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Central Intelligence Agency

Washington, D.C. 20505

DIRECTORATE OF INTELLIGENCE

23 November 1987

Financial Market Turmoil: Broader Implications

Summary

The continuing turmoil in world financial markets is creating, in our view, important implications for a number of key global economic and political trends. 25X1

Economic growth in the industrial countries seems almost certain to slow, although the degree of the slowdown remains a major question. CIA econometric estimates indicate industrial country growth next year will be off only 0.1 to 0.5 percent, while a major forecasting firm estimates a drop in growth of more than 1 percent in its *most likely* scenario. Econometric models, however, often *under*estimate the magnitude of economic turning points. 25X1

Although Tokyo and Bonn moved quickly to loosen monetary policy in the wake of the crisis, we doubt either government will consider expansionary fiscal policies unless they expect growth to plunge to politically unacceptable levels, which we believe to be less than 2 percent in Japan and less than 1 percent in West Germany. Moreover, Tokyo and Bonn probably would ease monetary policy further only if the dollar weakens substantially more. 25X1

This memorandum was prepared for The Honorable George Shultz, Secretary of State, by analysts in the Offices of Global Issues, European Analysis, and East Asian Analysis. Information as of 23 November 1987 was used in its preparation. Comments and queries are welcome and may be directed to the Director, Office of Global Issues 25X1

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Many LDCs probably will face reduced investment inflows and renewed capital flight as investor uncertainty causes a shift to higher quality assets in the industrial countries. Gains for the LDCs from current lower interest rates and the lower dollar will be dampened by the slackening industrial country demand for their exports. 25X1

Broader political and economic issues are also likely to be affected by fallout from the financial market turmoil. 25X1

The current financial difficulties have exacerbated foreign concern that US domestic problems will override long term US commitments abroad. Recipients of US foreign aid, for example -- particularly Israel -- fear that the financial crisis might result in even deeper cuts in US support. 25X1

International cooperation has increased in the immediate wake of the crisis, but if economic growth turns down in the future, cooperation on economic issues might be tougher to achieve as other actors in Asia and Europe assert their increased economic power relative to the United States. Foreign leaders are likely to take advantage of this growing strength to make proposals that may be contrary to US interests. 25X1

A severe downturn would also increase both the political and economic pressure on existing multilateral institutions. Economic organizations could face stiff foreign criticism for failing to cope with any protracted crisis. As in previous international economic crises, a wide range of proposals might emerge to modify these institutions or create new ones. 25X1

Some structural changes in the industrial countries will be examined more carefully now. For example, some foreign privatization programs and financial liberalization measures now might be slowed. 25X1

Because of their economic isolation, the economies of the Soviet Union and the other East Bloc countries will be much less affected by economic problems in the West. Should Western economies enter a prolonged downturn, however, efforts within these governments to liberalize may face greater obstacles. 25X1 25X1

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ECONOMIC IMPACTS

It is too soon to accurately gauge the effect of the stock market crash on the underlying global economy. Prior to the recent stock declines, most major studies--including those of the OECD, IMF, World Bank and leading US forecasters--were predicting moderate world growth in the 2- to 3-percent range through the next several years. These reports all emphasized, however, that the unprecedented trade and capital imbalances pose a serious threat to this forecast. 25X1

> The IMF report states, "A number of uncertainties cloud the economic outlook. One such uncertainty concerns how quickly financial imbalances in industrial countries...can be reduced, and whether their persistance increases the risk of disruptive market developments." 25X1

In the wake of the recent fall in stock values, growth forecasts have been lowered. The direct impact of the crash has been the loss of shareholder wealth -- estimated to be well over a trillion US dollars worldwide -- and a reduction of confidence in future economic growth among consumers and businesses. Indirectly, the crash has affected interest rates and exchange rates, which also changes the outlook for the global economy. 25X1

> <u>Interest rates</u> were driven lower following the stock market panic on 19 October as investors poured money into the more secure bond market and as central banks provided additional liquidity during the crisis. Continued lower interest rates could provide some stimulus to the world economy and ease concerns over the global debt overhang -- particularly for the 60 percent of Third World debt based on floating interest rates. 25X1

> Although the <u>US dollar</u> strengthened in the first few days following the crash, continuing investor concerns over the US trade and fiscal deficits -- along with the rising possibility of a US recession -- has weakened the dollar 5 to 7 percent against other major currencies. A lower dollar is likely to slow growth in the export-oriented economies of Japan and Western Europe, and could lead these governments to reexamine their austere economic policies. Moreover, a weaker dollar puts additional pressure on the EC budget, which is already projected to post a record $7 billion deficit in 1988. The Third World would likely benefit from a weaker dollar, however, because many of their currencies

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are linked to the US dollar and because most LDC debt is dollar denominated. 25X1

On balance, growth rates in the industrial economies are almost certain to slow, although the degree of the slowdown remains a major question. Econometric estimates indicate US growth will be 1.7-2.0 percent in 1988, down from an expected 2.5 percent due to the recent turmoil. 25X1

Growth in Europe and Japan will probably lag that of the United States, but the direct impact of the crash is estimated to be far less. At current exchange rates, CIA estimates put 1988 Japanese growth at 2.7 percent--off 0.3 percentage point because of the stock declines--and growth in Europe to be 2.2--an impact of a mere tenth of a percentage point. Econmetric models, however, often underestimate the magnitude of economic turning points--if consumers and businesses respond more strongly than suggested by historical trends in our model, the negative impact would be greater. 25X1

A worst-case scenario foresees a cut in global economic growth to about 1 percent in both 1988 and 1989, according to a leading forecasting firm. This scenario could occur if the US dollar falls below 110 yen next year, consumer savings increases sharply while business investment stagnates, and if the governments of the industrial countries exacerbate the slowdown by cutting spending rather than pursuing stimulative policies. The United States would fare somewhat better under these conditions than would Japan and West Germany, which would face a loss of exports because of the weaker dollar. LDCs would be severely hurt by a halt in the growth of world trade. 25X1

Regardless of whether the outcome is better or worse, it is likely that over the next five years the world economy will not be as strong as it has been since the 1980-82 global recession. Moreover, the downside risks of recession have clearly increased. If international economic problems become serious, the United States would confront a wider range of foreign policy challenges. 25X1

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BROADER POLICY IMPLICATIONS

Broader political and economic issues -- such as global economic leadership, foreign macroeconomic and asset management policies, and the LDCs -- will also be affected by the financial market turmoil.

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ECONOMIC LEADERSHIP

Recent financial events have galvanized concerns about a falling dollar and the prospects for sustained growth, and have shaken foreign confidence in the global economy. Economic officials and policymakers in Europe and Japan are concerned that Washington may not make the hard choices necessary to cut its deficits.

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The US budget deficit reduction negotiations were portrayed abroad and were seen as a litmus test for US economic leadership--foreign leaders hoped for reductions beyond the $23 billion mandated by Gramm-Rudman, and lobbied Washington both publicly and privately for further cuts.

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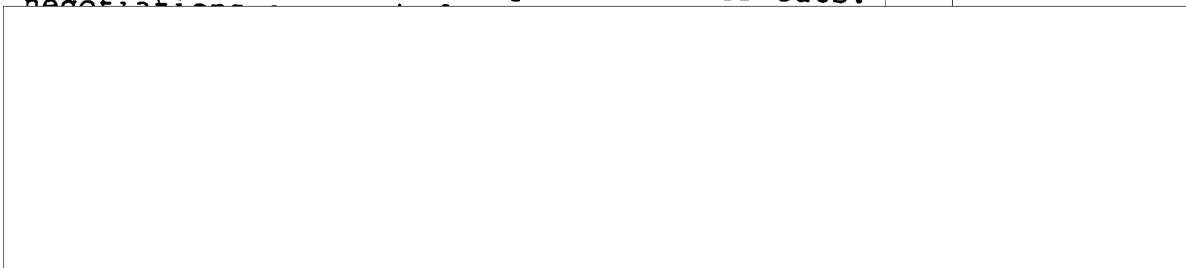

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US trading partners are worried the forces that led to the current financial crisis could eventually lead the United States to adopt protectionist trade policies. While foreign observers are hopeful the US Congress will not pass a highly protectionist bill this year, most remain concerned that domestic pressure may in the end produce a restrictive trade bill.

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FOREIGN MACROECONOMIC POLICIES

Although Tokyo and Bonn moved quickly to loosen monetary policy in the wake of the stock market crisis, policymakers in both countries are still moving slowly in considering expansionary fiscal policies. 25X1

The crisis rekindled debates within the Japanese and West German Governments over the need for fiscal stimulus, but the pro-austerity forces in each country remain strong. 25X1

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West German Finance Minister Stoltenberg, widely regarded as Bonn's most powerful decisionmaker, publicly insists larger federal budget deficits would be inflationary. 25X1

We believe neither government will make fundamental shifts in fiscal policies unless growth drops to politically unacceptable levels, which we believe to be less than 1 percent in West Germany and less than 2 percent in Japan. 25X1

Our econometric analysis suggests that the impact of stock market losses to date and the fallout from a further 15-percent depreciation of the dollar would cut growth in these countries to these unacceptable levels. 25X1

Further budget deficit cuts by Washington -- such as meeting the $50 billion total deficit reduction called for abroad -- would probably not spur a fundamental reassessment by Tokyo or Bonn. However, we believe both Tokyo and Bonn probably would consider it politically desirable to offer something limited in return -- increased public works spending in Japan, or a promise from West Germany to keep interest rates low and to reexamine fiscal policy if growth slows. Indeed, Takeshita is more likely than Nakesone to push the Finance Ministry to adopt a more expansoinary fiscal policy because of the political advantages that stem from greater public works spending. 25X1

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Despite their initial loosening of monetary policy, Tokyo and Bonn probably would further ease monetary policy only if the dollar weakens substantially more. 25X1

If the dollar does fall substantially, both governments -- as they have in the past -- are likely to urge their central banks to lower interest rates to prevent appreciating currencies from damaging their economies. 25X1

FOREIGN ASSET MANAGEMENT

The crisis so far has not affected foreign asset management strategies, but protracted market instability or a continued fall of the dollar could change the outlook. 25X1

Japanese investors appear to have sold little of their dollar-denominated assets during the crisis. 25X1 some Japanese institutional investors recognize that a major selloff of dollar-denominated assets would cause a further fall of the dollar. 25X1

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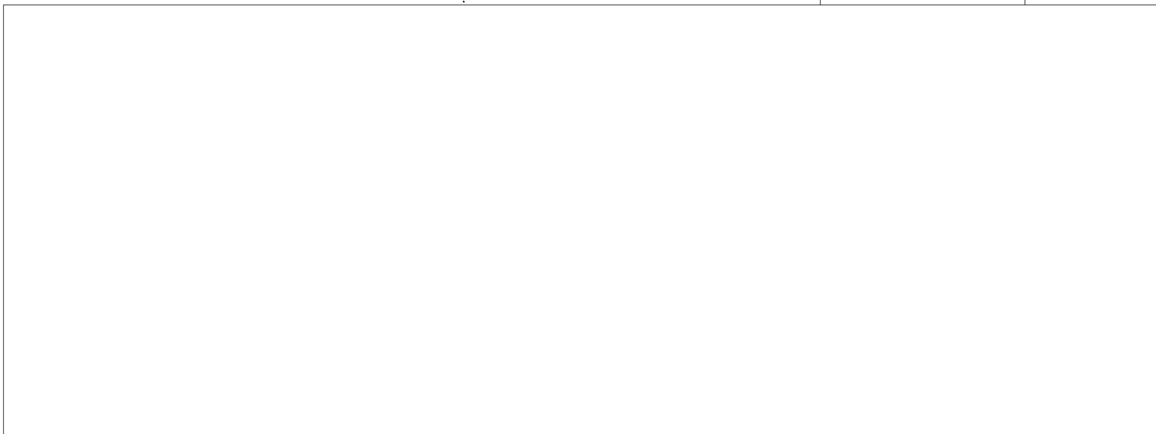

STRUCTURAL CHANGE

The effects of the stock market crisis have produced mixed reactions concerning privatization programs in the developed countries, and other structural economic issues like financial liberalization and the role of international financial institutions might also be affected. 25X1

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The United Kingdom moved ahead on schedule with its $12 billion dollar sale of British Petroleum shares. London was forced, however, to offer a support plan for the deal's underwriters -- who collectively stood to lose more than $1 billion -- which guaranteed that the Bank of England would buy back shares at a "floor price" of $1.20 per share, thereby capping underwriters' losses.

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France postponed its planned sale of shares in the defense and electronics firm Matra until markets stabilize, a move viewed by some French officials as a politically embarrassing policy compromise,

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West Germany put off announcing a date for sale of its remaining share in VW, and Belgium will also face tough decisions on privatizations planned for coming months because revenues anticipated from the sales have already been figured into government budgets.

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The crisis almost certainly will reinforce Tokyo's view that its present gradual, incremental liberalization of financial markets is the best course.

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West European governments are likely to step up efforts to strengthen financial regulatory cooperation among themselves and with the United States. Agreement on the pending G-10 accord on commercial bank capital adequacy might be speeded as a result.

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IMPLICATIONS FOR THE LDCS

The stock market crisis probably will reduce the investment resources available to many LDCs to finance development and could slow the progress of Third World economic reform.

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Losses in some emerging Latin American stock markets, for example -- which are on a par with drops in the developed countries -- are a setback to the development of stable markets needed to attract foreign capital, mobilize domestic investment, and facilitate the privatization of state-owned companies.

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Some LDCs, such as South Korea, are insulated from the direct financial impact of the crash because they restrict foreign access to their financial markets.

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Some LDC capital flight probably will resume as investors seek safer assets in the United States or other developed countries. Capital has already begun flowing out of Mexico because of the stock market collapse there, according to the US Embassy, contributing to the dramatic two-day, 49-percent fall of the peso against the dollar. 25X1

LDC debtors will benefit from the lower dollar and lower world interest rates, but these gains will be dampened by slackening industrial country demand for their exports. In addition, the crisis has caused their commodity export prices to dip. 25X1

IMPACT ON THE SOVIET BLOC

Because of their economic isolation, the economies of the Soviet Union and the other East Bloc countries will be much less affected by economic problems in the West. Should Western economies enter a prolonged downturn, however, efforts within these governments to liberalize may face greater obstacles. 25X1

Conservative factions that oppose economic reform efforts could point to problems within the market oriented Western economies in their political battle to maintain strong central planning domestically. This risk increases if the West is seen to go through a series of financial crises. 25X1

Weakening Western economies would lead to decreased opportunities for East Bloc exports. Weapons sales to the Third World and Soviet energy exports to Western Europe would slow. A prolonged recession would hinder Moscow's long-term efforts to boost sales of manufactured goods to the West. This would be a setback for these countries' efforts to increase trade ties with the West. 25X1

For Eastern Europe, a more difficult trade environment could make regimes more cautious about reform, as it did during the Hungarian experience of 1972-78. Moreover, difficulties in exporting would worsen the already severe debt problems of several East European countries and limit their ability to acquire needed Western goods. This, in turn, could weaken Eastern Europe's ability to support the Soviet modernization goals. 25X1

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The Soviet Union may find opportunities during a Western recession, however. Moscow's efforts to increase economic and political ties with the Third World may be enhanced, particularly during a period of deflation--which would increase LDC debt burdens while reducing cash earnings from commodity exports. As in the 1930s, this combination would significantly increase the use of countertrade worldwide, which might increase the number of Soviet Bloc barter deals in the Third World. Moreover, Moscow may be able to take advantage of weak demand and glutted markets in the West to secure better prices for machinery and equipment needed for its modernization drive, despite import problems that may arise for the other Bloc countries. 25X1

OTHER FOREIGN POLICY CONCERNS

The current financial difficulties have exacerbated foreign concern that US domestic problems will override long term US commitments abroad. 25X1

Recipients of US foreign aid fear that the financial crisis might result in even deeper cuts in US support. Both press reporting 25X1 indicate Israel is quite concerned that public and private aid from the United States may decline this year due to the financial crisis, and in the future as Washington wrestles with the budget deficit. 25X1

NATO allies see the crisis as yet another factor likely to force cuts in US commitments to the alliance. 25X1

International cooperation has increased in the immediate wake of the crisis, but if economic growth turns down in the future, cooperation on economic issues might be tougher to achieve as other economic actors in Asia and Europe assert their increased power. Foreign leaders are likely to take advantage of their growing strength to make proposals -- perhaps in such areas as the new GATT round, LDC debt, or monetary reform -- that may be contrary to US interests. 25X1

A severe global downturn would also increase both the political and economic pressure on existing multilateral institutions. Economic organizations could face stiff foreign criticism for

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failing to cope with any protracted crisis. As in previous international economic crises, a wide range of proposals might emerge to modify these institutions or even create new ones.

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In particular, the IMF and World Bank might face a reduction of repayments on their Third World loans as LDC exports decline and as interest rates possibly rise, worsening problems the Fund and Bank already face with LDC arrears. At the same time, developed countries would be less financially able to expand the resources of these institutions.

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A continued fall of the dollar also would imperil the World Bank's ability to lend to the LDCs because its capital is denominated in dollars. According to the Bank's own estimates, a further 9-percent decline -- in the absence of a capital increase -- would wipe out its funds available for lending.

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The Uruguay Round of GATT might also be jeopardized by heightened global trade tensions accompanying a weaker dollar and slower world growth.

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APPENDIX 1

ROLE OF GLOBALIZATION OF FINANCIAL MARKETS

The recent stock market turmoil has demonstrated the tight interdependence that now exists among the world's financial markets and among the economies themselves. This interdependence can be seen in the uniformity of the decline that occurred on 19 October -- Black Monday. Five of the world's top exchanges lost record percentage amounts within 24 hours of the New York crash. By contrast, stock market downturns in the late 1920s ranged over several years.

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The globalization of markets has occurred largely as a result of financial deregulation and has been greatly facilitated by the rapid growth in international capital flows as a result of the oil shocks and the widespread introduction of computers and telecommunications systems. Shares of many major multinational firms are now traded on multiple foreign exchanges, and the top investment institutions trade on an almost 24-hour basis through representatives in Tokyo, London, New York, and the smaller stock markets.

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The strong linkages between economies also helped transmit the effects of the crash. For example, Japanese export companies and stocks of American firms were hardest hit on the Tokyo exchange, largely over fears that the crash would weaken the US economy. Despite the rapid integration of global financial markets, there remains an effective separation between investment banking and commercial banking in most developed economies. This regulatory "firewall" between the two activities helped prevent the recent stock market turmoil from severely damaging the international banking system.

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APPENDIX 2

THE '29 AND '87 CRASHES: SIMILARITIES AND DIFFERENCES

Comparisons between the recent crash and the 1929 panic are inevitable. Despite the differences between the two events, there are two important lessons from the 1929 experience. First, the October 1929 stock market crash was a symptom of fundamental economic problems that existed, rather than a watershed point between good times and bad. Second, the later slide into the Great Depression was more a result of government policies and consumer responses that followed the crash rather than the crash itself. The similarities and differences between the two eras demonstrate these points in the causes, the crash itself, and the aftermath.

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Causes

The 1929 crash occurred several months after a recession began within the United States and amid a generally weakening economy internationally. By contrast, the global economy at the moment of last month's crash was muddling through with moderate growth by historical standards.

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In other ways, the economic backdrops were similar. In both cases there were rising interest rates that raised concerns over tightening credit causing economic hardship. Related to this, there were exchange rate difficulties in both cases. Because of the gold standard that prevailed in 1929, exchange rate "instability" manifested itself through increased flows of gold stocks, rather than by changes in rates themselves. Increased capital outflows to the United States, rather than fears of inflation, led London and other European governments to boost their interest rates to maintain their gold reserves. Moreover, a global debt overhang coupled with a reversal of easy-money policies contributed to the market downturn in both cases.

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The Crash Itself

Both the 1929 and 1987 crashes came several weeks after the peak in the market, and were characterized by accelerating declines over a period of days prior to the day of panic. Both markets crashed to price levels that prevailed late in the previous year, and observers--as many are now--cited this fact as a reason for optimism. As often occurs immediately following a stock panics, there was a large rally the day after each crash.

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Contrary to popular notions, the <u>initial</u> *government response to the 1929 crash was a textbook case of proper policy. As it did last month, the New York Federal Reserve Bank in 1929 provided substantial liquidity to the financial system during the days following the crash--more than six times the maximum allowed by standing regulations. Moreover, key governments moved quickly to lower interest rates both then and now--and Britain and West Germany acted to lower rates within a week of both crashes. Finally, international cooperation temporarily improved after the shock of the 1929 stock panic.*

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As a result, the world monetary situation eased in the days after both panics--although the recent pressure on the US dollar stands in contrast to the November 1929 period. In both cases, large financial institutions supported the markets to a greater extent than smaller investors in the weeks after the fall.

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The key difference between the two crashes lies in the effect on the banking system. During the late 1920s commercial banks were heavily involved in stock market financing, whereas tight restrictions now apply to such activity in the United States and most major foreign financial centers. This separation between investment banking and commercial banking has helped contain the damage done by the recent collapse.

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In addition, the 1987 crash was the first simultaneous global stock market panic. By contrast, the West German stock market peaked in 1927, the London market in 1928, the French market in the spring of 1929, and the then-important Vienna market began to fall in 1931. Moreover, the cross effects between markets in the 1920s were transmitted via the underlying economies, rather than through the stock markets themselves.

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The Aftermath

As an anxious global economy moves into the post-crash period, it is important to remember that the 1930s depression was far more the result of government actions taken long after October 1929 than it was of the crash itself. Indeed, the New York market rose strongly between November 1929 and April of 1930. General opinion in the months that followed the crash was relatively upbeat. Consumer spending stayed strong through Christmas of that year. By contrast, businesses began to retrench, which in conjuction with the delayed psychological impact of the stock market fall, began to sour consumer spending.

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Economic historians generally believe that the underlying weakness of the world economy in the late 1920s and early 1930s led to both the crash and the economic downturn that began earlier in 1929. But the emergence of counterproductive government policies worldwide turned the recession into depression. Despite widespread acknowledgement among foreign officials on the need for economic policy cooperation, most governments raised taxes, erected protectionist barriers, and devalued their currencies.

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Charles Kindleberger, an eminent scholar on the Depression, argues that the global economic system was fundamentally unsound throughout the 1920s as Britain could no longer provide economic leadership while the United States was not yet strong enough to fill the void. The consequence, Kindelberger argues, was a severe global adjustment process that became the depression.

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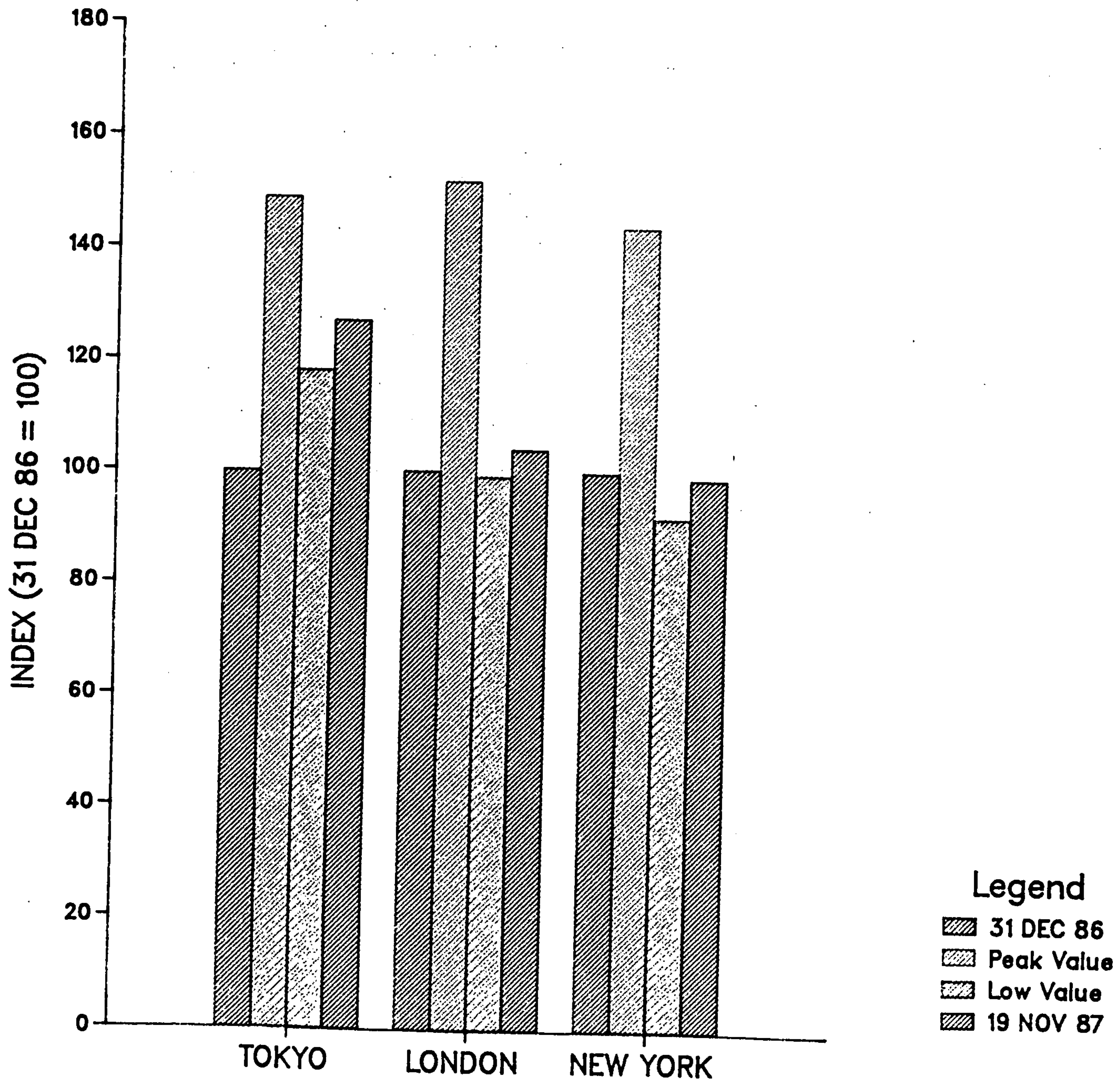

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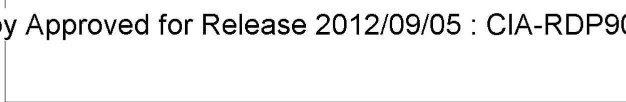

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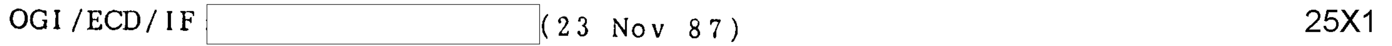

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