Thirty years since Wall Street's "Black Monday"

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Thirty years ago today, on October 19, 1987, the New York Stock Exchange experienced what remains its largest one-day fall in history. On "Black Monday", the Dow Jones fell 22.6 percent with the S&P 500 index dropping 28.5 percent for the period October 14-19.

The total loss of financial wealth during the crisis has been estimated to be around $1 trillion. But unlike 2008, the financial crisis did not precipitate a broader economic crisis and was over relatively quickly due to a major intervention by the US Federal Reserve, operating both directly and through the pressure it applied to major banks to extend liquidity to financial firms.

But that is not to say that its effects were transitory or that it merely represented some kind of brief malfunction in an otherwise sound financial system. In fact, what can be seen, both in the crash and the response to it, are the immediate origins of the processes that have led to the series of financial storms over the past three decades, the most serious, so far, being the crisis of September 2008.

The period leading up to "Black Monday" was one of great transition in the US economy and financial system, as well as globally. Whole areas of US industry were devastated by the high-interest rate regime, initiated by Carter appointee Paul Volcker as Federal Reserve chairman in 1979, a policy that was continued and deepened during the first years of the Reagan administration in the 1980s.

It was a process replicated around the world as key sections of industry, built up during the post-war economic boom, were laid to waste in what, to that point, was the most serious recession since the 1930s.

As industry was being destroyed, regulations that had been introduced to constrain the operations of finance started to be dismantled in order to clear the way for the accumulation of profit through speculative operations.

This was the start of the era of leveraged buyouts, using so-called junk bonds of dubious quality, in which whole firms could be gobbled up in hostile takeovers and then carved up and sold off at great profit. New financial instruments were developed to facilitate financial speculation that were to play a significant role in the 1987 crash.

In the lead-up to "Black Monday", the Dow Jones index had raced ahead, rising by 44 percent in the seven months to the end of August, leading to expressions of concern that a financial bubble was being created. But despite these warnings, the speculation continued.

In 1985, the major industrial nations of the G6—France, the US, Britain, Canada, West Germany, Great Britain—had reached a deal (the Plaza agreement) to allow the US dollar to depreciate. But two years on, this was causing inflation concerns, leading to a new agreement, the Louvre accord, in February 1987, which was aimed at trying to halt the slide of the dollar and stabilise currency alignments.

However, in October 1987, Germany, which had agreed to keep interest rates low, moved to raise them due to inflation fears, causing the Fed to lift its discount rate to 7 percent and sending the rate on US treasury bonds to 10.25 percent. The shift in interest rates was the immediate trigger for the collapse of markets that was to follow.

With the announcement of a larger-than-expected trade deficit, a fall in the value of the dollar and fears that interest rates would rise, the markets began to fall from October 14. By the end of trading on Friday, October 16, the Dow was down 4.6 percent on the day and the S&P 500 had dropped by 9 percent in the previous week, setting the stage for what was to happen.

When international exchanges opened on Monday, before US trading began, it was a bloodbath in Asia and the Pacific as markets plummeted—the New Zealand market dropped by 60 percent.

The US market crashed from the opening bell in what was the first global financial sell-off. The plunge was exacerbated by a series of financial innovations that had been introduced in the previous years in order to facilitate speculation.

US investment firms had developed new financial products known as "portfolio insurance". They were supposedly designed to protect investors from the effects of a downturn through the use of futures options and derivatives. The problem, however, was that they all operated on fundamentally the same model so that when the crash began there was a simultaneous rush for the exits.

Another factor was the introduction of computerised trading in which large numbers of stocks were sold, again on the basis of similar mathematical and financial models. Such was the volume of the trades that many of the reporting systems were simply overwhelmed. On the New York Stock Exchange, trade executions were reported up to an hour late, causing great confusion.

At the end of Black Monday, there were great fears about what was going to happen the next day. Before markets opened, the newly appointed chairman of the Federal Reserve, Alan Greenspan, who had taken over from Paul Volcker the previous August, issued a statement that was to become the basis of Fed policy from then down to the present day.

"The Federal Reserve, consistent with its responsibilities as the Nation's central bank, affirmed today its readiness to serve as a source of liquidity to support the economic and financial system," the statement read.

It was the beginning of what subsequently became known as the "Greenspan put", understanding that the central bank would always be on hand to step in and support the financial markets.

The statement was backed up by action. In testimony given to the Senate Banking Committee in 1994, Greenspan said that "telephone calls placed by officials of the Federal Reserve Bank of New York to senior management of the major New York City banks helped to assure a continuing supply of credit to the clearinghouse members, which enabled those members to make the necessary margin payments."

In 1990, Ben Bernanke, the future chairman of the Federal Reserve, noted that making such loans must have been a money-losing strategy from the point of view of the banks, otherwise Fed persuasion would not have been necessary, but it was a good strategy for the "preservation of the system as a whole."

The extent of the intervention can be gauged from the fact that the lending of Citigroup to securities firms increased from a normal level of $200 to $400 million per day to $1.4 billion on October 20, after the bank's president had received a call from the president of the New York Fed.

The policy of Fed intervention was to continue through the 1990s and into the new century. However, the fundamental contradictions of the capitalist financial system were not overcome but intensified. Consequently, when the crisis of 2008 struck, the Fed policy of leaning on the major banks was completely inadequate because it was the banks themselves that had either gone broke or were on the brink of collapse.

The Fed and other central banks around the world stepped in with massive bailouts and have sustained financial markets since then through their policies of financial asset purchases—quantitative easing—and ultra-low and even negative interest rates.

The outcome has been to neither restore economic growth nor create financial stability. Assessments of the price-earnings ratio of US markets have found that they are at elevated levels, exceeded only by 1929 and the dotcom bubble of the early 2000s. This is under conditions where economic growth, productivity and international trade—measures of the real economy—remain below their pre-2008 trends.

In 1987, the securities firms were bailed out by the banks. Little more than two decades on, the banks themselves had to be bailed out. But in another financial crisis, the central banks themselves will be directly involved because of their massive holdings of tens of trillions of dollars of government bonds and other financial assets.

In assessing the present situation, it is worth recalling an analysis made of the 20th anniversary of "Black Monday" by the Australian news outlet, the ABC—no doubt typical of many.

In the midst of a period of economic growth—the IMF had noted in 2006 that the world economy was expanding at its fastest rate for three decades—it cited financial analysts who maintained that a crash on a similar scale to 1987 was unlikely to be repeated. There was not the same interest rate structure and "we have a far more internationally coordinated banking system than was the case in 1987," according to one of them.

"With rapid economic growth expected to continue in Asia," the article concluded, "the market consensus appears to be that the bull run still has some way to go."

Just 11 months later, in September 2008, the world was plunged into the deepest economic and financial crisis since the Great Depression of the 1930s.