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Market Comment

CLARMOND

McAdoo and the Exit Plan.

William McAdoo was the Treasury Secretary of a debt-laden and emerging America on the eve of World War I. He was also the de facto leader of the newly created US central bank, the Federal Reserve, which Congress had just brought into existence. The financial destiny of the nation depended on how McAdoo tackled a re-minted US central bank and a European debacle.

AUGUST OF 1914 SAW EUROPE hurtling towards war. British and French investors were the largest holders of US debt and equities, especially railway stocks; the coming war demanded the liquidation of these assets with the Americans having to pay in gold. Unfortunately there was not enough gold in the USA to pay these creditors. Given that the US$ was backed by gold, William McAdoo faced a currency melt down, a stock market collapse, and a run on the banks; an all-encompassing financial calamity presented itself.

McAdoo had no economics education to frame the situation but he was an entrepreneur by experience and understood that speed and initiative mattered. The US Treasury Secretary exploded into action.

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So what did he do? McAdoo shut down Wall Street; the British and French were unable to sell any securities, but no one else could sell them either. The Europeans and the Street cried foul, but McAdoo stood firm in the face of this two-pronged attack. Now that he had dealt with the external gold drain threat, he addressed the internal currency needs by providing excess liquidity (the QE of his day) to the banking sector. McAdoo knew instinctively that these emergency measures "would damage America if they remained in place for an extended period, especially flooding the country with currency would wreck the United States of America."[1] But he took these measures with a clear exit plan in mind that would bring balance to the economy.

A Clear Plan

The exit plan was elegant and effective. McAdoo would only agree to lifting the sales ban if all the combatants allowed the US to sell agricultural commodities and war material to everyone – the British, the French, and the Germans. The British were staggered by this stance but seven weeks later accepted the terms as they needed the goods and the money for the fight. Soon American merchandise was landing in Bristol, Le Havre and Hamburg, insured by the American Bureau of War Risk Insurance, a US Treasury creation to guarantee and indemnify American shipping. McAdoo had offset the liquidation of US securities via exports; the gold stayed in the US.

The clarity of having an exit plan allowed McAdoo to take a shock and awe approach to the crisis; he knew the "collateral damage these potentially lethal medicines"[1] could have for the long term. Emergency action was just that, for emergencies only; it was critical to put aside crisis actions as soon as possible. The result of McAdoo's manoeuvrings was that America emerged as a global net-creditor rather than being a net-debtor and, significantly, the first steps were taken to catapult the US$ into a position to challenge Britain's Pound Sterling as the global medium of exchange and store of value. New York now contested London's financial super-power status. McAdoo's decisiveness had given birth to the future global reserve status of the US currency.

McAdoo makes a sharp exit.

Whither exit plan?

If we ask the same question today that McAdoo faced a century ago, what is the exit plan from the emergency measures taken four years ago by the Federal Reserve and other central banks? The answer is ambiguous, imprecise and uncertain; it depends on consumer spending, on rising real estate prices and on the wealth effect via higher stock prices. In fact there is no exit plan and emergency measures have become routine.

A hundred years later we find the Federal Reserve entwined in a new European crisis. McAdoo's age-old crisis counsel – "apply restraint quickly, repair, and restore normal functions"[1] is now ignored. Turning emergency actions into ordinary ones may ironically bring to a finale the US$'s monetary hegemony that McAdoo's exit plan established. ■

1. When Washington shut down Wall Street - William L. Silber