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Paul M. Warburg: Founder of the United States Federal Reserve

Prof. Richard A. Naclerio

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Paul Moritz Warburg

The name Paul Moritz Warburg is synonymous with the founding of the Federal Reserve System. Warburg's impact on American banking is a parallel to his family's impact on European banking. The epic story of the Warburg family of European bankers can be traced back to the early 1500s when Simon von Cassel settled in the German Westphalia town of Warburg (originally founded by Charlemagne in 778 and was then known as Warburgum) and began the family's quest for money and financial power. Although the Warburgs excelled in many other occupations throughout Europe, it was this lineage that produced some of the most successful bankers in the world. Blessed with sharp minds and good business sense, the generations of the Warburg clan gained seemingly boundless money and power.¹

In the 1700s the family splintered into two groups. Some went to Altona, Denmark, and others to Hamburg, Germany. Despite being relegated to Jewish ghettos and, by law,

¹ David Farrer, *The Warburgs: The Story of a Family* (Ann Arbor, 1975), 11-17.

referred to as “moneylenders” and not bankers, in 1774 a Warburg established the merchant-banking firm of S.G. Warburg. It soon became W.S. Warburg as the family grew and sons and grandsons began to contribute to the family business. This Warburg firm remained independent and consistent throughout the 19th century, and in 1807 the Altona Warburgs sold out to the Hamburg Warburgs of M.M. Warburg and Company, founded by Moses and Gerson Warburg in 1798.²

When Napoleon invaded Germany, Hamburg was captured by the French army in 1804, as was Moses’ brother Gerson. Napoleon himself held Gerson hostage and demanded a ransom from the entire Hamburg Jewish community for his release. However, Moses did not want to pay. It took immense pressure from the whole community until Moses finally put up the money, which was still a sum much lower than what was expected of him. But despite this proof of disloyalty, the two brothers signed a partnership in 1810, and expanded M.M. Warburg together.

The end of the war marked the beginning of economic rebuilding for Germany. When the French withdrew in 1814, Moses and Gerson saw the need for replenishment of the country’s stock of silver currency to boost the German economy. So a letter by the brothers was written to a prodigious banking firm in England, requesting the opportunity to handle bills of exchange of silver stock on behalf of the London firm of N.M. Rothschild and Sons.³ To put the Rothschild’s empire in perspective, the family’s biographer, Fredric Morton explained that the Rothschild dynasty had, “...conquered the

² Farrer, 22.

³ Farrer, 22-23.

world more thoroughly, more cunningly, and much more lasting than all the Caesars before or all the Hitlers after them.”⁴

Throughout the 1800s the firm of M.M. Warburg and Company maintained a slow but steady growth process. That century brought the Warburgs prosperity and new relationships with very important people.

In 1857, 150 banks went under in the United States and the virus began to spread to Germany. Banks were overleveraged and the need for no less than 10 million marks was imperative for the survival of German, particularly Hamburg, banks. When Prussian bankers refused to aid them, an attempt was made to sway the director of Austria's largest bank, the Kreditanstalt, who happened to be married to a Warburg daughter. Paul Schiff applied pressure to the Austrian Minister of Finance. Soon, the Emperor Franz Joseph loaded a train with silver ingots and sent it to Hamburg. In six months it was returned to Vienna, plus interest.⁵

The second half of the 19th century marked true progress for the Warburgs. After the Franco-Prussian War of 1870-71, Otto von Bismarck imposed reparations on the French in the form of merchandise, precious metals, commercial and financial bills, and myriad investments. M.M. Warburg and Company once again joined the Rothschilds in loaning the French government the capital to pay the reparations. This act of association, and many others over the years, with the largest banking family in the world marked the arrival of the Warburg family in the global banking field, and their slow ascent gave way to their amassing significant wealth and reputation.⁶

⁴ G. Edward Griffin. The Creature from Jekyll Island, (Westlake Village, 2010), 218.

⁵ Farrer, 24-25.

⁶ Farrer, 25.

Moritz Warburg was born in 1838 and as a young man was an apprentice for the Rothschilds in Paris and Italy. He was a practicing orthodox Jew and he married Charlotte, a member of the Frankfurt diamond merchant family of Oppenheims, and she too was notably devout in her Jewish faith. The two had five sons; Aby, Max, Paul, Felix, and Fritz. They were so famed for their success, rebellion, and progressive attitudes among their descendants, that future Warburgs referred to the brothers as the “Famous Five.”⁷

Aby, being the eldest son, was in line to head the bank. However, his passion was Art History, so he sold his birthright to his brothers, Max and Paul. Max and Paul ran M.M. Warburg, respectively, and in 1894 another Schiff entered the lives of the Warburg family in the form of, arguably, “the most famous Jew in New York”, one of the richest men in America, and a man who J.P. Morgan admitted was his only equal, Jacob Schiff.⁸

As a young man Jacob ventured to America and met Abraham Kuhn. After writing a cogent letter to Kuhn’s partner Solomon Loeb, he convinced the two men to bring him in to join the firm of Kuhn, Loeb and Company in 1873. By 1875 he was a full partner and in 1894 he married Solomon Loeb’s eldest daughter.

Jacob’s daughter Frieda married Felix Warburg in New York and when Paul went to America to be the best man at their wedding, he met Frieda’s very young aunt, and maid of honor, Nina Loeb – Jacob’s sister. The two Warburg brothers settled in New York to work for Jacob Schiff, and thus began the borderline-incestuous familial

⁷ Farrer, 30-33.

⁸ Stephen Birmingham, Our Crowd: The Great Jewish Families of New York (Syracuse, 1996), 158.

interweaving of the banking firm of Kuhn, Loeb and Company.⁹ The Kuhn and Loeb genealogy is as follows:

...with [Abraham] Kuhn and [Solomon] Loeb (who were brothers-in-law) both related to Abraham Wolff, another K-L partner whose daughter married yet another partner, Otto Kahn. A Loeb son married a Kuhn daughter, and another Loeb daughter married another partner, Paul Warburg, while Jacob Schiff's daughter Frieda married Paul Warburg's brother Felix (a partner too). This turned an aunt and her niece into sisters-in-law, and made Paul his brother's uncle.¹⁰

The young Paul M. Warburg was a charmer, a playboy, a ladies-man, and a terrible student. The future professor at Harvard University failed most of his high school exams back in Germany and never went to college. He divorced his first two wives and not until the 1920s did he, as his family put it, "begin to settle down." In the summer, he and his brother Felix would retreat from the city and retire to their 200 acre property in The Woodlands in White Plains, New York.¹¹

Despite his many struggles in school, Paul was arguably the most brilliant of all the Warburgs. His versatility and need for challenge was reflected in the fact that he was really a half-partner at Kuhn and Loeb. He spent six months a year in New York, and the other six months back in Germany to help run the Warburg family bank. He acted as a "financial liaison" between Germany and America, all the while, frustrated with what he felt was the primitive, disorganized, and decentralized U.S. banking system.¹² Thus, his efforts began to change the system he thought so little of, and in doing so, he changed the system, the country and the banking world, forever. In the May, 1915 issue of *Century*

⁹ Farrer, 34-41.

¹⁰ Birmingham, 9.

¹¹ Farrer, 383-384.

¹² Farrer, 353.

Magazine, an article was written describing Warburg and his emancipation of the U.S. banking system:

Paul M. Warburg is probably the mildest-mannered man that ever personally conducted a revolution... He stepped forth simply armed with an idea. And he conquered. That is the amazing thing. A shy, sensitive man, he imposed his idea on a nation of a hundred million people.¹³

Warburg was not an innovator by any means. He merely imported the central banking systems he was accustomed to from many European countries he dealt with through M.M. Warburg. The reforms were adeptly advertised as simple adjustments to insure help to banks in times of emergency. Warburg wanted a central bank that could: 1.) issue currency backed by gold. 2.) Institute a discount policy, and 3.) Dismantle stock and call loans as bank collateral.¹⁴

The theory was that the issuance of currency would make currency itself more “elastic.” In times of crisis, banks would hoard their reserves and money became very scarce and tight. A central banking system would enable money to circulate more freely, even in tumultuous economic times.

This elastic currency that Warburg was trying to create could not exist under the constrictions of the existing monetary system that depended on gold and government bonds. His system could expand and contract (elasticity) to accommodate fluctuations of the needs for the marketplace. For this to happen, Warburg had to convince the United States banking community, the politicians, and the public, to adopt a currency based on “commercial paper,” which is banker-speak for corporate IOUs.¹⁵

¹³ Harold Kellock. “Warburg the Revolutionist.” *The Century Magazine*, (May, 1915), 16.

¹⁴ Farrer, 354.

¹⁵ Griffin, 18-19.

The discount policy would enable banks to receive liquid assets from the central bank through the rediscounting of commercial paper. Corporate loans were always frozen. Money lent to corporations could not be resold as liquid assets. The central bank could rediscount those loans as assets so banks could pay depositors in times of need.¹⁶ In other words, if a bank over-leveraged itself, that is, lent out more money than it had, the central bank would give that bank money on the basis that the banks' loans, themselves, were assets and therefore collateral.

This would enable Warburg's third adjustment to take place. Since the central bank would be overseeing all banking bailouts, then banks no longer needed to back their deposits with call loans and stock exchange collateral, as they had been. Warburg insisted that this system would ensure no more panics and stock market crashes.¹⁷ That claim would quickly prove to be outrageously untrue.

Warburg explained, "Banks issuing unsecured notes which are to pass as the people's money should be restricted to buying paper that is endorsed by other banks or banking firms... They should be restricted also as to the kinds of loans to be made by them." He favored a central bank to oversee all of this. Warburg's worry was that these unsecured notes, mostly through short-term loans, would become viewed as fixed capital investments.

Warburg wanted to separate the loans from the capital by instituting a central bank to redefine acceptable bank assets so as to eliminate small business entrepreneurs to undertake what he called "unproductive enterprises." Some bankers and economists took

¹⁶ Ron Chernow, *The Warburgs: The Twentieth-Century Odyssey of a Remarkable Jewish Family* (New York, 2012), 130.

¹⁷ Chernow, 130-131.

a different perspective and believed this was an illegal filtration process to weed out undesirable bankers and businesses from the capitalist marketplace.

Others thought that this “Big Brother-like” monitoring of banking practices dismantled the financial foundations of the entrepreneurial, individualistic system of production and distribution that the American industrial revolution of the late eighteenth century was founded upon. Still, others believed it was purely and simply unconstitutional.¹⁸

He began by, simply running the idea by his boss at Kuhn, Loeb and Company, Jacob Schiff. Then the idea seeped into Wall Street, and by the Panic of 1907, the banking kings of Wall Street were clamoring for a change in banking regime. The *New York Times* asked Warburg to write an article about his banking reform ideas. Oddly, while barely being able to speak English, no less read and write it, “Defects and Needs of Our Banking System” by Paul M. Warburg was published in the November 12, 1907 issue of the *New York Times*.¹⁹

In December of 1907, Warburg met the man who could, and did, make his plan a reality: Senator Nelson W. Aldrich of Rhode Island. Author, Ron Chernow describes Aldrich as, “The Czar of the Republican party and the maestro of the smoke-filled rooms.”²⁰

The two men met when Aldrich visited Jacob Schiff at the Kuhn, Loeb offices, inquiring about the activities of the German Reichsbank. There, Schiff referred him to Warburg and the two formed an unlikely but powerful alliance. On New Year’s Eve,

¹⁸James Livingston, Origins of the Federal Reserve System: Money, Class and Corporate Capitalism, 1890-1913

(Ithaca, 1986), 169-171.

¹⁹ Chernow, 131-132.

²⁰ Chernow, 131.

1907, Warburg sent Aldrich his proposal on uniform currency and a central banking system. Throughout 1908, Warburg gave speeches on reform, testified at hearings set up by Senator Aldrich at the Metropolitan Club in New York City, and by May of 1908 the Aldrich-Vreeland Emergency Currency Act was passed. Very soon after that Warburg, upon the advice of Aldrich, applied for United States citizenship, and became one of Senator Aldrich's closest advisors.²¹

More speeches and writing ensued, on Warburg's part, and by December of 1910, the clandestine meeting between Senator Aldrich, his secretary, Paul Warburg, Benjamin Strong, and the four other banking moguls on Jekyll Island took place, the Aldrich Bill was drafted, and Warburg was on his way to becoming the "Father of the Federal Reserve." The *New York Times* agreed with that distinction when they wrote about Warburg, "In actual fact, he [Warburg] had a more legitimate distinction to that title ['Father of the Federal Reserve'] than any other American citizen."²²

Warburg spoke and wrote extensively on central banking and expressed his views on the troubles concerning the existing banking system the United States upheld. He was a co-founder of the Economic Club of New York, in 1907, and used it, along with many other vehicles, to spread his word about the need for a central bank in America.

Warburg's writings were extensive. In the beginning, he mocked the obsolescence of the current system: "The United States is in fact at about the same point that had been reached by Europe at the time of the Medicis, and by Asia, in all likelihood, at the time of Hammurabi."²³

²¹ Chernow, 132-133.

²² Chernow, 137.

²³ Paul M. Warburg, "Defects and Needs of Our Banking System" *New York Times*, January 6, 1907.

Amid the Panic of 1907, Warburg referred to the financial crisis as “appalling” and wrote in November of that year, that it was “the absolute necessity of a change in our present banking and currency system than all the efforts that have hitherto been made to warn the nation of the imminent danger.”²⁴ Warburg wrote further, eerily describing a central bank as a God-like, omnipotent entity, and preaching the self-flagellating repercussions of the present situation:

We need some centralized power to protect us against others and to protect us against ourselves, some power able to provide for the legitimate needs of the country and able at the same time to apply the brakes when the car is moving too fast. Whatever causes that may have precipitated the present crisis, it is certain that they never could have brought about the existing outrageous conditions, which fill us with horror and shame, if we had had a modern banking and currency system.²⁵

By 1911, Warburg had become a seasoned writer and speaker; however the subject-matter and scare-tactics remained the same for his audiences, even despite the markedly improved economy and the four years since the Panic of 1907. He continued to convey his belief in the necessity for banking reform and continued to evoke images of economic disaster for America if changes were not made. In this essay, he used the European banking model as the lifeboat in the white-capped sea of U.S. banking upheaval. It was this European model that he sold as the template for his Federal Reserve System:

Why has our building proved a fire trap and why is Europe’s structure so safe? Why does Europe’s system guarantee the avoidance of panics and why does ours inevitably insure their recurrence from time to time? ... It is from this point of view that the final question of monetary reform must be

²⁴ Paul M. Warburg, “A Plan for a Modified Central Bank” 4 (4) Proceedings of the Academy of Political Science in the City of New York (July, 1914), 23-28, New York Federal Reserve Archives, New York Historical Society.

²⁵ Paul M. Warburg, “A Plan for a Modified Central Bank” 4 (4) Proceedings of the Academy of Political Science in the City of New York (July, 1914).23-28, New York Federal Reserve Archives, New York Historical Society.

approached... It is of no avail to patch up a theoretically wrong system and to strengthen it by some practical measures which give a false assurance of safety. When the storm comes, fear and doubt will begin to creep in through the loophole which logic, then wide awake, will drill, and once well-founded distrust begins, the system loses its basis, which is confidence, and must collapse.²⁶

Senator Aldrich did his speaking and public relations as well. In an address before the American Bankers Association he said with both great clarity and great obtuseness, “The organization proposed is not a bank, but a cooperative union of all the banks of the country for definite purposes.”²⁷ To many, even in the wake of the aftermath of the panic, that idea sounded like something much too large and much too powerful.

Over the years preceding the formation of the Federal Reserve, Warburg wrote many essays and gave many public addresses on banking reform. Some of the titles include: *A Plan for a Modified Central Bank* (1907), *American and European Methods and Bank Legislation Compared* (1908), *A Central Banking System and the United States of America* (1908), *A United Reserve bank of the United States* (1910), *Principles That Must Underlie Monetary Reform in the United States* (1910), *The Discount System in Europe* (1910), *Circulating Credits and Bank Acceptances* (1911), *The Glass-Owen Bill as Submitted to the Democratic Caucus: Some Criticisms and Suggestions* (1913), *The Glass-Owen Bill: Should There be Four or Eight Federal Reserve Banks, and The Glass-Owen Bill: Gold or Lawful Money, Note Issue, and Government Bonds* (1913).

After the Federal Reserve Act was signed by Woodrow Wilson in 1914, the important undertaking of choosing a Board of Governors for the central Washington D.C.

²⁶ Paul M. Warburg, “Principles That Must Underlie Monetary Reform in the United States,” 1 (2) *Proceedings of the Academy of Political Science in the City of New York* (January, 1911), 117. New York Federal Reserve Archives, New York Historical Society.

²⁷ Griffin, 19.

branch was of utmost importance. Warburg, despite the fact that he was paramount in drafting and engineering the original bill, never thought he would be considered for the Board.

When his old adversary, Carter Glass, asked him if he would accept a seat on the new Board, Warburg verbalized the strange and ironic situation it created: “I took the question more or less as a joke, at the most, as a compliment, and told him that I did not think the President would be at all likely to submit the name of a man associated with one of the leading Wall Street firms.” After consideration and pressure from his Wall Street peers to appropriately represent their interests in the system, Warburg accepted the appointment without reservation.²⁸

Warburg was a partner at Kuhn and Loeb and M.M. Warburg. He was on the boards of directors of the B&O Railroad, Westinghouse Electric Company, and Wells Fargo Express. Not only did he have to relinquish all these positions to join the Board of the Federal Reserve, but he had to sacrifice his estimated 1914 annual salary of \$500,000 (what would be \$11,638,650 per year in 2013)²⁹ that he earned from all his endeavors, for the comparatively paltry sum of \$12,000 per year. Warburg had never cast a vote in America. He was in Europe during the 1912 election of President Wilson (the man who

²⁸ Chernow, 137-138.

²⁹ United States Bureau of Labor Statistics. “U.S. Bureau of Labor Statistics CPI Inflationary Calculator 1914 – 2013;” <http://www.bls.gov> (accessed March 24, 2013).

appointed him to the Board), he had been a U.S. citizen for only three years, and he was about to be one of the most powerful and influential financial officials in the United States.³⁰

For four weeks after his nomination, Warburg was drowning in controversy and doubt. He was grilled at Senate hearings and at one point he wrote President Wilson to withdraw his name from nomination. Wilson denied his request and prodded Warburg to testify. He was hammered by senators, especially Senator Joseph Bristow of Kansas who said that instead of being a candidate for the Board of the Federal Reserve, Warburg should be a, “candidate for punishments for unlawful acts in violation of the Sherman Law and other criminal statutes.”³¹

For a day and a half Bristow attacked Warburg about the nefarious dealings of Kuhn and Loeb and accused Warburg of being a Rothschild agent in the United States. Warburg replied, “I think that my firm is not up as nominee for membership of the Federal Reserve Board” and as for being a Rothschild agent, he adroitly passed the buck, noting that “August Belmont and Company performed that service.”³²

To some senators, appointing Warburg to the most powerful economic post in the country was like asking a wolf to look after the sheep. But on August 10, 1914, Paul Warburg took the oath of office and began his term of service on the Federal Reserve Board.³³

³⁰ Chernow, 138.

³¹ Chernow, 138.

The Sherman Antitrust Act of 1890 prohibits certain business activities that federal government regulators deem to be anticompetitive, or monopolizations.

³² Chernow, 139.

³³ Chernow, 139-140.

No sooner was Warburg sworn in, than were the nations of Europe enveloped in the Great War. European markets and banks began to shut down and Warburg led the Fed into the role of global banker. His optimism for the new system's future was overflowing and he brimmed with confidence and patriotism. At the same time he suffered slings of accusations of disloyalty, which built a boarder inside of him. Crestfallen about the horrors his countrymen were suffering, yet exhilarated over the potential of his thriving enterprise.³⁴

Anti-German sentiment and xenophobia marched across the country. Warburg and his wife Nina kept a safe distance from any of their German-Jewish friends, while Warburg devised rationalizations why the United States should not go to war with Germany. He stressed to President Wilson the need for peace and the need for America to remain neutral if it were to continue to be the "balance wheel" in world banking and politics.

Warburg was under attack on the basis of his religion, ethnicity and economic ideology by Anti-Semitic, Anti-German, Anti-Wall Street, and Anti-Federal Reserve ideologies swarmed about his position. The British ambassador in Washington, Sir Cecil Spring-Rice, tried to convince his contemporaries back in England that Jacob Schiff controlled the *New York Times* and was trying to destroy Britain. He believed that Paul Warburg's appointment to the Board of the Federal Reserve was all a part of a Jewish conspiracy, masterminded by Kuhn, Loeb:

Since [J.P.] Morgan's death, the Jewish banks are supreme and they have captured the Treasury Department by the small expedient of financing the bills of the Secretary of the Treasury... and forcing upon him the

³⁴ Chernow, 158-160.

appointment of the German, Warburg, and the Federal Reserve Board which he dominates.³⁵

In August 1916, President Wilson appointed Warburg as the vice-governor of the Board of the Federal Reserve, giving him even more power and influence. It was at that point, maybe more than ever, that Spring-Rice's warnings made sense to some. Warburg drafted a statement from the offices of the Federal Reserve, warning American investors not to purchase too many securities issued by unstable, warring nations. Since Germany had never issued any Wall Street loans, this caution would directly hinder the financial stability of both Britain and France during the war and after. Edward C. Grenfell, the senior J.P. Morgan partner in London, accused Warburg of hatching a plot to undercut the allies. He stated to the entire British Treasury that this was a scheme concocted by "Warburg and other German sympathizers..."³⁶

Many of the German-Jewish investors and bankers on Wall Street supported the German side during the First World War. Some were quite vocal about their views on U.S. involvement in the war. Even the staunchest Warburg supporter would be hard-pressed to deny the idea that Warburg was any different. Their collective protests to American intervention during the war led to the almost catastrophic decline of many of their careers, the tailspin of Kuhn, Loeb and Company, and in August of 1918, the failure of President Wilson to reappoint Paul M. Warburg, the "Father of the Fed," to the board of directors of the Federal Reserve System - the very institution to which he had dedicated and sacrificed so much to create.³⁷

³⁵ Chernow, 160-162.

³⁶ Chernow, 162.

³⁷ Murray N. Rothbard. The Case Against the Fed (Auburn, 2012),70.

In 1919 Warburg returned from Washington to New York, and through a merger, became the chairman of the board of Bank of Manhattan. As the 1920s roared on with spikes in the stock market, Warburg warned of over speculation and a dangerous bubble in the market. He was known as the “Cassandra of Wall Street” and those who heeded his warnings were few, and those who repressed his prognostications mocked him openly. On one occasion in 1928 upon entering the Century Club in Manhattan, one of the members shouted, “Here comes old Gloomy Gus!” and he was booed at the directors meeting later that day.

At the beginning of 1929, Warburg gave the annual report of the International Acceptance Bank. During the report he succinctly stated that,

[Climbing prices of stock were] in the majority of cases quite unrelated to respective increases in plant, property, or earning power...If orgies of unrestrained speculation [continued without control] the ultimate collapse is certain to not only affect the speculators themselves but also to bring about a general depression involving the entire country.³⁸

Boos and hisses were the response to Warburg’s apocalyptic forecast of America’s economic future, but barely six months later the “ultimate collapse” was triggered, and Warburg’s “I told you so’s” made him even less popular.³⁹

Paul Warburg’s unlikely, meteoric rise to the top of the U.S. economic and financial world was only as spellbinding as the Shakespearean-like downfall of his career as founder and board member of the Federal Reserve. After the war and for the rest of his life, although a large portion of his earnings was diminished by the Great Depression he warned so many about, Warburg enjoyed massive wealth and success as the largest acceptance banker in the world. However, from a European blueprint and the depths of

³⁸ Birmingham, 354.

³⁹ Birmingham, 354.

his keen financial mind, Paul Warburg built a central banking system that to this day wields more power than any other financial institution in the country, and then being stripped from the helm of it and cut loose, was truly the most shattering event in his life. In 1932, while his prophecy of economic destruction was still truthfully unfolding, it was said by his family, friends, and even his enemies that he died of a broken heart.⁴⁰

⁴⁰ Farrer, 91.

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