
The Lessons of Black Monday

By Barry Eichengreen *Thu, Feb 15, 2018*

When interpreting the recent market lurch, many will think back to 2008. But a better historical precedent for current conditions is Black Monday: October 19, 1987, writes our guest columnist, the famed macroeconomist.



US President Donald Trump has regularly pointed to the stock market as a source of validation of his administration's economic program. But, while the Dow Jones Industrial Average (DJIA) has risen by roughly 30% since Trump's inauguration, the extent to which the market's rise was due to the president's policies is uncertain. What is certain, as we have recently been reminded, is that what goes up can come down.

When interpreting sharp drops in stock prices and their impact, many will think back to 2008 and the market turbulence surrounding Lehman Brothers' bankruptcy filing. But a better historical precedent for current conditions is Black Monday: October 19, 1987.

Black Monday was a big deal: the 22.6% price collapse is still the largest one-day percentage drop in the DJIA on record. The equivalent today would be - wait for it - 6,000 points on the Dow.

In addition, the 1987 crash occurred against the backdrop of monetary-policy tightening by the US Federal Reserve. Between January and October 1987, the Fed pushed up the effective federal funds rate by nearly 100 basis points, making it more expensive to borrow and purchase shares. In the run-up to October 2008, by contrast, interest rates fell sharply, reflecting a deteriorating economy. That is hardly the case now, of course, which makes 1987 the better analogy.

The 1987 crash also occurred in a period of dollar weakness. Late in the preceding week, Treasury Secretary James Baker made some remarks that were interpreted as a threat to devalue the dollar. Like current Treasury Secretary Steven Mnuchin at Davos this year, Baker could complain that his comments were taken out of context. But it is revealing that the sell-off on Black Monday began overseas, in countries likely to be adversely affected by a weak dollar, before spreading to the US.

Finally, algorithmic trading played a role. The algorithms in question, developed at the University of California, Berkeley, were known as "portfolio insurance." Using computer modeling to optimize stock-to-cash ratios, portfolio insurance told investors to reduce the weight on stocks in falling markets as a way of limiting downside risk. These models thus encouraged investors to sell into a weak market, amplifying price swings.

Although the role of portfolio insurance is disputed, it's hard to see how the market could have fallen by such a large amount without its influence. Twenty-first-century algorithmic trading may be more complex,

but it, too, has unintended consequences, and it, too, can amplify volatility.

Despite all the drama on Wall Street in 1987, the impact on economic activity was muted. Consumer spending dropped sharply in October, owing to negative wealth effects and heightened uncertainty, but it quickly stabilized and recovered, while investment spending remained essentially unchanged.

What accounted for the limited fallout? First, the Fed, under its brand-new chairman, Alan Greenspan, loosened monetary policy, reassuring investors that the crash would not create serious liquidity problems. Market volatility declined, as did the associated uncertainty, buttressing consumer confidence.

Second, the crash did not destabilize systemically important financial institutions. The big money-center banks had used the five years since the outbreak of the Latin American debt crisis to strengthen their balance sheets. Although the Savings & Loan crisis continued to simmer, S&Ls were too small, even as a group, for their troubles to impact the economy significantly.

What, then, would be the effects of an analogous crash today? Currently, the US banking system looks sufficiently robust to absorb the strain. But we know that banks that are healthy when the market is rising can quickly fall sick when it reverses. Congressional moves to weaken the Dodd-Frank Act, relieving many banks of the requirement to undergo regular stress testing, suggest that this robust health shouldn't be taken for granted.

Moreover, there is less room to cut interest rates today than in 1987, when the fed funds rate exceeded 6% and the prime rate charged by big banks was above 9%. To be sure, if the market fell sharply, the Fed would activate the "Greenspan-Bernanke Put," providing large amounts of liquidity to distressed intermediaries. But whether Jay Powell's Fed would respond as creatively as Bernanke's in 2008 - providing "back-to-back" loans to non-member banks in distress, for example - is an open question.

Much will hinge, finally, on the president's reaction. Will Trump respond like FDR in 1933, reassuring the public that the only thing we have to fear is fear itself? Or will he look for someone to blame for the collapse in his favorite economic indicator and lash out at the Democrats, foreign governments, and the Fed? A president who plays the blame game would only further aggravate the problem.

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