THE STOCK MARKET CRASH AND THE WORLD ECONOMY

Ted Wheelwright

The crash last October is the most important single economic event of recent times. It was worse than the crash of 1929 in terms of the size of the fall, and it came very close to a financial collapse. The Chairman of the New York Stock Exchange said that it was the nearest thing to a "meltdown" that he ever wanted to see. President Reagan immediately set up a Task Force on Market Mechanisms, which reported in January. It said:

> Monday 19 October was perhaps the worst day in the history of the US equity markets...By midday Tuesday the financial system was in peril ... it was close to gridlock.

> It was only saved by the prompt intervention of the US Federal Reserve Board, which said that:

> The Federal Reserve, consistent with its responsibilities as the nation's central bank, affirmed to-day its readiness as a source of liquidity to support the economic and financial system.

Other Central Banks followed suit, pouring billions into the financial system, preventing its total collapse. This is one reason, incidentally, why interest rates fell, accentuating the switch from equity investment into bank deposits and property, causing a housing and property boom.

Analysing the Crash

Why had the financial system to be propped up in this way? The answer has to do with the close ties which have developed between the stock market and the banks.

Broadly, the dealers in stock market securities borrow heavily from the banks for their day-to-day operations. In some markets as little as 5-10% deposit is required; the rest is borrowed from the banks. It was J.M.Keynes who first called the stock-market a casino. But the essential point here is that the casino gamblers play with funds supplied by the banks. The collateral for these loans is the stock or shares being bought. If the price of the purchased stock is going up, its value exceeds that of the loan; but if it is falling sharply, the collateral for such loans can vanish in a few hours. In such circumstances the banks can suffer huge losses. Left to themselves, the most heavily committed banks would go broke, as happened in the USA in 1929, when the Federal Reserve tightened credit instead of loosening it.

The recent rescue of the system by central banks is prompting a revival of the old question whether the main function of central banks is to protect the wealth of the wealthy. It raises a new question - whether such action is an example of new techniques of socialism being practised by capitalists, ie., socialising losses and privatising profits. However, the essential point is that the system has been rescued - for the moment - by public action, using public funds.

Various enquiries into the crash in the USA have now reported. The following points emerge:

A small group of big financial institutions played a crucial role; five such institutions, including a bank, an insurance company and pension funds, placed huge orders - 30,000 contracts out of 80,000 - with a face value of $4 billion.

- They used techniques controlled by computers, involving a form of arbitrage called "portfolio insurance", which involved selling in one market - the stock exchange in New York - and buying in another market - the futures market in Chicago.

- These futures markets were unable to cope with the tremendous volume of orders; stock prices fell faster than the "insurance" programs were designed for.

- In short, the financial markets could not handle the sheer volume of trading fuelled by automation and processed by computers. These markets broke down, especially at "stockbrokers' lunchtime, when the automatic pilot was engaged during a period of unprogrammed turbulence".

This raises an important question about the nature and functioning of markets. It is well known that they have often over-reacted to price signals, thereby causing instability, but now there is an additional reason - the instantaneous reaction provided by computerisation. It is possible that in this case it operates to negate markets by cutting virtually to zero the time needed to make adjustments; i.e. it may be that imperfections in markets help their stability. This is an intriguing question calling for research, and it is associated with the acceleration of the concentration of financial markets into an even smaller number of ever larger financial institutions.

Too little attention is being paid to the oligopolisation of the finance industry which now dominates modern capitalism. One consequence stands out - that as financial institutions trading on stock markets have become so much larger, they are now trading "baskets", or portfolios of stocks and shares, which include those of many companies across a wide spectrum of industries, rather than trading in individual stocks. Hence such large investors are more concerned with the market as a whole, or at least large sections of it, rather than with the fortunes of a particular corporation. Consequently the managers pay more attention to matters such as interest rates, inflation, the price of the dollar, debt, and trade balances. Less attention is paid to the profitability of a particular company.

This is a good example of how, with increasing concentration and conglomeration, the distinction between "macro" and "micro" breaks down. It is also a good example of how, as capitalism "collectivises" itself, its *modus operandi* changes. The individual investor is all but driven out of the market, and the interaction of a few giant institutions, mediated through modern technology, creates a qualitative change in the nature of the market.

Deregulation

This takes us into the question of the transformation of the stock exchanges of the world, including Australia, partly as a result of de-regulation over the last decade. Regulations were placed on financial institutions and markets many years ago because it was thought to be economically unhealthy to have them too large, too irresponsible, and embracing too many functions which straddled several markets. The evidence for this was the endemic financial panics, swindles, crises and crashes around the world, which became evident from the Great Depression of the 1890s through to the hyper-inflations of the 1920s, the crash of 1929, and the Great Depression of the 1930s. Finance was thought to be too important to be left to the financiers.

For example, in various countries at various times:

- Banks had to be licensed by a central bank and the nature and extent of their lending was controlled by a range of devices
- In some countries banks had to be kept local and were not allowed to become national; in others foreign banks were not allowed in.
- Markets were segregated and not connected; financial activities were regulated according to function, such as those of savings banks, building societies, merchant banks, short term money market operators, stockbrokers and stock jobbers, etc.
- Stock-brokers were not allowed to be incorporated, or to sell shares to interested parties, such as merchant banks, trading banks, or fund managers.

Financial deregulation over the last decade has abolished much of this former state of affairs, and consequently has revolutionised and transformed financial markets throughout the world. This is probably the most important single event in the internationalisation of world capitalism over the last decade.

In the UK, for example, by the mid 1980s all except one of the London stockbrokers were owned by international financial conglomerates. Of all the equities traded on the exchange, 70% were owned by financial institutions. There is obsessive emphasis on short term returns. Managers of funds tend to compete with one another on this basis. The trading floor has been abolished on the London exchange; traders do not have to be there, physically, in the market, they can be anywhere in the world, as all trading is done on electronic screens.

The Australian Stock Market

In Australia, over the last five years or so, the stockmarket has also been transformed. It is now a peripheral market of global capital, dominated by the finance capital of the UK and the USA. This followed from the de-regulation of the banking and foreign exchange system by the Hawke Government in 1983, which had been begun by the Fraser Government as a result of the Campbell Commission established in 1979. In 1981 the Commission recommended that virtually all of the government controls over the financial system be either eliminated or drastically reduced. As a result, the whole financial system, and especially the stock exchange, was opened up to foreign capital. Previously brokers could not be incorporated, but by 1985 they could, and non-residents can now acquire 100% of the equity of such stock-broking companies.

The three big private banks were the first to take advantage of these opportunities: Westpac bought into Ord Minnett; the National Bank joined up with A.C. Goode; and ANZ took a part of McCoughan Dyson. By 1987, 70% of all stockbrokers had become corporate entities; there were 76 corporate stockbrokers, and about half had overseas partners, such as foreign banks or foreign stockbrokers. In some cases the foreign ownership has now reached 100%. Three big overseas companies will open their doors in Australia in the next few months: Merrill Lynch, the US firm, which has had the biggest slice of the Australian market of overseas brokers; Baring Brothers, which has had a presence here through its merchant bank, and is one of the strongest foreign brokers in Japan; and the British broker T.C. Coombs, which has always been a large dealer in Australian shares in London.

The only two institutions in Australia known to have portfolio insurance, or program trading, are Country Natwest which is owned by the National Westminster Bank, and Dominquez Barry Samuel Montagu Securities Ltd, which is believed to have been bought into by the British Midland Bank. Only Natwest had its system running at the time of the crash, managing about $70m which is a very small portion of the local equities market; just before the crash the capitalisation of the Australian Stock Exchange was $300,000 m. For comparison, that of Tokyo, the largest exchange in the world was US$2,837,760 m; that of New York was $2,489,280 m; and that of London $634,560 m. Australia's current share of the world equity market is about 2%.

According to Morgan Stanley Capital Analysis, the Australian share market had the biggest fall of all international markets in October, falling 44.7%, followed closely by Hong Kong with 43.6%, and then by Mexico and Singapore Malaysia. This prompted Colleen Ryan to observe in the SMH (22.12.87) that in international eyes Australia had become a peripheral market, a "hot money" market, which was now much more volatile after the removal of exchange controls. Pointing out that the previous rise was almost as meteoric - the fourth strongest in the world - she said that much of the money coming on the market in that quarter was foreign money, and much of the money leaving in October was foreign money.

However, no official figures are available on the presence of foreign money in the stock market. A poll of brokers' opinions places the figure at about 25% of market capitalisation at the height of the full market, down to about 10% by the end of the year. Ian Story, of brokers BZW Meares & Co, contends it is not so much the size of the foreign presence, as the multiplier effect at the margin in times of instability, because foreign money is more mobile than local money.

According to brokers, the biggest sellers in October were the UK fund managers, followed by the US ones, and to a lesser extent, the Tokyo ones. A structural factor is that the Australian market probably had a higher proportion of "entrepreneurial stocks", except perhaps for New Zealand, and when the investment climate turns to risk minimisation, "the entrepreneurs take a hammering". Also, a small market such as the Australian exchange has advantages for foreigners buying into a rising market, as they can show big gains in a short time; but when it begins to collapse, it is a different story, as there is not enough volume to get several billion dollars out of the market quickly, without a severe fall.

It seems clear that individual investors do not play much of a role in stockmarkets to-day. Most studies of share ownership show that the dominant owners are financial institutions of one kind or another, or other companies. On individual owners, a survey conducted by the Australian Associated Stock Exchanges, published in 1986, showed that only 7% of the population owned shares; most had shares in only one or two companies, and over 80 completed less than six transactions on the stock market per year.

Qualitative Changes

The major characteristics of stock exchanges have changed significantly in this decade in several important respects:

- the nature of the trading - by institutions rather than persons, and through computerised programming rather than individual decisions, causing ever larger volumes of trading to flow through the market more quickly than ever before.
- the characteristics of the traders- there are far fewer small scale partnerships, and far more very large operators who are owned by, or linked with, big banking institutions of one kind or another.
- the linkage of the stock market with foreign exchange markets, with futures markets, and with money markets - in which large operators are increasingly linked with big banks in various ways.

- the capitalization of stocks traded - this has increased enormously because of the increasingly capital intensive nature of most modern production; because of the scale of take-overs and mergers leading to increasing concentration of industry; and because of the tendency of already large corporations to operate on a global and therefore much larger scale.
- he increasing pace of the internationalization of capitalism - this has forced the internationalization of stock markets, so that what happens in one market is reflected in another instantaneously.

All this amounts to a qualitative change in the *modus operandi* of stock exchanges, and indeed all financial markets, which are increasingly interconnected. The key variables - size, volume, speed, range of operation, ownership and control, objectives - are all being revolutionised, and a new analysis of their functions is required. The analysis needs to recognise that the relationship between stock markets and economic systems varies internationally. For example, the two big surplus countries, Japan and W.Germany, have shown very different patterns; by mid-April this year the Tokyo market rose to its height of last year, whereas Frankfurt was down 32% from its previous high. Tokyo may be the "odd man out" because of the nature of state capitalism in Japan, where financial institutions have such economic concentration that, in conjunction with government, they are able to manage the market to a considerable extent. Of course, the impact of Japanese operations is not in doubt; it is the worlds' largest creditor country; it has the worlds' biggest stock market; and is the second largest economy in the capitalist world, with the highest rate of growth at the moment. Indeed, its massive selling of US bonds is believed to have driven up the bond rate to four times the return on equities, and is believed to have been the trigger for the stock market crash in the USA.

The essential point is that political economists need to focus more on the analysis of the relationship of stock markets to economic systems. An historical approach is needed, tracing the evolution of the capitalism from its origins as a small scale competitive system in which the stock market performed the function of providing capital, to a large scale oligopolistic system operating on an international scale, in which its function is to provide liquidity for investors, rather than capital. Increasingly, and especially with the de-regulation of other financial markets, this leads to speculation which has little to do with production, and becomes more and more parasitical. As Keynes pointed out in his *General Theory of Employment, Interest and Money* "when the investment decisions of a country become the by-product of a casino, the job is likely to be ill-done".

Towards Re-regulation?

Not surprisingly, regulatory agencies are considering what changes should be made to avoid a repetition of the sharemarket collapse. The chairman of the Australian National Companies and Securities Commission, Henry Bosch, said that the unprecedented suddenness of the share crash in Australia sprang largely from sell orders mainly generated by computer-linked trading and portfolio insurance techniques. The NCSC was considering the findings in the USA on the co-ordination of monitoring stock and futures markets and computer-linked trading. One finding was that the four largest data providers in the world now covered 100,000 equities, connected 110 exchanges, and included 300,000 terminals in over 110 countries. This, it could be said, is of the essence of global capitalism.

The chairman of the London Stock Exchange, Sir Nicholas Goodison, has called on central banks to become the prime regulators of the securities industry, because of the heavy involvement of banks in the securities markets, and the risks this brings to the world financial system. The chairman of the British Securities and Investment Board, Sir Kenneth Berrill, told the Securities Institute of Australia that the crash had intensified the need for centralised regulation. Recent trends, he said, were for major institutions to be part of a conglomerate which owned or controlled a bank somewhere, which enabled them to play in two or three major markets and a few smaller ones as well. While the markets themselves had come together to form a global market, regulatory measures had not.

These remarks echoed those of US regulators calling for more international co-operation in regulating the banking and securities industries, e.g. the Brady Commission suggested that the Federal Reserve be responsible for co-ordinating regulation of securities and banking activities in the US. In February senior regulators from the US and the UK met in New York to discuss the problems US security houses were facing because of new regulatory structures in Britain; another meeting involved Japanese regulators. These are the growing points of a trend towards new methods of the international regulation of financial markets, which are now largely out of national control but increasingly inter-linked on a world scale.

Conclusion

There is a kind of dialectic of world capitalism at work, which political economists need to study more closely. The immediate task is to relate the crash to the changing structure and technology of financial markets and institutions, and their relationship to global capitalism, which is seeking new forms of international co-ordination through economic summits and monetary agreements with central banks and their organisations. A re-reading of Hilferding's *Finance Capital*, and the revisionist thesis of Bernstein, would be a useful beginning.