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NASHVILLE NOTES

Wednesday, July 09, 2014 10:09 AM CT

Maybe the Fed’s decisions in the late 1920s haunt its decision making today

By Jeff K. Davis

For those of you who are finance aficionados who have not read *Lords of Finance* (2009) by Liaquat Ahamed, I recommend the book. The subtitle is "The Bankers Who Broke the World," though the book is not an anti-banker diatribe. It is a history of the U.S., U.K., German and French central banks and the fallible men who ran the banks from "the unexpected storm" in August 1914 to the Bretton Woods conference in 1944. One of the key characters is Benjamin Strong, who was present at Jekyll Island in 1910 when the outlines for the Federal Reserve were constructed by a group of bankers. He eventually resigned as president of Bankers Trust to become governor of the (then and now) powerful Federal Reserve Bank of New York.

Strong was no economic or monetary purist. I think he saw the role of the Fed to be flexible as monetary and economic conditions dictated. Perhaps to a fault he focused on helping European economies recover after World War I to foster global trade and the ability of highly indebted European countries to service their war-related debts. Strong also viewed the return of the pound sterling to the gold standard (i.e., convertible into gold) as key to undergirding sound money globally.

When England returned to the gold standard, the rate was set too high — one of several very bad decisions in the interwar years. Pride and a desire not to repay creditors with inflated currency outweighed pressure on an uncompetitive pound created for British industry and labor. Strong, apparently a dominant personality, kept rates low in the U.S. to support the pound and stem the flow of gold to the U.S. Further, the Fed had achieved success in maintaining stable prices in spite of a robust U.S. economy. In 1927, Strong was persuaded to cut rates to support the Bank of England and goose the U.S. economy a bit; rates were lowered to 3.5% from 4.0%. What Strong described as "un petit coup de whisky" intensified speculation in the stock market.

Even before the cut occurred, there were many bankers and policy makers who were concerned about speculation in stocks (and Florida real estate). Ironically, the man most associated with the crash — Herbert Hoover — was a vocal critic of market speculation as a cabinet member in the Coolidge administration. Strong apparently regretted the decision by early 1928 and reversed course, raising rates to 5.0% by July 1928.

What might have been is one of those alternate history questions. Strong died in October, a year before the great crash. He apparently was of a mindset to let the orgy on Wall Street burn itself out, concerned that if rates were raised further it would hurt the economy, draw more gold to the U.S. and maybe force sterling off the gold standard. His replacement was George Harrison. Ultimately, a divided Fed raised rates to decisively end the speculation that had taken on a life of its own. In August 1929, rates were hiked to 6.0%. You all know what happened next, though you may not know Harrison's quick actions to supply New York banks with liquidity once the crash occurred prevented any major banks from failing during the eye of the storm.

I have heard some comment that while Alan Greenspan turned a blind eye to the ridiculous speculation in the mortgage market last decade, he had a better sense of markets and would have moved sooner and more decisively to support the system than did Ben Bernanke. We will never know, but the debate over what the Fed should do today after six years of extraordinary monetary accommodation and whether the Fed has dug itself in a hole hangs over its policy decisions.

Chair Janet Yellen knows her critics' arguments, and answered them last week by stating that the Fed would not raise short rates to counteract perceived excesses in markets; rather, regulation would be used to improve resiliency. That is, she seemed to nix the surgical strike that Harrison mistakenly made in 1929 after his predecessor's surgical strike of cheaper money in 1927 fueled Wall Street's speculative flames.

So as earnings season begins to unfold and the Street produces its reams of notes about how banks' margins will expand once the Fed begins to lift short rates, I think investors should focus on what lenders and borrowers are saying about asset values and liquidity. In almost all instances, the answer will be that all is well. Liquidity usually trumps valuation and credit sins — and liquidity is abundant for the time being.

Green Street Advisors indirectly pointed to the importance of the Fed's zero interest rate policy and asset values, in my view, when it noted in its July monthly update that U.S. commercial property price appreciation has gained momentum over the past few months. Pricing in the Midtown Manhattan market was described as aggressive with no signs of abating.

At a dinner last fall in Washington, I sat next to an institutional investor who was investing large sums of money on behalf of Europeans in North American commercial real estate. He told me he was buying an office tower in San Francisco. I asked him the cap rate. He said he was embarrassed to tell me, but then blurted out less than 4%. I did not have the guts to ask him how much less because I did not want to embarrass him in front of others. If you do not know cap rate math, the inverse is the multiple. He was paying over 25x for the property's cash flow. Maybe 25x was not crazy, especially if a life insurance company offered a 30-year non-recourse mortgage to leverage the equity.

When bankers and investors complain about how much capital banks are required to hold, remember there is a very good reason the Fed is focused on improving the resiliency of banks. Many asset values are high, but they might not be as high if the Fed ever raises rates.

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