CRASH

by ALAN REYNOLDS

A year has passed since the steepest stock market drop in almost 60 years, with the Dow-Jones average falling by over a third from October 5 to October 19, 1987. Yet nothing much has come of it. Those who were expecting a deep recession at the end of 1987 instead began worrying, only a few months later, about a supposedly "overheated boom." The stock market quickly recovered about half of its loss, with stocks of smaller companies doing even better in the rebound of early 1988.

The enduring legacy of the Crash of '87 is that it provided a convenient excuse for a variety of possible increases in government authority, which may yet cause serious economic trouble. The crash has been used to denigrate a prolonged economic expansion during the Reagan years, to support calls for new taxes, and to argue for increased regulation of financial markets. A Securities and Exchange Commission "study" of the crash concluded that more SEC intervention in the market is just what we need—even though an October 19 remark by SEC Chairman David Ruder, suggesting he might temporarily close the New York Stock Exchange, undoubtedly accentuated the panic. The supposedly private Brady Commission, whose chairman went on to be appointed secretary of the Treasury in August, advocated tighter federal regulation of financial markets. The New York Stock Exchange blamed the Chicago futures market (and said it needed more government supervision), and vice versa.

But there is a basic flaw in all these "investigations" to determine what was wrong with markets or investors. Markets and investors should have instead investigated what is wrong with Congress, the U.S. Treasury, and the White House.

To understand why the market crashed, we have to brush aside several popular scapegoats—the budget deficit, Federal Reserve tightening, the trade deficit, and (the explanation emphasized by the Brady Commission) computer trading.

Consider, first, the budget. Politicians and pundits immediately concluded that investors all over the world had suddenly awakened one morning in October and noticed that the United States had a budget deficit—caused by, in *Time*'s words, "Reagan's long, obstinate resistance to tax increases." Investors, according to this strange theory, were eager for more taxes on the profits and sales of the companies they invested in or on their own interest income, dividends, and capital gains. But markets turn on news, and the only *new* information about the deficit was that it had fallen to $150 billion—half of some estimates earlier that same year.

Several prominent monetarist economists on Wall Street and inside the U.S. Treasury instead blamed the event on a tight-money policy by the Federal Reserve. But this argument suffered from the same bad timing as the rival story about budget deficits. The slow growth of the money supply from May to September 1987 was old news; it had not prevented the stock market from soaring during that time. True, on September 4 the Fed had hiked the discount rate to a relatively modest 6 percent, but the Dow-Jones stock index increased by 52 points over the next 10 days.

The crash was, above all, a global event. Stock market declines in countries as diverse as Australia, Ireland, Mexico, and Malaysia were far deeper than in the United States. And stock markets had already reached their peaks for the year as early as April 18 in Germany, July 16 in the United Kingdom, and August 25 in the United States. In short, the worldwide stock market crash cannot plausibly be blamed on such unchanged local news as the U.S. budget deficit or the U.S. money supply. A global phenomenon requires a global explanation. That naturally points toward trade deficits, trade legislation, and the dollar.

Financial markets in 1987 suddenly seemed obsessed with the notoriously unreliable estimates of the monthly U.S. trade deficit. Big increases in other countries' trade deficits, such as the United Kingdom's in early 1988, were not accompanied by comparable anxiety in foreign financial markets. The reason is surely that only the United States was threatening either protectionism or devaluation as a "solution." Congress was threatening to raise the cost of living and the cost of production with tariffs and quotas, and the White House and Treasury were threatening to inflate import prices by devaluing the dollar. These were merely two competing ways of making Americans poorer and making the United States a dangerous place to invest. So "bad news" about the monthly trade deficit directly implied bad news about U.S. policy.

The real trade story goes back to the Reagan administration's perverse decision in March 1987 to "get tough" about Japan's reluctance to overcharge U.S. high-tech industries for semiconductors. As the *New York Times* noted, the decision set off "a chain reaction in financial markets....Reaction to the dollar's decline was violent in the stock and bond markets, where prices plunged in near-panic selling." Another whiff of protectionism a month later, when the House passed the Gephardt Amendment, sent bond prices and the dollar plunging. When the Senate passed a more mildly protectionist trade bill on June 18, interest rates rose.

The stock market reacted similarly a year later, in April 1988, when a *New York Times* feature made a wildly premature guess about "increasing chances that the [trade] bill might escape a veto." That flimsy rumor alone took 101 points off the Dow on the day it appeared. That time, however, the conventional explanation was the trade-deficit figure, which happened to appear on the same day. Was it really the trade *deficit* or the trade *bill*?

That question leads us back to the first big day of the crash—October 14, 1987—when another "disappointing" trade-deficit figure was likewise blamed for a 95-point drop in the Dow. The trade deficit reported on October 14 was nearly $1

billion smaller than a month earlier. But the September figure had not provoked financial panic. On the contrary, as a headline in the *Los Angeles Times* noted: "Trade Deficit at Record High but Stocks Soar." Why would stocks (and the dollar) take off on news of a $16.5-billion deficit but then collapse on news of a $15.8-billion deficit? The real reason is that the trade deficit per se was never the real issue. The issue was the trade bill, along with taxes and the dollar.

The damaging role of House Ways and Means Committee tax proposals put out on October 14 is not seriously disputed, but it is played down in the various government studies of the crash. Among a variety of soak-the-rich schemes approved by the House was a tax bill making it virtually impossible to deduct the interest expense in takeover deals, which would devastate even deals that were then pending. Ed Yardeni of Prudential Bache later documented that takeover stocks were among the earliest and hardest hit in the crash. Congress was obviously intent on protecting inefficient business managers from domestic competition as well as foreign competition.

More bad news on the tax front had been announced by Germany in early October: a new withholding tax on interest earnings, even for foreign investors. The immediate effect, predicted by *The Economist*, was higher interest rates on German bonds to compensate for the tax. Since Germany was under international pressure to *reduce* tax and interest rates, the October news was taken as further evidence of a general breakdown of international cooperation—a breakdown that might well have encouraged a trade war and debt defaults.

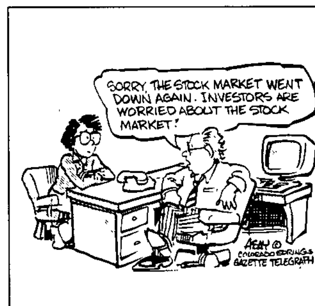
In addition, top officials in Germany, Japan, and the United States were openly inviting investors to get out of dollars—including stocks and bonds priced in dollars. German monetary officials made it clear on October 6 that they intended to raise interest rates regardless of the effect on the dollar. The Dow fell 92 points that day. Later that week, similar intentions to hike interest rates were attributed to Japanese central bankers. Treasury Secretary James Baker later made it clear that the United States didn't care about the dollar, either. A cover story in *Fortune* in mid-October—"Why Greenspan Is Bullish," ironically upstaged by events—said the Fed chairman expected the dollar to gradually sink by another 30 percent.

On November 4, 1987, the *Wall Street Journal*, reviewing this period, published a chart indicating a close match between each daily drop in the dollar and the drop in the Dow. A year earlier, a very similar public rift in early September between the same German and U.S. officials over exchange rates had likewise pushed all the world's major stock markets down by 6-9 percent.

Malcolm Forbes, Jr., neatly summarized the causes of the crash in his November 11, 1987, *Forbes* column, noting that "the possibilities of protectionism, tax, increases . . .and a weaker greenback did to equities what a similar combination did 58 years ago." Since rational fear of such blunders in government policies caused the crash, the event scarcely supports proposals by the Brady Commission and others to increase government intervention in financial markets. Indeed, the mere release of the Brady Commission report, on January 8, 1988, was greeted by a huge, 140-point drop in the Dow.

It may well be true that "portfolio insurance"—the report's favorite whipping boy—made investors too sanguine as the market rose, and too sheep-like in the crash. But portfolio insurance is just a strategy, not an actual market, and its newly obvious limitations are all the regulation that was either needed or possible. The commission may even be correct to propose that margin requirements on stocks, options, and futures be made more equal, so that investors don't prefer options and futures merely because of greater leverage. But Treasury Secretary Brady has rightly suggested that this could be accomplished by reducing margin requirements on stocks, as Japan did, rather than by penalizing options and futures—which would simply drive those markets to places like London and Singapore. (Brady's remark also casts some doubt on the speculation that, should he remain as Treasury secretary if George Bush is elected, heavy-handed regulation of the financial markets would follow.)

Since limitations on markets tend to reduce their liquidity (for example, the ability to switch into cash quickly), mere announcement of such schemes would depress stock values. To limit or stop trading during a downturn, as the SEC chairman proposed during the crash, is like closing the doors in a theater that is on fire. Hong Kong, which closed its stock market during the crash, suffered a lasting loss of credibility, while Japan, which instead reduced margin requirements, quickly recovered.



Could a comparable crash happen again? Probably not one as sudden or as deep. The fact that portfolio insurance has been largely discredited should minimize the related rush by investors to get out of the market at the same time. And stock prices are already much lower today, relative to earnings, than they were on the eve of the crash. But any similar collection of bad news regarding future government policies would certainly reduce expected profits or raise the interest rate at which those profits are discounted—and sink the stock market. A Dukakis presidency might scare foreign and domestic investors away from U.S. assets, for the same reasons.

If we want to avoid another crash, the lesson is to avoid protectionism, punitive taxes, and a weak currency. Far from being a legitimate excuse for more government intrusion, the crash illustrates once again how hazardous the government can be to our financial health. ■

Contributing Editor Alan Reynolds is chief economist with Polyconomics Inc., a consulting firm in Morristown, New Jersey.