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October 19 and 20, 1987:

The Crash and The Freeze

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The Wall Street Journal's main headline of Nov. 20 was

"TERRIBLE TUESDAY

HOW THE STOCK MARKET ALMOST DISINTEGRATED
A DAY AFTER THE CRASH

CREDIT DRIED UP FOR BROKERS AND ESPECIALLY SPECIALISTS
UNTIL FED CAME TO THE RESCUE

MOST PERILOUS DAY IN FIFTY YEARS."

"A month ago today, the New York Stock Exchange died. But within an hour or two, it was raised from the dead." was the first paragraph of the article that followed. During this short death on Tuesday October 20 stock exchange assets could not be sold at a price that covered debts that security dealers had used to finance their holdings. These assets were frozen; to sell them at the market price guaranteed bankruptcy.

This freeze following the crash of October 19 meant that capitalism itself was critically ill. Massive government interventions were required to bring about its recovery. Such interventions took place and were successful.

The combination of market failure and successful intervention should lay to rest the claim of conservative economics that modern market economies are both self equilibrating and engines of economic growth. It tends to validate the position that capitalist economies are intermittently unstable and that successful capitalism needs both regulation and intervention.

The New York Stock Exchange operates on a "specialist" system. Each specialist is a market maker for particular stocks. He has a "book" with orders to buy and sell these stocks. Normally this book is such that if price falls a bit buy orders exceed those to sell and if price rises a bit sell orders exceed those to buy. By buying and selling for their own account specialists make sure that prices rise and fall smoothly.

By noon of October 20th the market was overwhelmed by orders to sell. There were no orders to buy at prices that were even remotely related to recent transaction prices. To maintain a smooth market the specialists would have to absorb billions of dollars of stocks. This was beyond their capacity and, as the potential for losses was great, such absorption would not be wise.

Trading in stocks came to a virtual halt: stock market assets were frozen. By noon stock exchange quotations greatly exaggerated the prices at which transactions could take place.

Specialists and other security firms operate on borrowed money. On Tuesday the major New York and international banks informed specialists and security dealers that further credit was not available. Furthermore banks began to call in loans. As the crash developed on Monday the Federal Reserve provided funds to the banking system. Financing was withdrawn on Tuesday because banks believed the risks were too high, not because funds were short.

When the market froze on Tuesday the Federal Reserve Bank of New York intervened. Corrigan, President of the New York Federal Reserve Bank, was in touch with bankers, such as Reed of Citicorp. After receiving "assurances from the Fed" and "greater than normal considerations" (Wall Street Journal, Nov.20) banks began to accomodate Wall Street firms. It is reasonable to conjecture that lending was resumed because these Federal Reserve "assurances" and "considerations" protected banks from losses.

Before Tuesday ended Citicorp increased its loans to security firms to $1,400 million from a "normal" day's $200 to $400 million. During the week of October 19 the New York banks increased their loans to security dealers by some $5.5 billions. The Federal Reserve's implicit or explicit absorbtion of risk was effective in inducing lending.

Between noon and 1:00 p.m. a number of giant firms announced programs to buy back their shares on the open market. Apparently these announcements were orchestrated by the the White House staff and the Treasury.

It is likely that an esoteric stock index security was manipulated by security dealers, but this is of secondary importance in the thawing of the market. The intervention by the Federal Reserve and the orchestration of buy back announcements by the administration ae of primary importance in explaining why assets that were frozen at noon were once again liquid at 1:00 p.m. and why a day that started as another disaster ended with the Dow-Jones index enjoying a substantial gain.

The fragility of prosperity in 1987 is in sharp contrast to the robustness of prosperity in the 1950's and 1960's. This shift to fragility from robustness reflects an often noted characteristic of capitalist financial structures to become fragile after an extended period of overall success.

The stock market crash reflected a decrease in confidence in the future of business profits and the freeze showed the vulnerability of the stock market to disruption. The lower price of stocks can be expected to induce a decline in the price of other assets. In particular the prices of commercial real estate can be expected to fall. The post crash environment will lead to a decline in the demand for commercial space. We can expect commercial construction to be adversely affected.

After 1982 the potential for gains on the stock exchange induced foreigners to hold dollar assets. This propped up the value of the dollar. We can now expect the dim prospects of the stock market to lead to a withdrawal of funds from the United States. As a result the exchange value of the dollar will fall below the level that would suffice to eliminate our trade deficit.

The beggar my neighbor exchange rates that operated in favor of Germany and Japan in the 1980's will give way to begger my neighbor exchange rates that operate in favor of the United States. But for this to be consistent with the world avoiding a severe recession, Germany and Japan will have to sustain their economies by expansionary monetary and fiscal policies to offset their loss of exports.

The crash of October 19th was chilling, the freeze of the 20th was frightening. The worst that could have happened did not happen because of the massive intervention by the Federal Reserve and the orchestration or manipulation of markets by the administration.

The jury is still out on whether the disaster of a depression will be avoided, but the chances for avoiding disaster will be enhanced if a year from now we are awaiting the inauguration of a President who understands the constructive role government must play for a capitalist economy to be successful.