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# The October ’87 Crash Ten Years Later

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*This* Economic Letter *is adapted from remarks delivered by Robert T. Parry, President and Chief Executive Officer of the Federal Reserve Bank of San Francisco, at a conference sponsored by the Graduate School of Management at the University of California, Davis, on October 17, 1997, entitled “The October ’87 Crash: What Have We Learned about the Causes and Consequences of Large Market Movements?”*

On October 19, 1987, “Black Monday,” the Dow Jones Industrial Average plunged 508 points–the largest one-day drop in history. The next day, Tuesday, raised the spectre of a disintegration of the market and with it a very serious threat to the functioning of the entire U.S. financial system. While the “whys and wherefores” of this event remain the subject of research and debate, this *Economic Letter* focuses instead on the Fed’s role in responding to the crisis. Specifically, it discusses why the Fed intervened after the crash, what we did to help stabilize the market, and what lessons we learned.

## The Fed’s role in financial crises

A stock market crash raises a couple of interrelated policy issues for a central bank: one has to do with our role as monetary policymaker, and the other with our role in ensuring the safety and soundness of financial markets and the payments system–that is, as “lender of last resort.”

From the monetary policy point of view, we were concerned that the loss of wealth due to the crash might cut consumer spending and lead to an economic contraction. When the market bottomed out, the loss of wealth owned by individuals amounted to nearly eight hundred billion dollars, and in theory, this could have reduced people’s spending on consumer goods. It’s true that the response of consumption to a given change in wealth has always been estimated to be relatively small. But the size of *this* crash meant that the wealth effect might have had an important impact on overall economic activity.

As it turned out, the “wealth effect” *wasn’t* a key threat. Looking back, it appears to have had nearly imperceptible effects on spending. One reason may have been that stock prices right after the crash were actually above the levels of the previous year.

Fortunately, we didn’t need to wait for the published data–which come in with a substantial lag–to know that we weren’t dealing with an overall slowdown in economic activity. Through the District Banks and their branches, the Fed has a nationwide network of contacts that includes current and former Directors on our Boards as well as a number of Advisory Council members. And the message from virtually all of them was that the crash wasn’t having a big effect on regional economic activity. Indeed, in the year after the crash, GDP growth was quite strong.

Instead, the greater threat was to the viability of the exchanges and brokerage firms, and, by extension, to the perfectly sound businesses that might have failed if the exchanges had collapsed. Addressing this threat has a lot in common with the Fed’s historic role as lender of last resort in preventing banking panics. Like banks, the various intermediaries in the stock and bond markets held relatively small amounts of capital. This made them vulnerable to sudden withdrawals by lenders.

When firms have problems because of their own business decisions, it’s clearly *not* the Fed’s role to step in and help out. In fact, doing so would only create a moral hazard, inducing firms to take excessive risks and leading to instability in the financial system as a whole. But when the effects of a bank run or a break in the stock market spread to fundamentally sound firms and threaten the stability of the financial system–that is, when there’s *systemic* risk–then the Fed has a clear and important role to play.

### How systemic risk arose in 1987

We usually think of stock exchanges as highly liquid markets, largely because of the financial intermediaries in these markets who stand between buyers and sellers by guaranteeing the execution of transactions. For example, stock exchange specialists *must* buy into falling markets in order to serve as a shock absorber. The system works very well to maintain liquidity when buy and sell orders aren’t too far out of balance. Ordinarily, a small stock of inventories relative to gross trade flows is enough to bridge the gap between buy and sell orders. Furthermore, clearinghouses can guarantee the execution of trades in the face of any individual’s default risk.

But on October 19, order flows were grossly out of balance–there were virtually no other buyers. That left the specialists at the end of the day with much larger inventories than usual. They had to pay for those purchases within five business days and needed credit to do so. In addition, investors had to meet margin calls as prices fell, and brokerage firms extended credit to many of their customers to enable them to do so. Finally, the solvency of the clearinghouses was in doubt, because the default risk they were insuring was systemic. Although the clearinghouses were well capitalized, they weren’t able to bear this kind of risk, and on the morning of October 20 there was a real possibility that they might fail.

At this point, then, all these players needed *additional* credit to continue their functions. But banks were growing nervous and reluctant to lend. And who can blame them? The drop in asset prices cast doubt on the creditworthiness of all parties: investors, specialists, brokerages, and clearinghouses. Furthermore, the reluctance of banks and other creditors to issue further loans itself increased the risk of default. So there was a genuine risk that expectations of a market meltdown would become self-fulfilling.

### How the Fed intervened

Before the market opened on October 20, the Fed issued the following announcement: “The Federal Reserve System, consistent with its responsibilities as the nation’s central bank, affirmed today its readiness to serve as a source of liquidity to support the financial and economic system.” This affirmation of the Fed’s responsibilities to serve as lender of last resort was intended to reverse the crisis psychology and to guarantee the safety and soundness of the banking system.

The Fed backed up this announcement with a number of critical actions, and I’ll highlight four of the most important.

- First, we added substantially to reserves through open market operations. The funds rate fell from 7-1/2 percent just before the crash to 6-1/2 percent in early November. This added liquidity helped prevent the crash from spreading to bond prices.
- Second, we liberalized the rules governing the lending of securities from our own portfolio to make more collateral available.
- Third, we used all of our contacts in the financial system to keep the lines of communication clear and open. In talking with banks, for example, we stressed the importance of ensuring adequate liquidity to their customers, especially securities dealers, and at the same time affirmed that they were responsible for making their own independent credit judgments. We also were in close touch with participants and regulators in the government securities market, officials at the various exchanges and their regulators, and our colleagues at central banks in other countries.
- Finally, as a means of gathering real-time information, we placed examiners in major banking institutions to monitor developments–such as currency shipments–to identify the potential for bank runs.
- To sum up, performing the lender-of-last-resort activity, and backing it up with close monitoring and close communication, did what it was supposed to do: it transferred the systemic risk from the market to the banks and ultimately to the Fed, which is the only financial institution with pockets deep enough to bear this risk. This allowed market intermediaries to perform their usual functions and helped keep the market open.

### What did we learn?

As our mothers sometimes tell us, we learn more from our mistakes than from our successes, and the policy lesson here really comes from the Great Depression, rather than from the October 1987 crash. During the Depression, the Fed failed to avert the collapse of the banking system, and the loss of intermediary services was one reason why the Depression was so deep and so prolonged.

So the crash of 1987 and the Fed’s swift and decisive response serves to reaffirm our understanding of what we need to do. While this should give confidence to the markets, I think it’s worth repeating that it should be used sparingly. Such Fed actions must be limited to crises marked by systemic risk. Bailing out individual firms is *not* the job of the Fed, nor is it in the public interest since it would induce excessive risk-taking in the private sector.

Let me conclude with one last caveat that brings me back to monetary policy concerns: once the critical stages have passed, the Fed needs to be especially careful not to generate *another* set of problems–that is, we must be careful not to *overplay* an easier policy stance. That could create inflationary pressures that would menace the process of healing in the financial system and possibly create future economic crises.

I think it’s fair to say that the Fed did not make this mistake following the ’87 crash. In the face of a strong economy, tight labor markets, and an upward creep in inflation, monetary policy was tightened noticeably between early 1988 and early 1989. The funds rate rose from a low of around 6-1/2 percent in late 1987 to just under 10 percent in early 1989. While some people have debated about whether this action contributed to the 1990-1991 recession, I think it is clear that it helped set the stage for the decline in inflation that has occurred in the 1990s.

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