a thing or two about the rise and fall of civilizations, wrote in his annual review of the year's

events for the Royal Institute of International Affairs, “In 1931, men and women all over the world were seriously contemplating and frankly discussing the possibility that the Western system of Society might break down and cease to work.”

During the summer a letter that Montagu Norman had written just a few months before to his counterpart at the Banque de France, Clément Moret, appeared in the press. “Unless drastic measures are taken to save it, the capitalist system throughout the civilized world will be wrecked within a year,” declared Norman, adding in the waspish tone that he reserved for the French, “I should like this prediction to be filed for future reference.” It was rumored that before he went off to convalesce in Canada, he had insisted that ration books be printed in case the country reverted to barter in the wake of a general currency collapse across Europe.

At times of crisis, central bankers generally believe that it is prudent to obey the admonition that mothers over the centuries have passed on to their children: “If you can’t say anything nice, don’t say anything at all.” It avoids the recurring dilemma that confronts financial officials dealing with a panic—they can be honest in their public statements and thereby feed the frenzy or they can try to be reassuring, which usually entails resorting to outright untruths. That a man in Norman’s position was willing to talk quite openly about the collapse of Western civilization signaled loud and clear that, in the face of the “economic blizzard,” monetary leaders were running out of ideas and ready to declare defeat.

Not only was Norman the most eminent banker in the world, he was also admired as a man of character and judgment by financiers and officials of every shade of political opinion. Within that bastion of the plutocracy the partnership of the House of Morgan, for example, no one’s advice or counsel was more highly valued—the firm’s senior partner, Thomas Lamont, would later acclaim him as “the wisest man he had ever met.” At the other end of the political spectrum, the British chancellor of the exchequer, Philip Snowden, a fervent Socialist who had himself frequently predicted the collapse of capitalism, could write gushingly that Norman “might have stepped out of the frame of the portrait of the most handsome

courtier who ever graced the court of a queen,” that “his sympathy with the suffering of nations is as tender as that of a woman for her child,” and that he had “in abundant measure the quality of inspiring confidence.”

Norman had acquired his reputation for economic and financial perspicacity because he had been so right on so many things. Ever since the end of the war, he had been a fervent opponent of exacting reparations from Germany. Throughout the 1920s, he had raised the alarm that the world was running short of gold reserves. From an early stage, he had warned about the dangers of the stock market bubble in the United States.

But a few lonely voices insisted that it was he and the policies he espoused, especially his rigid, almost theological, belief in the benefits of the gold standard, that were to blame for the economic catastrophe that was overtaking the West. One of them was that of John Maynard Keynes. Another was that of Winston Churchill. A few days before Norman left for Canada on his enforced holiday, Churchill, who had lost most of his savings in the Wall Street crash two years earlier, wrote from Biarritz to his friend and former secretary Eddie Marsh, “Everyone I meet seems vaguely alarmed that something terrible is going to happen financially. . . . I hope we shall hang Montagu Norman if it does. I will certainly turn King’s evidence against him.”

THE COLLAPSE OF the world economy from 1929 to 1933—now justly called the Great Depression—was the seminal economic event of the twentieth century. No country escaped its clutches; for more than ten years the malaise that it brought in its wake hung over the world, poisoning every aspect of social and material life and crippling the future of a whole generation. From it flowed the turmoil of Europe in the “low dishonest decade” of the 1930s, the rise of Hitler and Nazism, and the eventual slide of much of the globe into a Second World War even more terrible than the First.

The story of the descent from the roaring boom of the twenties into

the Great Depression can be told in many different ways. In this book, I have chosen to tell it by looking over the shoulders of the men in charge of the four principal central banks of the world: the Bank of England, the Federal Reserve System, the Reichsbank, and the Banque de France.

When the First World War ended in 1918, among its innumerable casualties was the world's financial system. During the latter half of the nineteenth century, an elaborate machinery of international credit, centered in London, had been built upon the foundations of the gold standard and brought with it a remarkable expansion of trade and prosperity across the globe. In 1919, that machinery lay in ruins. Britain, France, and Germany were close to bankruptcy, their economies saddled with debt, their populations impoverished by rising prices, their currencies collapsing. Only the United States had emerged from the war economically stronger.

Governments then believed matters of finance were best left to bankers; and so the task of restoring the world's finances fell into the hands of the central banks of the four major surviving powers: Britain, France, Germany, and the United States.

This book traces the efforts of these central bankers to reconstruct the system of international finance after the First World War. It describes how, for a brief period in the mid-1920s, they appeared to succeed: the world's currencies were stabilized, capital began flowing freely across the globe, and economic growth resumed once again. But beneath the veneer of boomtown prosperity, cracks began to appear and the gold standard, which all had believed would provide an umbrella of stability, proved to be a straitjacket. The final chapters of the book describe the frantic and eventually futile attempts of central bankers as they struggled to prevent the whole world economy from plunging into the downward spiral of the Great Depression.

The 1920s were an era, like today's, when central bankers were invested with unusual power and extraordinary prestige. Four men in particular dominate this story: at the Bank of England was the neurotic and enigmatic Montagu Norman; at the Banque de France, Émile Moreau, xenophobic and suspicious; at the Reichsbank, the rigid and arrogant but also

brilliant and cunning Hjalmar Schacht; and finally, at the Federal Reserve Bank of New York, Benjamin Strong, whose veneer of energy and drive masked a deeply wounded and overburdened man.

These four characters were, for much of the decade, at the center of events. Their lives and careers provide a distinctive window into this period of economic history, which helps to focus the complex history of the 1920s—the whole sorry and poisonous story of the failed peace, of war debts and reparations, of hyperinflation, of hard times in Europe and bonanza in America, of the boom and then the ensuing bust—to a more human, and manageable, scale.

Each in his own way illuminates the national psyche of his time. Montagu Norman, with his quixotic reliance on his faulty intuition, embodied a Britain stuck in the past and not yet reconciled to its newly diminished standing in the world. Émile Moreau, in his insularity and rancor, reflected all too accurately a France that had turned inward to lick the terrible wounds of war. Benjamin Strong, the man of action, represented a new generation in America, actively engaged in bringing its financial muscle to bear in world affairs. Only Hjalmar Schacht, in his angry arrogance, seemed out of tune with the weak and defeated Germany for which he spoke, although perhaps he was simply expressing a hidden truth about the nation's deeper mood.

There is also something very poignant in the contrast between the power these four men once exerted and their almost complete disappearance from the pages of history. Once styled by newspapers as the “World’s Most Exclusive Club,” these four once familiar names, lost under the rubble of time, now mean nothing to most people.

The 1920s were a time of transition. The curtain had come down on one age and a new age had yet to begin. Central banks were still privately owned, their key objectives to preserve the value of the currency and douse banking panics. They were only just beginning to espouse the notion that it was their responsibility to stabilize the economy.

During the nineteenth century, the governors of the Bank of England

and the Banque de France were shadowy figures, well known in financial circles but otherwise out of the public eye. By contrast, in the 1920s, very much like today, central bankers became a major focus of public attention. Rumors of their decisions and secret meetings filled the daily press as they confronted many of the same economic issues and problems that their successors do today: dramatic movements in stock markets, volatile currencies, and great tides of capital spilling from one financial center to another.

They had to operate, however, in old-fashioned ways with only primitive tools and sources of information at their disposal. Economic statistics had only just begun to be collected. The bankers communicated by mail—at a time when a letter from New York to London took a week to arrive—or, in situations of real urgency, by cable. It was only in the very last stages of the drama that they could even contact one another on the telephone, and then only with some difficulty.

The tempo of life was also different. No one flew from one city to another. It was the golden age of the ocean liner when a transatlantic crossing took five days, and one traveled with one's manservant, evening dress being de rigueur at dinner. It was an era when Benjamin Strong, head of the New York Federal Reserve, could disappear to Europe for four months without raising too many eyebrows—he would cross the Atlantic in May, spend the summer crisscrossing among the capitals of Europe consulting with his colleagues, take the occasional break at some of the more elegant spas and watering holes, and finally return to New York in September.

The world in which they operated was both cosmopolitan and curiously parochial. It was a society in which racial and national stereotypes were taken for granted as matters of fact rather than prejudice, a world in which Jack Morgan, son of the mighty Pierpont Morgan, might refuse to participate in a loan to Germany on the grounds that Germans were “second rate people” or oppose the appointment of Jews and Catholics to the Harvard Board of Overseers because “the Jew is always a Jew first and an American second, and the Roman Catholic, I fear, too often, a Papist first

and an American second.” In finance, during the late nineteenth century and early twentieth century, whether in London or New York, Berlin or Paris, there was one great divide. On one side stood the big Anglo-Saxon banking firms: J. P. Morgan, Brown Brothers, Barings; on the other the Jewish concerns: the four branches of the Rothschilds, Lazards, the great German Jewish banking houses of Warburgs and Kuhn Loeb, and mavericks such as Sir Ernest Cassel. Though the WASPs were, like so many people in those days, casually anti-Semitic, the two groups treated each other with a wary respect. They were all, however, snobs who looked down on interlopers. It was a society that could be smug and complacent, indifferent to the problems of unemployment or poverty. Only in Germany—and that is part of this story—did those undercurrents of prejudice eventually become truly malevolent.

As I began writing of these four central bankers and the role each played in setting the world on the path toward the Great Depression, another figure kept appearing, almost intruding into the scene: John Maynard Keynes, the greatest economist of his generation, though only thirty-six when he first appears in 1919. During every act of the drama so painfully being played out, he refused to keep quiet, insisting on at least one monologue even if it was from offstage. Unlike the others, he was not a decision maker. In those years, he was simply an independent observer, a commentator. But at every twist and turn of the plot, there he was holding forth from the wings, with his irreverent and playful wit, his luminous and constantly questioning intellect, and above all his remarkable ability to be right.

Keynes proved to be a useful counterpoint to the other four in the story that follows. They were all great lords of finance, standard-bearers of an orthodoxy that seemed to imprison them. By contrast, Keynes was a gadfly, a Cambridge don, a self-made millionaire, a publisher, journalist, and best-selling author who was breaking free from the paralyzing consensus that would lead to such disaster. Though only a decade younger than the four grandees, he might have been born into an entirely different generation.

TO UNDERSTAND THE role of central bankers during the Great Depression, it is first necessary to understand what a central bank is and a little about how it operates. Central banks are mysterious institutions, the full details of their inner workings so arcane that very few outsiders, even economists, fully understand them. Boiled down to its essentials, a central bank is a bank that has been granted a monopoly over the issuance of currency.* This power gives it the ability to regulate the price of credit—interest rates—and hence to determine how much money flows through the economy.

Despite their role as national institutions determining credit policy for their entire countries, in 1914 most central banks were still privately owned. They therefore occupied a strange hybrid zone, accountable primarily to their directors, who were mainly bankers, paying dividends to their shareholders, but given extraordinary powers for entirely nonprofit purposes. Unlike today, however, when central banks are required by law to promote price stability and full employment, in 1914 the single most important, indeed overriding, objective of these institutions was to preserve the value of the currency.

At the time, all major currencies were on the gold standard, which tied a currency in value to a very specific quantity of gold. The pound sterling, for example, was defined as equivalent to 113 grains of pure gold, a grain being a unit of weight notionally equal to that of a typical grain taken from the middle of an ear of wheat. Similarly, the dollar was defined as 23.22 grains of gold of similar fineness. Since all currencies were fixed against gold, a corollary was that they were all fixed against one another. Thus there were 113/23.22 or \$4.86 to the pound. All paper money was legally obligated to be freely convertible into its gold equivalent, and each of the

*The monopoly need not be complete. In Britain, while the Bank of England was granted a monopoly of currency in 1844, Scottish banks continued to issue currency and existing English banks with the authority to issue currency were grandfathered. The last private English banknotes were issued in 1921 by Fox, Fowler and Company, a Somerset bank.

major central banks stood ready to exchange gold bullion for any amount of their own currencies.

Gold had been used as a form of currency for millennia. As of 1913, a little over \$3 billion, about a quarter of the currency actually circulating around the world, consisted of gold coins, another 15 percent of silver, and the remaining 60 percent of paper money. Gold coinage, however, was only a part, and not the most important part, of the picture.

Most of the monetary gold in the world, almost two-thirds, did not circulate but lay buried deep underground, stacked up in the form of ingots in the vaults of banks. In each country, though every bank held some bullion, the bulk of the nation's gold was concentrated in the vaults of the central bank. This hidden treasure provided the reserves for the banking system, determined the supply of money and credit within the economy, and served as the anchor for the gold standard.

While central banks had been granted the right to issue currency—in effect to print money—in order to ensure that that privilege was not abused, each one of them was required by law to maintain a certain quantity of bullion as backing for its paper money. These regulations varied from country to country. For example, at the Bank of England, the first \$75 million equivalent of pounds that it printed were exempt, but any currency in excess of this amount had to be fully matched by gold. The Federal Reserve (the Fed), on the other hand, was required to have 40 percent of all the currency it issued on hand in gold—with no exemption floor. But varied as these regulations were, their ultimate effect was to tie the amount of each currency automatically and almost mechanically to its central banks' gold reserves.

In order to control the flow of currency into the economy, the central bank varied interest rates. It was like turning the dials up or down a notch on a giant monetary thermostat. When gold accumulated in its vaults, it would reduce the cost of credit, encouraging consumers and businesses to borrow and thus pump more money into the system. By contrast, when gold was scarce, interest rates were raised, consumers and businesses cut back, and the amount of currency in circulation contracted.

Because the value of a currency was tied, by law, to a specific quantity of gold and because the amount of currency that could be issued was tied to the quantity of gold reserves, governments had to live within their means, and when strapped for cash, could not manipulate the value of the currency. Inflation therefore remained low. Joining the gold standard became a “badge of honor,” a signal that each subscribing government had pledged itself to a stable currency and orthodox financial policies. By 1914, fifty-nine countries had bound their currencies to gold.

Few people realized how fragile a system this was, built as it was on so narrow a base. The totality of gold ever mined in the whole world since the dawn of time was barely enough to fill a modest two-story town house. Moreover, new supplies were neither stable nor predictable, coming as they did in fits and starts and only by sheer coincidence arriving in sufficient quantities to meet the needs of the world economy. As a result, during periods when new gold finds were lean, such as between the California and Australian gold rushes of the 1850s and the discoveries in South Africa in the 1890s, prices of commodities fell across the world.

The gold standard was not without its critics. Many were simply cranks. Others, however, believed that allowing the growth of credit to be restricted by the amount of gold, especially during periods of falling prices, hurt producers and debtors—especially farmers, who were both.

The most famous spokesman for looser money and easier credit was Williams Jennings Bryan, the populist congressman from the farm state of Nebraska. He campaigned tirelessly to break the privileged status of gold and to expand the base upon which credit was created by including silver as a reserve metal. At the Democratic convention of 1896 he made one of the great speeches of American history—a wonderfully overripe flight of rhetoric delivered in that deep commanding voice of his—in which, addressing Eastern bankers, he declared, “You came to tell us that the great cities are in favor of the gold standard; we reply that the great cities rest upon our broad and fertile plains. Burn down your cities and leave our farms, and your cities will spring up again as if by magic. But destroy our farms and the grass will grow in the city. . . . You shall not press

down upon the brow of labor this crown of thorns. You shall not crucify mankind upon a cross of gold.”

It was a message whose time had come and gone. Ten years before he delivered that speech, two gold prospectors in South Africa, while out for a Sunday walk on a farm in the Witwatersrand, stumbled across a rocky formation that they recognized as gold-bearing reef. It proved to be an outcrop of the largest goldfield in the world. By the time of Bryan’s speech, gold production had jumped 50 percent, South Africa had overtaken the United States as the world’s largest producer, and the gold drought was over. Prices for all goods, including agricultural commodities, once again began to rise. Bryan won the Democratic nomination then and twice more, in 1900 and 1908, but he was never elected president.

Though prices rose and fell in great cycles under the gold standard due to ebbs and flows in the supply of the precious metal, the slope of these curves was gentle and at the end of the day prices returned to where they began. While it may have succeeded in controlling inflation, the gold standard was incapable of preventing the sort of financial booms and busts that were, and continue to be, such a feature of the economic landscape. These bubbles and crises seem to be deep-rooted in human nature and inherent to the capitalist system. By one count there have been sixty different crises since the early seventeenth century—the first documented bank panic can, however, be dated to A.D. 33 when the Emperor Tiberius had to inject one million gold pieces of public money into the Roman financial system to keep it from collapsing.

Each of these episodes differed in detail. Some originated in the stock market, some in the credit market, some in the foreign exchange market, occasionally even in the world of commodities. Sometimes they affected a single country, sometimes a group of countries, very occasionally the whole world. All, however, shared a common pattern: an eerily similar cycle from greed to fear.

Financial crises would generally begin innocently enough with a surge of healthy optimism among investors. Over time, reinforced by cavalier attitudes to risk among bankers, this optimism would transform itself into

overconfidence, occasionally even into a mania. The accompanying boom would go on for much longer than anyone expected. Then would come a sudden shock—a bankruptcy, a surprisingly large loss, a financial scandal involving fraud. Whatever the event, it would provoke a sudden and dramatic shift in sentiment. Panic would ensue. As investors were forced to liquidate into a falling market, losses would mount, banks would cut back their loans, and frightened depositors would start pulling their money out of banks.

If all that happened during these periods of so-called distress was that foolish investors and lenders lost money, no one else would have cared. But a problem in one bank raised fears of problems at other banks. And because financial institutions were so interconnected, borrowing large amounts of money from one another even in the nineteenth century, difficulties in one area would transmit themselves through the entire system. It was precisely because crises had a way of spreading, threatening to undermine the integrity of the whole system, that central banks became involved. In addition to keeping their hands on the levers of the gold standard, they therefore acquired a second role—that of forestalling bank panics and other financial crises.

The central banks had powerful tools to deal with these outbursts—specifically their authority to print currency and their ability to marshal their large concentrated holdings of gold. But for all of this armory of instruments, ultimately the goal of a central bank in a financial crisis was both very simple and very elusive—to reestablish trust in banks.

Such breakdowns are not some historical curiosity. As I write this in October 2008, the world is in the middle of one such panic—the most severe for seventy-five years, since the bank runs of 1931–1933 that feature so prominently in the last few chapters of this book. The credit markets are frozen, financial institutions are hoarding cash, banks are going under or being taken over by the week, stock markets are crumbling. Nothing brings home the fragility of the banking system or the potency of a financial crisis more vividly than writing about these issues from the eye of the storm. Watching the world’s central bankers and finance officials grappling

with the current situation—trying one thing after another to restore confidence, throwing everything they can at the problem, coping daily with unexpected and startling shifts in market sentiment—reinforces the lesson that there is no magic bullet or simple formula for dealing with financial panics. In trying to calm anxious investors and soothe skittish markets, central bankers are called upon to wrestle with some of the most elemental and unpredictable forces of mass psychology. It is the skill that they display in navigating these storms through uncharted waters that ultimately makes or breaks their reputation.

PART ONE

*

THE
UNEXPECTED
STORM

*

AUGUST 1914

1. PROLOGUE

What an extraordinary episode in the economic progress of man that age was which came to an end in August 1914!

—JOHN MAYNARD KEYNES,
The Economic Consequences of the Peace

IN 1914, London stood at the center of an elaborate network of international credit, built upon the foundations of the gold standard. The system had brought with it a remarkable expansion of trade and prosperity across the globe. The previous forty years had seen no big wars or great revolutions. The technological advances of the mid-nineteenth century—railways, steamships, and the telegraph—had spread across the world, opening up vast territories to settlement and trade. International commerce boomed as European capital flowed freely around the globe, financing ports in India, rubber plantations in Malaya, cotton in Egypt, factories in Russia, wheat fields in Canada, gold and diamond mines in South Africa, cattle ranches in Argentina, the Berlin-to-Baghdad Railway, and both the Suez and the Panama canals. Although every so often the system was shaken by financial crises and banking panics, depressions in trade were short-lived and the world economy had always bounced back.

More than anything else, more even than the belief in free trade, or the ideology of low taxation and small government, the gold standard was the economic totem of the age. Gold was the lifeblood of the financial system.

It was the anchor for most currencies, it provided the foundation for banks, and in a time of war or panic, it served as a store of safety. For the growing middle classes of the world, who provided so much of the savings, the gold standard was more than simply an ingenious system for regulating the issue of currency. It served to reinforce all those Victorian virtues of economy and prudence in public policy. It had, in the words of H. G. Wells, “a magnificent stupid honesty” about it. Among bankers, whether in London or New York, Paris or Berlin, it was revered with an almost religious fervor, as a gift of providence, a code of behavior transcending time and place.

In 1909, the British journalist Norman Angell, then Paris editor of the French edition of the *Daily Mail*, published a pamphlet entitled *Europe's Optical Illusion*. The thesis of his slim volume was that the economic benefits of war were so illusory—hence the title—and the commercial and financial linkages between countries now so extensive that no rational country should contemplate starting a war. The economic chaos, especially the disruptions to international credit, that would ensue from a war among the Great Powers would harm all sides and the victor would lose as much as the vanquished. Even if war were to break out in Europe by accident, it would speedily be brought to an end.

Angell was well placed to write about global interdependence. All his life he had been something of a nomad. Born into a middle-class Lincolnshire family, he had been sent at an early age to a French lycée in St. Omer. At seventeen he became the editor of an English-language newspaper in Geneva, attending the university there, and then, despairing of the future of Europe, emigrated to the United States. Though only five feet tall and of slight build, he plunged into a life of manual labor, working in California for seven years variously as a vine planter, irrigation-ditch digger, cowpuncher, mail carrier, and prospector, before eventually settling down as a reporter for the *St. Louis Globe-Democrat* and the *San Francisco Chronicle*. Returning to Europe in 1898, he moved to Paris, where he joined the *Daily Mail*.

Angell's pamphlet was issued in book form in 1910 under the title *The*

Great Illusion. The argument that it was not so much the cruelty of war as its economic futility that made it unacceptable as an instrument of state power struck a chord in that materialistic era. The work became a cult. By 1913, it had sold more than a million copies and been translated into twenty-two languages, including Chinese, Japanese, Arabic, and Persian. More than forty organizations were formed to spread its message. It was quoted by Sir Edward Grey, the British foreign secretary; by Count von Metternich; and by Jean Jaurès, the French Socialist leader. Even Kaiser Wilhelm, better known for his bellicosity than his embrace of pacifism, was said to have expressed some interest in the theory.

Angell's most prominent disciple was Reginald Brett, second Viscount Esher, a liberally minded establishment figure, and close confidant of King Edward VII. Though Lord Esher had been offered numerous high positions in government, he preferred to remain merely deputy constable and lieutenant governor of Windsor Castle while exerting his considerable influence behind the scenes. Most important, he was a founding member of the Committee of Imperial Defense, an informal but powerful organization formed after the debacles of the Boer War to reflect and advise on the military strategy of the British Empire.

In February 1912, the committee conducted hearings on issues related to trade in time of war. Much of the German merchant marine was then insured through Lloyds of London, and the committee was dumbfounded to hear the chairman of Lloyds testify that in the event of war, were German ships to be sunk by the Royal Navy, Lloyds would be both honor-bound and, according to its lawyers, legally obliged to cover the losses. The possibility that while Britain and Germany were at war, British insurance companies would be required to compensate the Kaiser for his sunken tonnage made it hard even to conceive of a European conflict.

It was no wonder that during a series of lectures on *The Great Illusion* delivered at Cambridge and the Sorbonne, Lord Esher would declare that “new economic factors clearly prove the inanity of war,” and that the “commercial disaster, financial ruin and individual suffering” of a European war

would be so great as to make it unthinkable. Lord Esher and Angell were right about the meager benefits and the high costs of war. But trusting too much in the rationality of nations and seduced by the extraordinary economic achievements of the era—a period the French would later so evocatively call *La Belle Époque*—they totally misjudged the likelihood that a war involving all the major European powers would break out.

2. A STRANGE AND LONELY MAN

BRITAIN: 1914

*Anybody who goes to see a psychiatrist ought to have
his head examined.*

—SAMUEL GOLDWYN

ON TUESDAY, July 28, 1914, Montagu Norman, then one of the partners in the Anglo-American merchant banking firm of Brown Shipley, came up to London for the day. It was the height of the holiday season, and like almost everyone else of his class in Britain, he had spent much of the previous week in the country. He was in the process of dissolving his partnership and was required briefly in the City. That same afternoon it was reported that Austria had declared war on Serbia and was already bombarding Belgrade. Despite this news, Norman, "feeling far from well" under the strain of the painful negotiations, decided to return to the country.

Neither he nor almost anyone else in Britain imagined that over the next few days the country would face the most severe banking crisis in its history; that the international financial system, which had brought so much prosperity to the world, would completely unravel; and that, within less than a week, most of Europe, Britain included, would have stumbled blindly into war.

Norman, indeed most of his countrymen, had paid only cursory atten-

tion to the brewing European crisis over the previous month. The assassination in Sarajevo of the archduke Franz Ferdinand, heir presumptive to the Austrian Empire, and his wife Sophie by a comic-opera band of bomb-throwing Serbian nationalists on June 28 had seemed at the time to be just another violent chapter in the disturbed history of the Balkans. It did finally capture the news headlines in Britain when Austria issued an ultimatum to Serbia on July 24, accusing it of being complicit in the assassination and threatening war. But even then, most people blithely continued with their relaxed summer schedule. It was hard to get too concerned about a crisis in Central Europe when the prime minister himself, H. H. Asquith, felt sufficiently at ease to insist upon his weekend of golfing in Berkshire, and the foreign secretary, Sir Edward Grey, had gone off, as he did every weekend in the summer, to his lodge in Hampshire for a spot of trout fishing.

It had been one of those glorious English summers, not a cloud in the sky for days on end, with temperatures in the 90s. Norman had taken an earlier extended two-month holiday in the United States, spending his time, as he usually did on his annual visits, in New York and Maine. He had sailed back to England at the end of June, to spend a leisurely July in London, enjoying the good weather, catching up with old friends from Eton, and passing the days at Lord's watching cricket, a family obsession. He had also finally settled with his partners about withdrawing his capital, and going his own way. It had been a painful decision. His grandfather had been the senior partner at Brown Shipley, an affiliate of the U.S. investment house of Brown Brothers, for more than thirty-five years. Norman himself had worked there since 1894. But a combination of ill health and recurring conflicts with the other members of the firm had seemed to leave him with little choice but to sever his connections.

Norman returned to Gloucestershire on the morning of Wednesday, July 29, to find an urgent telegram recalling him to London. Taking a train the same day, he arrived in the evening, too late to attend a frantic meeting of the "Court"—the board of directors—of the Bank of England. Norman had been a member of this exclusive club since 1905.

Though forty-three years old, Norman was still not married and lived alone in a large two-story stucco house, Thorpe Lodge, just off Holland Park in West London. The house and his staff of seven servants were his two great luxuries. When he had bought it in 1905, it was a wreck; over the next seven years, he had devoted his energies to a complete reconstruction. He had designed much of the interior himself, including the furniture. Influenced by the ideals of William Morris and the Arts and Crafts movement, he had hired the best craftsmen and employed the most expensive materials, even occasionally stopping by the workshops on his way home from the City to help with the carpentry.

His taste in decoration was, it has to be said, a little idiosyncratic, even odd. The house was paneled in exotic woods imported from Africa and the Americas, giving it the austere and gloomy air of a sort of millionaire's monastery. There was little ornamentation: an entrance hall of shimmering bricks, which looked like mother-of-pearl but were in fact a type of industrial silicone; two giant embroidered Japanese panels depicting peacocks; and a gigantic seventeenth-century Italian fireplace. But it was his haven from the world. On one side, he had built a huge groin-vaulted music room, in which he held small concerts: string quartets playing chamber music by Brahms or Schubert, occasionally for Norman alone. And below the house, he had converted a small paddock into an exquisite little terraced garden shaded by fruit trees, overlooked by a pergola where he took his meals in summer.

Although he had some inherited wealth, the house aside, Norman lived quite simply. He had passed his father's estate at Much Hadham, in Hertfordshire, on to his younger brother, who was married and had a family, while he contented himself with a little farmyard cottage on the grounds.

NORMAN NEITHER LOOKED nor dressed like a banker. Tall, with a broad forehead and a pointed beard, already white, he had the long fine hands of an artist or a musician. He looked more like a grandee out of Velázquez or a courtier from the time of Charles II. But despite appearances, his profes-

sional pedigree was impeccable: his father and mother had come from two of the most established and well-known English banking families.

Born in 1871, Montagu Norman, from his early childhood, had never quite seemed to fit in. He was sickly from birth and as a boy suffered from terrible migraines. His emotional and highly strung mother, herself subject to depressions and imaginary illnesses, fussed over him excessively. Like his grandfather and father before him, he went to Eton. But unlike his grandfather, father, uncle, and eventually his brother, who had all been captains of the cricket XI, Montagu did not excel in the atmosphere of competition and athleticism, and was a misfit—lonely, isolated, and generally moody. In 1889 he went up to King's College, Cambridge, but again unhappy and out of place, he withdrew after a year.

Even as a young adult, he seemed to have a hard time finding himself. He spent a desultory couple of years traveling in Europe, living for a year in Dresden, where he picked up German and an interest in speculative philosophy, and a year in Switzerland. In 1892, he returned to England to join the family concern, Martins Bank, in which his father and an uncle were partners, as a trainee clerk in the Lombard Street branch. Unable to muster much enthusiasm or interest in the dull business of commercial banking, in 1894, he decided to try out his maternal grandfather's bank, Brown Shipley. Its main activity was financing trade between the United States and Britain, which at least got him out of London and enabled him to spend almost two years working at the offices of Brown Brothers in New York City. He found life in America, with its fewer social restrictions, more liberating and less hidebound than the constricted world of London banking and even began to contemplate settling in the United States.

Instead, he found his deliverance in war. In October 1899, the Boer War broke out. Norman, who had joined the militia in 1894, spending several weeks in training every summer, and by now a captain, immediately volunteered for active service. He was not a particularly fervent imperialist. Rather he seems to have been motivated by a romantic quest for adventure and a desire to escape his mundane existence.

By the time he arrived in South Africa in March 1900, the British oc-

cupping force of some 150,000 men was engaged in a bitter guerrilla war with a Boer insurgency of some 20,000 men. Placed in command of a counterinsurgency unit, whose job it was to hunt down Boer commandos, Norman became a changed man in the field. Despite the difficult conditions, poor food, oppressive heat, and lack of sleep, he relished the danger and discovered a newfound confidence. "I feel a different person now . . .," he wrote to his parents. "One looks ahead with something of dismay to the time when one will again have to settle down to civilized life."

He was eventually awarded a D.S.O.—the Distinguished Service Order, the second highest decoration for bravery by an officer. It would remain one of his proudest achievements—for many years, even when he had attained worldwide prominence, it was the only distinction that he insisted on including in his entry in the British edition of *Who's Who*. But sheer physical hardship took its toll on his frail constitution, and in October 1901, he developed severe gastritis and was invalided home.

Back in civilian life, he spent the next two years rebuilding his health, including several months convalescing at his uncle's villa at Hyères on the Riviera, thus beginning a long affair with the Côte d'Azur. Not until 1905 was he able to resume full-time work at Brown Shipley, where for the next six years he was one of the four main partners—an especially dispiriting time marred by endless disagreements with his colleagues over business strategy.

But it was his personal life that weighed most on him. In 1906, a broken engagement drove him into the first of his nervous breakdowns. Thereafter he displayed the classic signs of manic depression: periods of euphoria followed by severe despondency. Normally one of the most charming of companions, when afflicted by one of his black moods, which could last for weeks, he would become extremely irritable, indulging in tantrums and lashing out irrationally at anyone and everyone around him. After 1909, these episodes intensified until in September 1911 he collapsed. Advised by his doctors to take a complete rest, he worked only intermittently for the next three years, becoming progressively more reclusive. As if searching for something, he traveled a great deal. He embarked on a three-month holi-

day through Egypt and the Sudan in December 1911, and set off, a year later, on another extended journey through the West Indies and South America.

In Panama, a friendly bank manager recommended that he consult the Swiss psychiatrist Dr. Carl Jung. He immediately returned to Europe and arranged for an appointment in Zurich. In April 1913, following a few days of tests, including blood and spinal fluid tests, the rising young psychiatrist informed Norman that he was suffering from “general paralysis of the insane” (GPI), a term then used to describe the onset of mental illness associated with tertiary syphilis, and that he would be dead in a few months. While some of the symptoms of GPI were in fact similar to those associated with manic depression—sudden shifts between euphoria and profound melancholy, bursts of creativity followed by suicidal tendencies, delusions of grandeur—this was an egregious misdiagnosis.

Profoundly shaken, Norman sought a second opinion from another Swiss doctor, Dr. Roger Vittoz, a specialist in nervous diseases, under whose care he spent the next three months in Zurich. Vittoz had developed a method of alleviating mental stress, using techniques similar to those used in meditation. His patients were taught to calm themselves by concentrating on a series of elaborate patterns, or sometimes on a single word. Vittoz would later become very popular in certain social circles in London, where his patients included Lady Ottoline Morrell, Julian Huxley, and T. S. Eliot.

For Norman it was the beginning of a lifelong history of experimenting with esoteric religions and spiritual practices. For a while, he was a practicing Theosophist. In the 1920s, he became a follower of Émile Coué, a French psychologist who preached the power of self-mastery through conscious autosuggestion, a sort of New Age positive-thinking cult very much in vogue during those years. He even dabbled in spiritualism. He would end up embracing all sorts of strange ideas, insisting to one of his colleagues, for example, that he could walk through walls. Because he also took a certain mischievous pleasure in twitting people with his more unconventional notions, it was always difficult to know how seriously to take him.

It was perhaps not surprising that Norman should have acquired a reputation as an oddity and an eccentric. He was viewed by his City acquaintances as a strange and lonely man who spent his evenings alone in his grand house immersed in Brahms, and who frequently quoted the Chinese sage Lao Tzu. He certainly made no attempt to fit into the clubby atmosphere of the City. His interests were primarily aesthetic and philosophical, and though he counted a few bankers among his close friends, he generally preferred to mix in a more eclectic circle of artists and designers.

BY THURSDAY, JULY 30, it had become apparent that what had initially appeared to be just a remote Balkan affair between a fading empire and one of its minor states was escalating toward a general European war. In response to Austria's attack on Serbia, Russia had now ordered a general mobilization. The international political crisis brought a financial crisis in its wake. The Berlin, Vienna, Budapest, Brussels, and St. Petersburg stock exchanges all had to suspend trading. With all the bourses of Europe except Paris's shut, the panic liquidation of securities concentrated on London.

On Friday, July 31, when Norman arrived at his City office, just north of the Bank of England, he found the financial community solidly against any British involvement in a Continental conflict. David Lloyd George, the chancellor of the exchequer, would later recount how Walter Cunliffe, the governor of the Bank of England, a man of few words not usually given to theatrical displays, came to plead "with tears in his eyes 'Keep us out of it. We shall be ruined if we are dragged in.'"

London was the financial capital of the world, and the City's livelihood depended much more on foreign finance than on providing capital to domestic industry. The merchant bankers housed in the warren of streets around the Bank of England, that select inner circle of household names—Rothschilds, Barings, Morgan Grenfell, Lazards, Hambros, Schrodgers, Kleinworts, and Brown Shipley, which gave the City of London its mystique—oversaw the greatest international lending operation the world had ever seen. Every year a billion dollars of foreign bonds were issued through

London bankers. In the previous year, Barings and the Hongkong and Shanghai Bank had syndicated a loan of \$125 million to China; Hambros had brought a loan to the Kingdom of Denmark to market; Rothschilds had underwritten a \$50 million issue for Brazil and was in the midst of negotiations for another loan; there had been bond issues for Rumania, for the cities of Stockholm, Montreal, and Vancouver. In April, Schrodgers had even led an \$80 million bond issue for the imperial government of Austria, a country against which Britain might soon be at war. All of this financing and the profits that went with it would dry up in the event of war.

The closure of stock exchanges around Europe, and the risk that gold shipments would be prohibited, causing the entire gold standard to unravel, created a more immediate problem. It was now difficult, if not impossible, for Europeans to send money abroad to settle their trade debts. The merchant banks, which had guaranteed all this paper, were faced with bankruptcy.

Bankers were not the only ones terrified by the threat posed to world financial order by the prospect of war. Even the foreign secretary, Sir Edward Grey, who of all the cabinet had staked his career on the ambiguous “understanding” with France and was most committed to fighting, warned the French ambassador that “the coming conflict will plunge the finances of Europe into trouble, that Britain was facing an economic and financial crisis without precedent, and that British neutrality might be the only way of averting the complete collapse of European credit.”

At ten o'clock on Friday morning, a notice was posted on the door of the stock exchange announcing that it was to be closed until further notice, for the first time since its founding in 1773.

Banks around the city began refusing to pay out gold sovereigns to customers. Soon a long queue assembled outside the Bank of England on Threadneedle Street, the one bank that remained legally obliged to convert five-pound notes into gold coins. There was no panic, just an atmosphere of “acute anxiety.” While the crowd, many of them women who “stood nervously fingering their notes,” was admitted into the Bank’s inner courtyard, an even larger group of bemused onlookers gathered on the steps of

the Royal Exchange opposite. The *Times* reported that “although many hundreds of people, a great many of them foreigners, must have been in the queue in the course of the day, there was no kind of disorder.” This was in sharp contrast to the reports of panic coming from the cities of Europe and could be attributed, asserted the *Times* haughtily, to the “traditionally phlegmatic and cool” character of the English. On the next day, the crowd outside the Bank was even larger, but there was still no sense of real alarm. Nevertheless, just in case, the Bank’s porters, in their distinctive salmon-pink tailcoats, red waistcoats, and top hats, were sworn in as special policemen, with the right to make arrests.

There may have been no riots in the streets, but fear was sweeping through the boardrooms of the great commercial banks. For the previous six months they had been engaged in a terrible controversy with the Bank of England over the adequacy of both their own and the Bank’s gold reserves in the event of just such a crisis. In February, a memorandum circulated to a committee of bankers had warned that “in case of an outbreak of war, foreign nations would have the power, and would use it ruthlessly, of inflicting serious financial disturbance by demanding gold.” Now faced with the prospect of large parts of the City of London going under, the commercial bankers in a panic had begun withdrawing gold from their accounts at the Bank of England. Its bullion reserves fell from over \$130 million on Wednesday, July 29, to less than \$50 million on Saturday, August 1, when the Bank, to attract deposits and conserve its rapidly diminishing stock of gold, announced that it had raised its interest rates to an unprecedented 10 percent.

Meanwhile on the Continent, the crisis was inexorably ratcheting up. Germany countered the Russian mobilization with a general mobilization of its own on Friday, July 31, and dispatched an ultimatum demanding that France declare its neutrality and turn over the fortresses of Toul and Verdun as a pledge of good faith. Next day, it declared war on Russia, and France ordered its own general mobilization. By Sunday, it was clear that in a matter of hours, France, committed to its alliance with Russia, would also be at war with Germany. That weekend Norman cabled his American

partners at Brown Brothers in New York, “European prospects very gloomy.”

Over the weekend, the mood of Britain shifted decisively in favor of war. It was the August Bank Holiday weekend and thousands of people, too excited to stay home and drawn outdoors by the sunshine, crammed into the center of London all the way from Trafalgar Square across Whitehall to Buckingham Palace, blocking all car and bus traffic, cheering and singing patriotic songs—“La Marseillaise” as well as “God Save the King”—and clamoring for action.

On Monday, the City would normally have been completely deserted for the August Bank Holiday. Instead, Norman joined 150 other bankers gathered at the Bank of England. It was a stormy meeting. As Lloyd George, the chancellor of the exchequer, would later remark, “Financiers in a fright do not make a heroic picture.” Many of the men participating did not know whether or not they had lost everything they had. Voices were raised and one banker even “shook his fist” at the governor himself. The meeting decided to recommend to the chancellor that the Bank Holiday should be extended for another three days to buy time for the panic to subside. The Treasury also announced that all trade debts would automatically be extended for an extra month while the Bank of England decided how best to go about bailing out the merchant banks threatened with insolvency or even bankruptcy.*

Norman’s immediate concern in those first few days was simply to make sure that Brown Shipley would survive. Otherwise, he would have no hope of getting his capital out. Over the weekend, hundreds of the firm’s American clients, stranded in Europe, gathered at the Pall Mall offices, trying to cash their letters of credit. But as the dust began to settle, it became apparent that with so much of the firm’s business concentrated in the United States, which remained happily neutral, it would emerge relatively unscathed. As a member of the Court of the Bank of England,

*Eventually the government would end up assuming the risk on all this unpaid trade debt until the end of the war.

however, Norman found himself having to spend most of his time on the business of the Bank, particularly in trying to disentangle the labyrinth of unpaid trade debts.

Strangely, the enormous tensions of the time, the burden of the workload, which left him little time to brood, actually seemed to alleviate his mental incapacities. As he wrote to a friend in the United States, "I have been at work morning and night, and not an ache or pain have I had, nor even been better for years past." In an odd but very real way, the war was to be good for him.



Hjalmar Schacht

3. THE YOUNG WIZARD

GERMANY: 1914

'Tis a common proof

That lowliness is young ambition's ladder

—WILLIAM SHAKESPEARE, *Julius Caesar*

ACROSS EUROPE that week, people were left stunned by the speed of events. The crisis seemed to have come from nowhere. And even though most of the Continent had been half expecting a war for the last decade, few could have imagined, at the end of June, that it would be the assassination of an Austrian archduke that would set off the avalanche.

The continued complacency of most Germans during the month of July 1914, even after the assassination in Sarajevo, was very much the result of a deliberate campaign by their own government to project a surface of calm. Behind the scenes, Austria was being goaded on by the highest circles in Berlin to use the assassination as an excuse to bring Serbia to heel once and for all. Meanwhile, both the Austrian and German leaders took great pains in public to keep their intentions well disguised. All put on a great show of maintaining their usual summer holiday schedules. The emperor Franz Joseph made a point of staying at his hunting lodge at Bad Ischl for all of July. The kaiser departed on July 6 for his annual three-week holiday, aboard his yacht, *Hohenzollern*, in the Norwegian fjords. The chancellor, Theobald von Bethmann-Hollweg, came to Berlin for some

emergency meetings in early July but rapidly resumed his holiday on his 7,500-acre estate at Hohenfinow, some thirty miles away, while the chief of the General Staff, General Helmuth von Moltke, remained in Karlsbad taking the waters, and Secretary of State Gottlieb von Jagow departed on his honeymoon.

Among those whom the crisis took by surprise was a thirty-six-year-old banker in Berlin with the uniquely improbable name of Horace Greeley Hjalmar Schacht. In spite of the authorities' elaborate charade, rumors of war had already begun to percolate early in July within the highest banking circles in Germany. One of those who seemed to take a particularly pessimistic view of the situation from the start was Max Warburg, scion of the prominent Hamburg banking family, who significantly was known to be close to the imperial court. The famously indiscreet kaiser himself contributed to the gossip from those circles by insisting that his friend Albert Ballin, head of the Hamburg-America Line, be informed in advance of a general mobilization. There was also talk that the crown prince had been breaking the strictest confidences to warn his friends in financial circles, including the managing director of the Dresdner Bank, Eugen Guttman, that for all the surface calm, the optimism of the Berlin Stock Exchange was misplaced and war between Germany and Russia very likely.

But Hjalmar Schacht, only an assistant director and branch manager at Guttman's Dresdner Bank, was still too far down the Berlin banking hierarchy to be party to these exalted hints from court. From his lowly point of view, he found it hard to believe that the situation had been allowed to spiral so far out of control—it seemed so profoundly irrational to let international rivalries threaten the German economic miracle.

THOUGH SCHACHT'S POSITION at the Dresdner, one of Germany's two largest banks, was still modest, for a young man in imperial Germany with no family connections, he had come a long way. He was certainly being noticed. In the months before the crisis began, he had been working on a loan for the city of Budapest, financed by a consortium of German, Swiss,

and Dutch banks. The Swiss banker Felix Somary would later recount how Schacht even then “considerably outshone his fellow directors, all sons of rich fathers or mere time-servers.”

With his clipped military mustache and brush-cut hair parted very precisely down the center, Schacht could easily have passed for a Prussian officer. He walked very erectly with a “curiously stiff gait,” his rigid bearing, exaggerated by the starched, high, gleaming white celluloid collars that he favored. But he was neither a Prussian nor in any way connected to the military. He came from a lower-middle-class family, originating from the area of Germany bordering on Denmark, and had been brought up in Hamburg, the most cosmopolitan city in the whole empire.

Schacht would one day become famous for his boundless ambition and ferocious will to succeed. They were in part a reaction against a father with a long history of failure. Wilhelm Ludwig Leonhard Maximilian Schacht had been born on the western coast of North Schleswig, a narrow neck of land connecting Denmark to Germany. The Dithmarschen is a region of salt marshes and small isolated dairy farms, a bleak and wind-swept country protected by large dykes against the constantly encroaching North Sea. The people are reputedly independent and tough, laconic to the point of rudeness. Schleswig and the neighboring duchy of Holstein had historically been ruled by the Danish crown, although the population was split between German- and Danish-speakers and throughout the nineteenth century, sovereignty over the two states had been subject to a dispute between Prussia and the Kingdom of Denmark.* In 1866, following two short wars, Bismarck annexed Schleswig and Holstein, incorporating them into the Prussian empire. After the war, in 1920, the northern parts of Schleswig, including the region from which the Schacht family had come, reverted to Denmark as a result of a plebiscite.

Wilhelm Schacht was one of the eleven children of a country doctor.

*The origins of the dispute were so arcane that Lord Palmerston famously remarked that only three men in the world fully understood them: Prince Albert, who was dead; a clerk in the Foreign Office, whom it had driven mad; and Palmerston himself, who had forgotten.

In 1869, unhappy at the prospect of having become a Prussian subject liable to the Prussian military draft, five of the Schacht brothers emigrated to the United States, where Wilhelm spent seven years. But although he became a U.S. citizen, he never quite managed to find his feet, drifting from one job to another, working for a while in a German brewery in Brooklyn and in a typewriter factory in upstate New York. Finally, in 1876, he decided to return to Germany.

Arriving back just as the economic boom unleashed by the Franco-Prussian War was ending and a depression setting in, he continued to be plagued by the same bad luck. During the next six years, he tried his hand at various professions—schoolteacher, editor of a provincial newspaper, manager of a soap factory, bookkeeper for a firm of coffee importers—all unsuccessfully. Eventually he found a job as a clerk with the Equitable Insurance Company, where he would remain for the next thirty years. While Schacht was always a little defensive about his father, claiming that he was simply “a restless wanderer unable to remain for long in one place,” the contrast between the father’s fecklessness and the gigantic ambitions of the son could not have been greater. Even Schacht could not help observing in his autobiography that by the age of twenty-five, he was already earning more than his father.

In contrast to his awkward and retiring father, his mother, “sentimental, gay and full of feeling,” always cheerful despite years of hardship, provided the center of affection for the family. Born the Honorable Constanze Justine Sophie von Eggers, the daughter of a Danish baron whose family had a long history of service to the crown, she had taken a large step down the social ladder by marrying Wilhelm Schacht. Her grandfather, a counselor to the king, had worked for the emancipation of serfs and had been responsible for a currency reform in Denmark in the late eighteenth century. But the family fortunes had declined over the years, leaving young Constanze von Eggers without any inheritance. She had met Wilhelm Schacht, then a penniless student, in 1869 and followed him to the United States, where they were married three years later.

Hjalmar Schacht himself was born in 1877, a few months after his family returned to Germany, in the small town of Tingleff in North Schleswig. He was christened with the unusual names Horace Greeley Hjalmar—in a typically impractical gesture, his father had chosen his first two names as a tribute to the founder and editor of the *New York Tribune*, whom he had admired while living in Brooklyn. His grandmother had insisted, however, that he have at least one conventional German or Danish name, and the young Schacht grew up as Hjalmar. Later in his life, though, some of his English friends and associates would use the name Horace.

During his early childhood, the family moved frequently as Wilhelm Schacht bounced from job to job, but in 1883, they finally settled in Hamburg. Germany in the last few years of the nineteenth century was a country of contradictions. Gripped by the most rigid class system in Europe—in fact almost a caste system—and governed by an autocratic constitution that still vested most of the power in the monarch and in the Junker military cadre surrounding him, it simultaneously offered Europe's most meritocratic educational system. But for that, Schacht might have been condemned to the narrow confines of lower-middle-class existence as a clerk or perhaps a teacher. Instead, in 1886, at the age of nine, he was accepted into the Johanneum, one of the finest gymnasia in Hamburg, where he received a rigorous classical education, emphasizing Latin, Greek, and mathematics.

He could not completely escape the constrictions of his class-ridden society. Life at school was full of petty humiliations stemming from his family's poverty: taunts at his living in a ratty tenement district, mockery of the cheap cloth of his trousers, sharing a graduation gown because he could not afford to buy one for himself. Cold-shouldered by the richer students, he was solitary, obsessively hardworking, and conscientious.

In 1895, Schacht graduated from the Johanneum and entered a university. Finally liberated, over the next few years he actually seemed to enjoy himself. He wrote poetry; joined a literary society; worked as a stringer for the *Kleines Journal*, a gossipy Berlin tabloid; and even composed the li-

breto for an operetta.* While he initially enrolled at the University of Kiel, he followed the German practice of transferring from one university to another, spending semesters in Berlin, Munich, Leipzig, and in 1897, the winter semester in Paris. He began as a medical student, tried his hand at literature and philology, and eventually graduated with a major in political economy, going on to write a doctoral thesis on the foundations of English mercantilism in the eighteenth century.

Doctorate in hand, Schacht began a career in public relations, initially at an export trade association, writing economic commentary for a Prussian journal on the side. Diligent and reliable, eager to impress the bankers and business magnates whom he was now beginning to meet, in 1902, he finally caught the attention of a board member of the Dresdner Bank and was offered a job. He rose quickly and, by 1914, was a well-established middle-level officer of one of the powerful banks in Berlin.

In imperial Germany, a man of Schacht's background would have found his opportunities for advancement in the military or the civil service limited. But in the years leading up to the war, Germany had gone from being an agrarian backwater at the edge of Western Europe, to becoming its leading industrial power, overtaking even Britain—an economic surge that had thrown open enormous opportunities in business to ambitious men. It was a particularly good time to be a banker, for in no other European country were banks quite so powerful. While Berlin still could not compete with either London or even Paris as an international financial center, the large German houses dominated the domestic economic landscape as the main suppliers of long-term capital to industry.

Disguising his social insecurities behind a stiffly formal exterior, Schacht seemed to possess a natural ability to get himself noticed. In 1905, his fluency in English got him sent with a member of the Dresdner's board to the United States, where they met with President Theodore Roosevelt, and

*Many years later, when he was a prominent official, the libretto was much to his embarrassment made public. Schacht sued the man responsible.

more important for a young banker, were invited to lunch in the partners' dining room at J. P. Morgan & Co.

He also married well—to the daughter of a Prussian police officer who had been assigned to the imperial court. By 1914, they had two children, the eleven-year-old Lisa and the four-year-old Jens, and were living in a small villa in the western garden suburb of Zehlendorf, from which Schacht commuted to and from work into the Potsdamerplatz station on one of the modern electric trains that now linked all of Berlin.

AS SCHACHT WATCHED the international crisis grow, he continued to hope, even until the end of July, for a last-minute diplomatic solution. Though he insisted that it would never come to war, this assertion stemmed primarily from wishful thinking. He had done well for himself in imperial Germany, had much to lose, and found it difficult to look at his own country dispassionately. For despite his liberal family background, he was a typical product of the Kaiserreich—conformist, unquestioningly nationalistic, and fiercely proud of his country and its material and intellectual achievements.

Like most other German bankers and businessmen, he believed that the villain of the piece was a fading Britain conspiring to deny Germany its rightful place among the Great Powers. As he later wrote, “Germany’s steady advance in the world’s markets had aroused the antagonism of those older industrial countries, who felt their chances in the markets were being threatened.” England in particular had “engaged in creating a strong network of alliances and agreements directed against Germany,” designed to encircle it.

That last few days of July 1914 constituted a whispering gallery of rumors and counterrumors. Berlin was gripped by alternating waves of war hysteria and anxiety. From the Dresdner Bank’s headquarters next to the Opera House on the Bebelplatz, Schacht had a ringside seat at the epic drama being enacted in the streets below. Daily, huge crowds of people

paraded under the great limes of Unter den Linden, singing “Deutschland, Deutschland, Über Alles” and other patriotic songs. Several times that week angry mobs attempted to storm the Russian embassy, only a few blocks away from his office.

Finally, on Friday, July 31, at 5:00 p.m. a lone lieutenant of the Grenadier Guards climbed up on the base of the giant equestrian statue of Frederick the Great, which divided Unter den Linden just outside the Dresdner’s offices, to read a proclamation in the emperor’s name. The Russians had ordered a general mobilization. A state of *Drohende Kriegsfahr*, imminent danger of war, was in force in Germany—still one step away from a declaration of war, but placing the city of Berlin under full military control.

The next day, when a general mobilization was announced, the streets went wild with excitement. Pubs and beer gardens stayed open all night. A craze of spy hunting swept over the city and the country. Anyone suspected of being a Russian agent, including a few German soldiers, was beaten to death. On August 3, Germany declared war on France, and to reach France, invaded Belgium the next morning. Britain, which had guaranteed Belgian neutrality since 1839, issued an ultimatum to Germany to withdraw. When this expired at midnight on August 4 and Germany found herself at war with Britain, a large “howling mob” stoned all the windows of the British embassy, then moved on to the Hotel Adlon next door to demand the heads of English journalists staying there. Bizarre rumors spread through the country. According to one police report, “The Paris banking house of Mendelssohn is trying to send a hundred million francs, in gold, across Germany to Russia.” The hunt for “gold cars” became a curious obsession in the countryside; vehicles driven by innocent Germans were accosted by armed peasants and gamekeepers. A German countess and a duchess were even shot by accident.

Nevertheless, despite the public hysteria, those first few days of war proved to be relatively benign. Germany seemed to be weathering the financial storm that swept across Europe remarkably well—in Schacht’s view, far better than was Britain. There were some minor debacles. The collapse of stock values in the last week of July put several banks in Ger-

many in difficulties—the Norddeutsche Handelsbank, one of the largest banks in Hanover, had to close its doors—and was accompanied by the usual litany of suicides by overextended financiers. One of the best-known bankers in Thuringia shot himself on Wednesday, July 29, and the next day a private banker in Potsdam killed his wife, then took cyanide himself.

But for all this turmoil among the rich, the general public remained remarkably calm. There was a nationwide run on small savings institutions, and long lines of women, many of them domestic servants and factory workers, could be seen patiently waiting outside the city municipal savings banks to withdraw their deposits. But there was none of the usual panic demand for gold that in those days routinely accompanied entry into war, and the Reichsbank lost only about \$25 million of its \$500 million in gold reserves in the first few days.

It was no secret that the Reichsbank had been preparing against such an event for several years. The financial spadework had begun in earnest after the Agadir crisis of 1911 when Germany decided deliberately to provoke a confrontation with France over Morocco. In the middle of the crisis, Germany was hit by a financial panic. The stock market plunged by 30 percent in a single day, there was a run on banks across the country as the public lost its nerve and started cashing in currency notes for gold, and the Reichsbank lost a fifth of its gold reserves in the space of a month. Some of this was rumored to have been caused by a withdrawal of funds by French and Russian banks, supposedly orchestrated by the French finance minister. The Reichsbank came close to falling below the statutory minimum of gold backing against its currency notes. Faced with the potential humiliation of being driven off the gold standard, the kaiser backed down and had to watch impotently while the French ended up taking over most of Morocco.

A few months later, the emperor, still nursing his wounded pride, summoned a group of bankers, including the president of the Reichsbank, Rudolf von Havenstein, and demanded to know whether German banks were capable of financing a European war. When they hesitated, he reputedly told them, “The next time I ask that question, I expect a different answer from you gentlemen.”

After that episode, the German government was determined that it would never again allow itself to be financially blackmailed. Banks were told to build up their gold reserves, the Reichsbank itself increasing its holdings from \$200 million at the time of Agadir to \$500 million in 1914—by comparison, the Bank of England held only some \$200 million. The government even revived a plan originally conceived by Frederick the Great back in the eighteenth century for a war chest of bullion—\$75 million in gold and silver—stored in the Julius Tower in the fortress of Spandau on the western outskirts of Berlin. Furthermore, to prevent the sort of raid on the mark that the French had allegedly orchestrated in the Moroccan crisis, the Reichsbank instructed banks to curb the amount of money taken on deposit from foreigners.

With all these measures under its belt, the Reichsbank entered August 1914 with large enough gold reserves on hand to feel confident about avoiding a replay of 1911 and was also quick, once the crisis became apparent, to take preemptive action by suspending the gold convertibility of the mark on July 31.

But as Schacht watched the long columns of soldiers in their field-grey uniforms marching through the cheering, weeping crowds of Berlin, he could not help thinking back to Prince Bismarck. The Iron Chancellor had spent his whole career making sure that Germany would not be so isolated within Europe that it would have to fight a war on two fronts against Russia and France. As a schoolboy of seventeen, Schacht had attended a torchlight procession staged in honor of the prince, then seventy-nine years old, in retirement at his estate at Friedrichsruh in the Saxon Forest, just outside Hamburg. The image of “a tremendous solemnity [emanating] from the old man as though he alone foresaw how onerous and dark the future would be” engraved itself on Schacht’s memory. He liked to think that during the parade Bismarck had cast that piercing look directly at him in an attempt to warn the young man and the other schoolboys gathered there, not to “allow his work to be carelessly destroyed.” Even in youth, Schacht had a vivid imagination and a grandiose vision of his own destiny.