Bang, crash, slump?

Will the stock market crash of 1987 lead to the slump and trade wars of 1988 or 1989? Paul Demuth reports from New York and London on why share prices crashed, and what it means for economic prospects.

One thing about Mammon is it is never short of cliches and hyperbole. Since 19 October, when world stock markets crashed (it instantly became "Black Monday") the pages of the *Wall Street Journal* have been brimming with extraordinary contributions to the English language.

Bears have been climbing the walls (of the pits in the Chicago futures exchange), New York has achieved "meltdown", it is generally considered "not a time to go gunslinging". Panic stricken share traders have been "cleaning the blood off their hands" after days spent "shovelling $100 bills down a mineshaft".

It certainly was fairly serious. By Guy Fawkes night, the Dow Jones Industrial Index, the most frequently used indictator of US share prices, had fallen by 27%. While the half-expected wave of bankruptcies among securities firms had so far failed to materialise, a lot of people had lost a lot of money. 'Yuppies' in Manhattan and Docklands had lost their jobs, amidst much gleeful crowing from a press which for the past few years has often seen its main function as catering to their every need and prejudice.

The imbalances which form the backdrop to the stock market crisis have their roots in the politics pursued in the major capitalist countries since the recession of 1979-81 and the subsequent recovery. In the United States the Reagan administration's determination to re-arm while simultaneously cutting taxes has led to a huge federal budget deficit, currently at $148 billion (for the fiscal year which ended in September).

The relatively high interest rates needed to attract money from abroad to cover the deficit pushed up the value of the dollar, making it difficult for American exporters to sell their products abroad and cheapening imports so that demand from US consumers soared. The US current account deficit jumped from $40.8 billion to $117.7 billion between 1983 and 1985, while the dollar effective exchange rate (Bank of England measure) rose by almost 13 per cent.

At the same time, the other major capitalist countries pursued tight monetary and fiscal policies. Calculations by the OECD and the IMF showed that between 1981 and 1984, there was an expansionary "fiscal impulse" in the US worth 3 per cent of Gross National Product, while in West Germany there was a contractionary impulse worth 0.9 per cent of GNP and in Japan there was a contractionary impulse worth 0.6 per cent of GNP.

The result was a world economic recovery characterised by booming demand in the US, which sucked in imports, leading to huge trade surpluses among its major competitors. Total real domestic demand in the US grew by 5 per cent in 1983, 8.5 per cent in 1984, slowing to 2.8 per cent in 1985. By contrast, the figures for Japan were 1.8 per cent, 3.8 per cent and 3.7 per cent in each year and for West Germany 2 per cent, 2 per cent and 1.4 per cent (OECD figures). Over the period, the West Germany trade surplus more than trebled, from $4.1 billion to $13.1 billion, while the Japanese surplus more than doubled from $20.8 billion to $49.3 billion.

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By 1985, most economists in and out of the major capitalist governments considered the trade, fiscal and foreign exchange rate imbalances to be unsustainable. The US, where households have a relatively low tendency to save rather than consume, was having to finance its budget deficit with huge inflows of money from Japan, where there is a large savings surplus. The US became a net debtor for the first time in decades. The fear was that foreign investors would eventually lose confidence in the over-inflated US dollar and sell out, sending the dollar into 'free-fall' and plunging the world into recession.

In September 1985, the finance ministers of Britain, West Germany, Japan and France, agreed their central banks should start selling dollars and the US agreed to co-operate by reducing interest rates. In a move that has been the centre of controversy ever since, it was also agreed that Japan and West Germany should opt for expansionary fiscal measures so their economies could take up what the US Government is fond of calling "the burden of growth".

The short-term monetary measures did have an immediate effect. Between the end of December 1984 and 2 October this year (that is, before the sharp fall in the dollar which came after the stock market crash), the Bank of England effective dollar exchange rate index fell by almost 30 per cent while the yen index rose by 23 per cent and the Deutschmark index by 11 per cent. The interest rate on three-month US Treasury bills, which peaked at 9.66 per cent during 1983, fell to a low of 5.55 per cent at the beginning of May this year.

The agreement was apparently so successful that by January this year the finance ministers decided that the process had gone far enough and agreed a programme to stabilise the dollar.

But what the financial markets wanted to see was the dollar adjustment having an effect on the US trade deficit and firm action from Washington on the budget deficit. On this front, matters were much less encouraging. The US trade deficit actually widened from $124 billion in 1985 to $147 billion last year. At the time of the August trade figures which immediately preceded the stock market crash, it was running at $152.5 billion over 12 months.

The expansion of other economies to take up the slack from the US has been a long-drawn-out process. The Japanese government has generally won the approval of the US for introducing public spending increases and tax changes, but the gradual nature of a two-part programme of tax cuts introduced by the West Germany government and its reluctance to cut interest rates substantially has come in for widespread criticism from the other major capitalist countries (including Britain).

The recovery from recession may have been accompanied by yawning trade and fiscal imbalances, but recovery it still was, and this has been reflected in corporate profits, which have been rising strongly since the early 1980s. In the UK, for example, return on capital employed in large industrial companies improved from 13.6 per cent in 1980 to 17.9 per cent last year (according to a Bank of England survey).

Buoyed up by booming profits, at least since 1982-3, the end of the high inflation of the 1970s and confidence in the fiscal and monetary rectitude of the right wing governments in power, share prices have been moving strongly ahead since the mid to late 1970s. The rises have been particularly marked in Britain and Japan. According to figures compiled by 'The Economist', the market capitalisation of the UK stock market has risen from around 35 per cent of Gross Domestic Product in 1976 to around 80 per cent in 1986. The Japanese market has swollen from about 30 per cent of GDP to around 80 per cent. By contrast, although the main market indices have been moving strongly ahead on Wall Street the market capitalisation of the US stock market has stayed relatively stable at between 50-60 per cent of GDP.

Booming share prices and worries over the future of world economic growth form the backdrop to the events on stock markets since "Black Monday" on 19 October. But to explain why the crash occurred just then means leaving the heights of economic policy and plumbing the depths of the psychology of greed and fear which rules the world's bourses.

In the most immediate sense, there were two triggers to the stock market crash. One was provided by the US trade deficit. Share prices on Wall Street began to fall sharply in the week before "Black Monday" when the US government announced an August trade deficit of $15.68 billion, hardly a significant fall from July's record $16.47 billion. The markets decided the foreign exchange rate agreements were not working.

The second trigger was provided by US Treasury Secretary James Baker, a man whose flamboyant style (he likes to wander around the Treasury Deparment in cowboy boots) had already given him a reputation for making injudicious comments. On the Friday before the crash, Baker accused the West German government of violating its agreement to keep interest rates low under the Louvre Accord. This was read as a signal that the international agreement might fall apart and that Baker and the US Federal Reserve might be prepared to see the dollar move sharply downwards.

A third factor was more esoteric, but possibly more fundamental. While share prices had been heading upwards, if erratically, since the summer, the underlying worries about the economy had been more pronounced in the world's bond markets, which had been weak over a three-month period.

The result of the weakness in bond markets was that the 'yield gap' between bonds and equities (shares in companies) had been increasing. The yield on a stock measures the income on the stock (the interest in the case of bonds, the dividend paid by the companies in the case of shares) against the price. So as prices fall, yields rise. Bonds always yield more than shares. But rising equity prices and falling bond prices had opened up the 'yield gap' to the point where the slightest knock to confidence could spark off a mass exit from equities into bonds (which is precisely what has happened since the crash).

Whatever the mix of these factors, the result was dramatic. Shares on Wall Street lost $500 billion on Black Monday as the Dow Jones Industrial Index fell by 22.6 per cent in a single session. In London, where the doom and gloom had been bottled up since the previous Thursday, as markets had been closed on the Friday because of storm damage, the Financial Times 100 share index fell by almost 250 points (its previous largest one-day fall was 56 points). Tokyo, now the world's largest stock market, held up rather well. It suffered only its sixth largest daily fall.

In both London and Wall Street, the falls in the market quickly developed into all-out panic, which has now given way to fear as prices stabilise to some extent. The fall in the stock market was quickly followed by a slump in the dollar, which only staged a (fragile) recovery when President Reagan declared he thought it had fallen far enough.

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The bare figures of the crash are dramatic. If stock markets are compared with their world highs on 26 August last year, by 7 November, the US market had fallen by 24 per cent, the UK by 20 per cent, the Japanese by 9 per cent (these figures use the broadly-based Financial Times, Goldman Sachs and Wood Mackenzie actuaries indices rather than the more usual market indicators. The main indices have fallen even further as they concentrate on the shares of the largest companies, which are much more widely traded).

The immediate reaction of leaders of the capitalist countries to the crash was to declare that "the economic fundamentals are sound". Their counterparts said exactly the same after the stock market crash in 1929, which later turned into a catastrophic slump. Share traders, who had been boning up on the events of 1929, were quick to spot the coincidence.

The major fear is that the fall in share values could of itself at best reduce economic growth, especially in the US, at worst produce a recession. This is because of the 'wealth effect'. People with a stake in the equity market feel that they are worse off, so they cut spending and save more, which will cut demand in the economy. Some US economists are predicting only 1 per cent growth in the US economy next year as a result of the wealth effect, while the Bank of England has said it expects a wash-on effect in this country.

To counter the recessionary threat (and in a more immediate sense to calm the financial markets) interest rates have been reduced in the major capitalist countries since the crash. This has risks attached, particularly for the US, which has lost the ability to raise interest rates to support the dollar.

But the economic imbalances still remain and will remain even if the White House agree details with Congress on its deal to cut the US budget deficit by more than $70 billion over the next two years. The longer the US trade deficit remains big, the greater will be the pressure for protectionist legislation against Japanese and German imports. A round of protectionism could quickly tilt faltering economic growth over the edge into outright recession.

Dithering over the deficit and the threat of protectionism could easily lead to another and even more dramatic crash on Wall Street. Traders have been nervously noting that in 1929 initial falls were followed by a period when share prices rose only to fall even further.

The threat of recession is, as usual, leaving those who can least afford to suffer the most to fear. If massive budget cuts are made in the US then, barring enormous tax increases which the Reagan administration would find unacceptable, it will be people who receive welfare benefits who will stand to lose most. Even tax increases are more likely to come through regressive tax increases (a sales tax, for example) than through income tax rises, which the 'supply side' economists in the White House will argue would lessen incentives and promote recession.

An even more dramatic effect could be felt by debt-ridden Third World countries. A fall in world interest rates will lessen the debt load to some extent, but the benefit could be more than wiped out by the loss of export markets which they need to produce the foreign exchange to cover their interest payments. A sharp fall in US imports from the Third World could have drastic effects in South America and move the global crisis on to a different plane — the threat of large-scale default by Brazil or Mexico and the consequent collapse of one or more US banks. The scenario would be likely to produce a crash on world bourses which would make October's falls look like a mere correction of over-inflated share prices.

Behind the jargon

FUNDAMENTALLY, all the operations of Wall Street and City are based on the efforts of working capitalists to get *cash* in return for a promise of a share in their future profits.

Wealthy people give their cash to working capitalists, who can then use it to build factories, buy machines, employ workers, and so on, or to the government. In return the working capitalists, or the government, give the wealthy people bits of paper.

These bits of paper may be entitlements to a fixed rate of interest on the cash — 5 per cent a year, or 10 per cent a year, or whatever. Then they are called **BONDS**. Bonds usually also carry a promise to repay the original cash after a fixed number of years. The Government sells lots of bonds (British Government bonds are also called **GILT-EDGED** stock, and for short-term cash the Government sells **TREASURY BILLS**, which are IOUs repayable, usually, in three months). But capitalist companies sell bonds, too.

Usually capitalist companies do not want to tie themselves to fixed payments in the future, so they sell **SHARES**, or **EQUITIES**, instead of bonds. These bits of paper entitle the holder to a portion, or **DIVIDEND**, of the future profits of the working capitalist's business; but the dividend is not a fixed percentage. It is decided by the company each year.

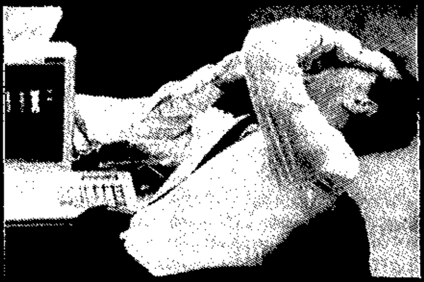
Shares also generally give the shareholder a say in the business. Big shareholders can, and sometimes do, overrule the managers who actually run the business.

When people buy shares, the company never pays back the cash. But wealthy people think it is worthwhile buying shares because of the dividends — and because they reckon they can probably sell the shares to a third person for as much as, or more than, the original price. Share prices go up and down because of two basic factors — the level of dividends, and the general prospects of the company (which influence the price that will be offered for the shares in a takeover). There is also a third factor: if wealthy people *think* that the price of a company's shares will go up, then they will try to buy those shares, and so, by the workings of supply and demand, the price of the shares *will* go up. Within limits, rises and falls in share prices can be self-propelling.

Bond prices can go up and down, too. Suppose a £100 bond is issued at a time when the going rate of interest is 5 per cent. A year later, the going rate is 10 per cent. Suppose, too, that it is a long-term bond — the repayment date for it is many years away. Then the £100 bond — at 5 per cent — will bring the owner just the same gain as a £50 bond issued the second year, at 10 per cent. One is as good as the other. So if the holder of the bond with a face value of £100 sells it, one year on, no-one will pay him or her more than £50 for it.

As this example shows, the price of long-term bonds goes up when the rate of interest falls, and goes down when the rate of interest rises.

So bond and share prices go up and down quite a lot; and people can make big gains by buying when they are cheap and selling when they are dear. That's what the City and Wall Street are all about. They are the arenas in which the moneyed classes carve up among themselves the profits they have screwed out of the working class (and, besides, a chunk of taxpayers' money, through the interest which the Government pays on its bonds) — and try to swindle each other in the process.



It is of no interest to the working class which millionaire strikes lucky and which gets swindled. But the City and Wall Street do affect the wider capitalist economy. Capitalism, after all, is ruled by profit, so the carving-up of profit is important to it. Capitalism produces nothing if not for ready cash or acceptable credit; and the City and Wall Street are where the wealthy and the big capitalist companies find cash and credit.

A crash in share and bond prices, and a rise in the rate of interest, makes it more difficult for businesses and wealthy individuals to get cash or credit. It thus cuts back investment and individual spending. That means a slump in demand, therefore a slump in profits and in employment.

The City and Wall Street are also arenas where the contradiction between capitalism's international reach and its division into national economies works itself out. In the **FOREIGN EXCHANGE** markets, people sell dollars for deutschmarks, or yens for pounds, and so on. They can make gains from that, too. One dollar was worth over 250 yen in February 1985, and is only 130 yen now. So if an American millionaire changed $1 million into yen in February 1985, and changes it back into dollars today, he will have nearly $2 million.

EURODOLLARS are dollars held in banks outside the US (mostly in London). **EUROBONDS** are bonds issued in exchange for Eurodollars (or Euroyen, or whatever).

Governments can influence what happens in these financial arenas. The rate of interest is pushed down if the Government prints a lot of pounds or dollars, and up if the Government holds back the supply of new cash.

A Government is said to have a *tight*, or *contractionary*, **MONETARY POLICY**, if it is going for a high rate of interest and trying to make cash and credit hard to get. The opposite is a *lax*, or *expansionary* monetary policy, when the rate of interest is low and cash and credit are easy to get.

A Government's **FISCAL POLICY** is its policy on the balance between its spending and the taxes it gets in. If the budget **DEFICIT** — the gap between spending and tax revenue — is big, then fiscal policy is said to be expansionary; if it is small, or there is a surplus of tax revenue over spending, the policy is said to be contractionary. Usually, though not always, an expansionary fiscal policy goes together with an expansionary monetary policy, and a contractionary fiscal policy with a contractionary monetary policy.

The rate of interest also affects the **BALANCE OF PAYMENTS**. If the rate of interest is 9 per cent in the US and 3½ per cent in West Germany, then — all other things being equal — wealthy people will take their wealth out of Germany and put into a US bank or buy US bonds. (All other things usually aren't equal. At present, for example, the wealthy classes fear that the dollar's value will fall further, so they prefer to have their money in German bonds or bank deposits even though the rate of interest is lower).

Such flows of money in search of higher interest rates or currencies which are increasing in value make up the **CAPITAL ACCOUNT** of the **BALANCE OF PAYMENTS**. The other side of it is the **CURRENT ACCOUNT** — the flows of money due to trade (imports and exports), interest, profit or dividends going abroad or coming in, and so on. So the trade balance is part of the current account, which in turn is part of the balance of payments.

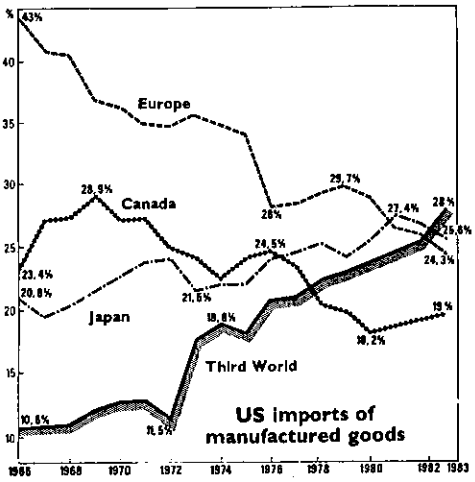
Countries have problems if there is a big deficit on their balance of payments — that is, if there is much more foreign money going out than comes in. Their reserves of foreign currency can be wiped out, and then they have to try to buy currencies on the foreign exchange markets, which — by supply-and-demand — drives down the value of their own currency.

1950-68: long boom

From 1950 to the late '60s, capitalism had its greatest-ever period of growth. Under US domination, the world had fairly free trade and a good supply of credit as the US pumped out dollars. Industries like cars grew and spread enormously. World trade grew at 8.5% per year, output at 5% per year. But the boom undermined US supremacy. Japanese and West European capitalisms, pushed forward by US investment and not burdened by military spending as huge as the US's, grew fastest.

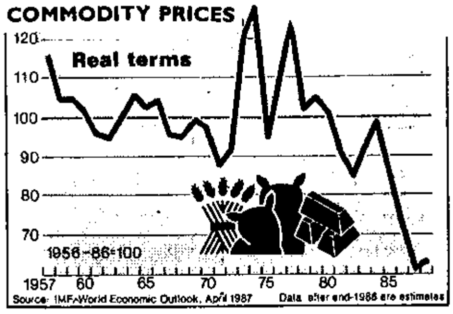
1968-71: the dollar no longer king

Spending on the Vietnam war finally made the US unable to maintain its guarantee of the dollar's value. The orderly, regulated post-war framework began to break down into chaotic cutthroat competition and speculation.

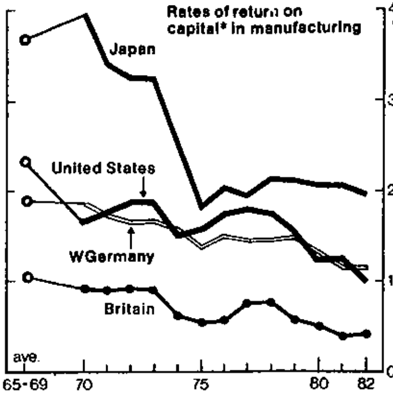


1970s: oil crash and bank lending boom

The balance of forces had been turning not only against the US, but also against the old capitalist metropolises as a whole. Third World countries had won independence and were developing their own capitalisms, fast. This change was signalled in 1973, when oil exporting countries managed to triple the price of oil and grab a much bigger share of oil profits for themselves. The price rise tipped sickly world capitalism into a slump. But the oil cash was channelled through the international banks into loans to quickly-expanding Third World manufacturing powers.



Source: IMF-World Economic Outlook, April 1987 Data after end-1986 are estimates



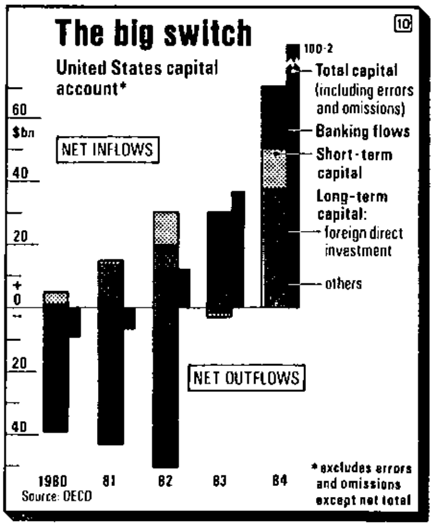
*Gross operating surplus as % of gross capital stock

1979-82: the first world-wide slump

Profit rates had been drifting downwards for many years, as new investment failed to produce the same returns as older, more labour-intensive forms. Capitalism slumped again in 1979-82. The vast expansion of financial connections between countries in the '70s made this the first really global slump ever. Eastern bloc countries like Poland, heavily in debt to the international banks, were pulled in too.

1982: debt crisis

Reduced demand for their exports from the slump-hit advanced economies, and higher interest rates, made Third World countries unable to keep up payments on the money they had borrowed in the '70s. In 1982, Mexico declared itself unable to pay, and the debt crisis has raged ever since, bringing vicious IMF austerity plans to many countries. Falling prices for the raw materials which are still their basic exports have made the squeeze still tighter for many poor countries.



Source: OECD

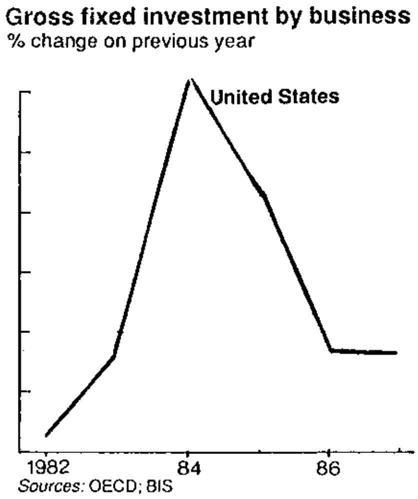
* excludes errors and omissions except net total

1983-7: the US spends, spends, spends

The big capitalist governments decided to 'sweat out' the 1979-82 slump, and used it for a fairly successful assault on workers' organisations. Since 1983 profit rates have risen again. The US has had a sort of boom, with high military spending and consumer credit. The huge amount the US spent on imports from Pacific Rim countries has brought it a big trade deficit, but this has been balanced by a tremendous flow of investment into the US.

1986: Big Bang

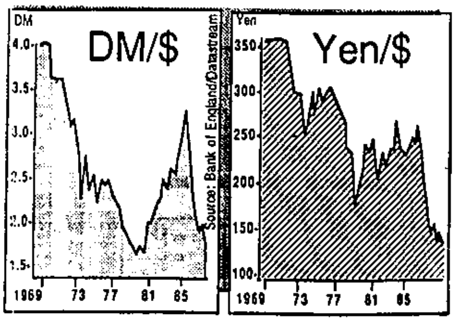
In the 1980s international capital has become more and more fluid and mobile. London's 'Big Bang', in October 1986, epitomised this trend. Share prices boomed; up to February 1985 the dollar rose higher and higher as money flooded into the US. But then the dollar slid, without this mending the US's trade deficit; and investment fell off in the US.



Sources: OECD; BIS

19 October 1987: share prices crash.

The bubble burst on 19 October last year. In a few weeks some $1,000 billion was wiped off share prices in the US, and similar amounts elsewhere.



Source: Bank of England/Datastream

Into the unknown

Since last October the dollar has slid fast, and one possibility now is a catastrophic loss of confidence in what is still the only approximation to world money. Trade wars, a slump in demand in the US, and sudden worsening of the Third World debt crisis are other possible routes to slump. The hectic chaos of modern international finance is taking its revenge on those who have profited from it.