

RESTRICTED  
FM WASHINGTON  
TO IMMEDIATE FCO  
TELNO 2301  
OF 270125Z OCTOBER 87  
AND TO PRIORITY CG NEW YORK  
INFO SAVING OTHER CGS IN USA

US ECONOMY: REACTIONS TO DEVELOPMENTS ON WALL STREET  
SUMMARY

1. UNPRECEDENTED VOLATILITY BLAMED ON TWIN DEFICITS AND PROGRAMME TRADING. CONSUMPTION AND INVESTMENT LIKELY TO BE DELAYED, LOWERING GROWTH NEXT YEAR. MANY SMALL AND POSSIBLY A FEW LARGE FINANCIAL BANKRUPTCIES EXPECTED. BANKING DEREGULATION LIKELY TO GO ON BACK BURNER. SILVER LININGS ARE PRESIDENT'S AGREEMENT TO DISCUSS BUDGET DEFICIT REDUCTION (BUT THIS MAY HAVE BEEN OVERSOLD), LIKELY INCREASE IN DOMESTIC SAVINGS AND LOWER INTEREST RATES. MARKET VOLATILITY LIKELY TO CONTINUE.

DETAIL

2. OVER THE LAST TEN DAYS THE STOCK MARKET HAS FALLEN BY 22 PER CENT ON THE DOW JONES INDEX. EQUITIES ARE NOW 26 PER CENT BELOW THE PEAK LEVEL REACHED ON 25 AUGUST BUT ARE STILL 142 PER CENT ABOVE THE TROUGH ATTAINED ON AUGUST 12, 1982 (COMMONLY REGARDED AS THE START OF THE BULL MARKET). THE DECLINE CONTINUED ON 26 OCTOBER (ANOTHER 157 POINTS). VOLATILITY HAS BEEN AT UNPRECEDENTED LEVELS AND TRADING VOLUME HAS BEEN FOUR TIMES HIGHER THAN USUAL.

3. THE DOMINANT VIEW HERE IS THAT THE FUNDAMENTAL CAUSES OF THE SLIDE ARE THE TWIN DEFICITS AND, TO A LESSER EXTENT, FEARS THAT THE FED WOULD HAVE TO RAISE INTEREST RATES TO COMBAT RISING INFLATIONARY EXPECTATIONS. KAUFMAN HAS ARGUED THAT THE BULL PHASE OF THE MARKET WAS ARTIFICIALLY PROLONGED BY COMPANIES BUYING THEIR OWN STOCK, THEREBY REDUCING THE SUPPLY OF SUCH SHARES AND PUSHING UP THEIR PRICE IN AN ATTEMPT TO WARD OFF HOSTILE TAKEOVERS. PROGRAMME TRADING IS BEING WIDELY BLAMED FOR INCREASING THE VOLATILITY OF, BUT NOT THE DECLINE IN, THE MARKET.

4. A NUMBER OF CONSEQUENCES AND CONCERNS ARISING FROM LAST WEEK'S EVENTS HAVE ALREADY EMERGED, THE MOST SIGNIFICANT BEING: (I) A LASTING IMPRESSION OF THE TRUE RISKINESS OF EQUITIES WHICH WILL PROBABLY REDUCE THE SCALE OF DIRECT EQUITY INVESTMENT BY INDIVIDUALS FOR SOME TIME:



(II) THE REALISATION THAT FUTURES MARKETS AND, IN PARTICULAR, STOCK INDEX OPTIONS DO NOT OFFER MUCH HEDGING PROTECTION BUT APPEAR TO INCREASE VOLATILITY SIGNIFICANTLY. (IN THE YEAR TO DATE TRADING IN STOCK FUTURES HAS EXCEEDED TRADING IN ORDINARY STOCKS BY 50 PER CENT.) TRADING IN STOCK INDEX OPTIONS WAS BANNED AT TIMES LAST WEEK AND SOME COMMENTATORS ARE ARGUING THAT THEY SHOULD BE PERMANENTLY OUTLAWED:

(III) GROWING WORRIES ABOUT THE CONSEQUENCES OF FINANCIAL DEREGULATION. IT IS NOW MUCH LESS LIKELY THAT CONGRESS WILL TAKE RADICAL STEPS TO REFORM THE GLASS-STEAGALL ACT'S DIVISION BETWEEN BANKING AND SECURITIES DEALING. INDEED THERE ARE ALREADY MOVES TO CONSIDER IMPROVING THE REGULATION OF FINANCIAL MARKETS, IN PARTICULAR, THE FUTURES MARKETS:

(IV) INCREASING CONCERN ABOUT THE CAPITALISATION OF SECURITIES HOUSES. IN NEW YORK RUMOURS THAT MANY SMALL, AND SOME LARGE, HOUSES ARE IN TROUBLE ARE WIDESPREAD. E F HUTTON HAS BEEN MENTIONED AS A POSSIBLE LARGE CASUALTY, BUT MOST PEOPLE BELIEVE THE FED MAY ORGANISE TAKEOVERS RATHER THAN ALLOWING FIRMS TO FAIL:

(V) RISING OPTIMISM OVER THE PROSPECTS FOR BUDGET DEFICITS IN THE LIGHT OF THE PRESIDENT'S AGREEMENT TO DISCUSS A DEFICIT REDUCTION PACKAGE WITH CONGRESS (BUT SEE PARA 7 BELOW):

(VI) LOWER EXPECTATIONS OF ECONOMIC GROWTH NEXT YEAR. MOST ANALYSTS AGREE THAT INVESTMENT PLANS AND EXPENDITURE ON CONSUMER DURABLES AND HOUSES COULD WELL BE DELAYED FOR SOME TIME. THE FED'S MODEL SUGGESTS THAT A 20 PER CENT DROP IN EQUITY PRICES WOULD REDUCE REAL GNP GROWTH BY 0.75 PER CENT IN THE FOLLOWING YEAR, ALTHOUGH THE FED STAFF REGARD THIS ESTIMATE AS SOMEWHAT ON THE HIGH SIDE. PRIVATE SECTOR MODELS PRODUCE MUCH SMALLER EFFECTS. THE ADVERSE EFFECTS ON CONSUMPTION, INVESTMENT AND THE HOUSING SECTORS MAY BE OFFSET SOMEWHAT BY THE LARGE FALL IN INTEREST RATES. BUT THE INCREASED VOLATILITY OF INTEREST RATES WILL TEND TO OFFSET THE ADVANTAGES OF A REDUCTION IN THEIR LEVEL. THE ONE POSSIBLE SILVER LINING IS THAT DOMESTIC SAVINGS MAY RISE AS CONSUMPTION IS POSTPONED AND INCOMES REMAIN AT LEAST INITIALLY UNAFFECTED:

(VII) FEARS THAT 1987 COULD BE A REPEAT OF 1929. FEW BELIEVE THAT THE FED WILL MAKE THE MISTAKE OF TIGHTENING POLICY AS THEY DID IN 1929 AND GREENSPAN IS WIDELY PRAISED FOR INJECTING LIQUIDITY INTO THE SYSTEM IN A TIMELY FASHION. MANY COMMENTATORS HAVE USEFULLY POINTED OUT THAT 1929 WAS FOLLOWED BY SMOOT-HAWLEY WHICH WAS A MAJOR CAUSE OF THE GREAT DEPRESSION. THIS MAY SERVE TO STRENGTHEN THE ANTI-PROTECTIONISTS IN THEIR EFFORTS TO IMPROVE THE ATATADE BILL:



(VIII) WORRIES THAT THE DOLLAR MAY ALSO COME UNDER PRESSURE IN THE NEAR FUTURE. FOREIGN EXCHANGE ANALYSTS IN NEW YORK ARE ARGUING THAT THE FED DARE NOT RAISE INTEREST RATES TO DEFEND THE DOLLAR BECAUSE OF THE FRAGILITY OF ATE FINANCIAL SYSTEM. IF FOREIGNERS DECIDE TO TAKE THEIR INVESTMENTS OUT OF DOLLARS IT MAY THEREFORE NOT BE POSSIBLE FOR THE G7 COUNTRIES TO PREVENT A DECLINE IN THE DOLLAR UNLESS THERE IS CONCERTED INTERVENTION ON A MASSIVE SCALE, OR INTEREST RATES OVERSEAS ARE REDUCED. (ANALYSTS WILL REGARD THE EXTENT OF JAPANESE PARTICIPATION IN THE TREASURY'S QUARTERLY AUCTION, SCHEDULED FOR 3-5 NOVEMBER, AS A GOOD INDICATOR OF FOREIGN INTEREST IN DOLLAR SECURITIES.)

## COMMENT

5. WALL STREET'S PROBLEMS SEEM FAR FROM OVER. THE MARKETS HAVE YET TO DIGEST FULLY THE POOR TRADE FIGURES CONTAINED IN THE PRELIMINARY THIRD QUARTER GNP REPORT RELEASED ON 23 OCTOBER. BOTH EXPORTS AND IMPORTS ARE ESTIMATED TO HAVE INCREASED IN VOLUME TERMS BY 16.5 PER CENT (ANNUAL RATE) IN THE THIRD QUARTER. SINCE IMPORTS ARE MUCH LARGER THAN EXPORTS, THE TRADE BALANCE DETERIORATED. THIS IS A BLOW TO ONE OF THE ADMINISTRATION'S MAIN ARGUMENTS ABOUT THE SLOWNESS OF THE J-CURVE EFFECT TO SHOW UP, NAMELY THAT EVEN IF IN DOLLAR TERMS THE GAP HAD NOT YET NARROWED, IN VOLUME TERMS THE SITUATION WAS IMPROVING. THE RESILIENCE OF IMPORT VOLUMES DESPITE THE PRICE INCREASE OF 8.3 PER CENT (ANNUAL RATE) WILL PROVIDE AMMUNITION TO THOSE IN FAVOUR OF A TOUGHER TRADE BILL (THOUGH SEE ALSO PARA 4(VII) ABOVE). THE FALL IN THE STOCK MARKET IS EXPECTED TO WEAKEN CONSUMPTION AND INVESTMENT WHICH MAY HELP TO REDUCE IMPORTS. HOWEVER THE DECLINES IN OVERSEAS STOCK MARKETS MAY HAVE A SIMILAR DAMPENING EFFECT ON DEMAND FOR US EXPORTS.

6. THE PROSPECTS FOR AGREEMENT BETWEEN CONGRESS AND THE ADMINISTRATION ON A DEFICIT REDUCTION PACKAGE HAVE IMPROVED AS A RESULT OF THE UPHEAVALS IN THE STOCK MARKET. ON THE CONGRESSIONAL SIDE, THERE HAVE BEEN INCREASING SIGNS IN THE LAST FEW DAYS OF A MORE BIPARTISAN APPROACH. AND DESPITE DOUBTS ABOUT THE ABILITY OF A WEAKENED PRESIDENT TO PROVIDE THE NECESSARY LEADERSHIP TO CALM THE MARKETS, THE PRESIDENT'S NEW WILLINGNESS TO START NEGOTIATIONS WITH CONGRESS HAS HAD A POSITIVE PSYCHOLOGICAL EFFECT. SPRINKEL (CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS) SUGGESTED ON TV AT THE WEEKEND THAT THE PRESIDENT MIGHT ACCEPT MEASURES TO CLOSE LOOPHOLES AND REDUCE DEDUCTIONS AS PART OF A PACKAGE THAT INCLUDED SPENDING CUTS. THE RECONCILIATION BILLS PASSED BY THE HOUSE WAYS AND MEANS AND THE SENATE FINANCE COMMITTEES CONTAIN MEASURES OF THIS KIND WHICH WOULD RAISE AROUND DOLLARS 12 BILLION IN REVENUE. IT MAY



THEREFORE BE POSSIBLE TO AGREE A PACKAGE WHICH RAISES SUFFICIENT REVENUE WITHOUT INCREASING TAX RATES (SOMETHING THE PRESIDENT STILL EVIDENTLY REFUSES TO ACCEPT). SPRINKEL SUGGESTED THAT A FREEZE OF CERTAIN SPENDING PROGRAMMES COULD BE A USEFUL PART OF AN OVERALL DEFICIT REDUCTION PACKAGE.

7. THE HOUSE RECONCILIATION BILL IS LIKELY TO BE VOTED ON (AND PROBABLY PASSED) LATER THIS WEEK. IT IS LIKELY THAT ANY MEASURES AGREED WITH THE PRESIDENT COULD BE INCLUDED IN A SENATE BILL, WHICH HAS NOT YET REACHED THE FLOOR. A CONFERENCE WILL BE NEEDED TO AGREE A COMPROMISE BILL, SO IT IS UNLIKELY THAT A DEFICIT REDUCTION PACKAGE WILL BE SIGNED INTO LAW MUCH BEFORE THE 20 NOVEMBER DEADLINE IMPOSED BY THE REVISED GRAMM-RUDMAN LEGISLATION. IF THERE IS NO AGREEMENT BY THEN, THE DOLLARS 23 BILLION SEQUESTRATION WILL BE IMPLEMENTED. TREASURY SECRETARY BAKER AND HOUSE WAYS AND MEANS COMMITTEE CHAIRMAN ROSTENKOWSKI HAVE EXPRESSED SCEPTICISM ABOUT THE POSSIBILITY OF AGREEING A PACKAGE INCLUDING LARGER CUTS THAT HAS THE SUPPORT OF SENATORS DOLE, BENTSEN AND CHILES. BUT IT IS LIKELY THAT THE OUTCOME OF THE TALKS BETWEEN CONGRESS AND THE ADMINISTRATION WILL MAINLY DETERMINE THE FORM OF DEFICIT REDUCTION, NOT THE AMOUNT. NEVERTHELESS THE MARKETS SEEM TO ATTACH IMPORTANCE TO THE WHITE HOUSE REACHING AGREEMENT WITH CONGRESS AND MAY REACT BADLY IF THE TALKS BREAK DOWN OR FAIL TO PRODUCE ANYTHING SIGNIFICANT. IT IS WORTH EMPHASISING THAT, EVEN WITH A DOLLARS 23 BILLION CUT, NEXT YEAR'S DEFICIT IS LIKELY TO BE CONSIDERABLY ABOVE THE FY 87 LEVEL, AS THE LATTER WAS REDUCED BY A NUMBER OF ONE-OFF FACTORS. THE CONGRESSIONAL BUDGET OFFICE HAVE ESTIMATED THAT THE DEFICIT WILL BE DOLLARS 156 BILLION IN FY 88 IF CUTS OF DOLLARS 23 BILLION ARE IMPLEMENTED (AS OPPOSED TO AN ESTIMATED DOLLARS 148 BILLION FOR FY 87).

8. FCO PLEASE ADVANCE TO PS/CHANCELLOR, SIR P MIDDLETON, SIR T BURNS, PERETZ, EVANS AND LOMAX (TREASURY), PS/GOVERNOR, GEORGE, WALKER AND GREEN (BANK), HILTON (DTI), AND RICHARDSON (ERD).

ACLAND

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