MANAGING MARKET MELTDOWN: LESSONS FROM THE CRASH

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"What everyone knows is that the sharemarkets have been out of kilter with reality." - editorial, *Business Daily*, Aug.10,1987

"Shoot the first person who said they predicted it - no one could have expected this." - stockbroker, *Sydney Morning Herald*, Oct.24,1987

Hegel is supposed to have said that people and governments have never learnt anything from history, or acted on principles deduced from it. This is uncharacteristically pessimistic for the father of the dialectic but a perfect maxim for the myopia of contemporary libertarian culture. No better indication comes from the range of respectable opinion on stock market volatility before and after the crash in October 1987.

In what follows, expert opinion within the business and financial media is examined with a view to gauging its intelligibility. Can we obtain an adequate interpretation of the crash from such sources? In general, the answer is no. Sources that are treated as authoritative by the media exude a pervasive ignorance. This holds for the insiders of the stockbroking community itself. It also holds for the professional opinion-makers, predominantly economists, within the business think tanks and the media[1]

What does the stockbroking community know and what informs its knowledge? Any attempt to understand the finance sector faces a major obstacle whenever the label 'the market' is applied to any of its constituent parts. This linguistic portcullis cuts off innocent inquiry. Of course, the term 'the market' does carry a substantial

baggage of implications. The participants are numerous and therefore individually powerless. Anonymity is not a reason for suspicion but a product of an impersonal environment. There is an innate rationality to the process - a collective omniscience impersonally and irrepressibly imposed. Any inquiry as to what is hidden behind the label is thus both unnecessary and impertinent.

However, the business/finance media requires perennial statements of opinion for public consumption. A window to the mind of 'the market' is thus available through the statements of flesh-and-blood individuals. What do they have to say for themselves?

Opinions Before the Crash

In the months before the crash,the Australian finance sector showed few signs of pessimism, dwelling on bouyant financial-year profit figures, privileged industries like gold, and Keating's austere budget. In July, Equitylink's Brian Sherman saw a "sustained bull market for the next couple of years".[2] At the beginning of the downturn, Capita's Nigel Weaver claimed that "the sellers out there are a bunch of panic merchants".[3] Innumerable opinions in this vein could be quoted.

There were some exceptions to the euphoric mood. Rothschild Australia's Peter Griffin claimed that the market was hopelessly overvalued.[4] Public expressions of such views were sparse. However, John Spalvins of Adelaide Steamship was a well-publicised bear, believing that market values ought to have reflected underlying net worth.[5] Spalvins risked Adsteam's capital on his belief that the share market would fall - objectively sound, but amiss on the group psychology of his confreres. For his reluctance to play the game, regardless of the rationality of the rules, Spalvins apparently incurred the displeasure of the business fraternity. Spalvins changed his mind just in time to also suffer from the crash.

The US magazine Barron's carried in December 1986 a lengthy interview with a maverick investor called Jim Rogers.[6] Atypical for his profession, Rogers possessed well-considered opinions on both global characteristics and the fine details of the US economy. According to his analysis, for over five years global liquidity had escalated beyond its capacity to finance real output. A plethora of new financial instruments and new institutions had come into being, increasingly processed by a new generation short on fundamentals and on historical perspective. Rogers predicted that the US stock market was heading for the worst bear market since 1937, and for that reason

had his capital in foreign currency and in good old unglamorous government bonds. Evidently Barrons is not much read in Australia.

There was another opinion circulating that combined the vision of the pessimists with the behaviour of the optimists. It could be encapsulated as follows. "There is a crash coming but not yet; with any luck it won't be as bad as the old days. In the meantime, other institutions are profiting as intermediaries for this boom mentality. We have to ride the wave as well and hope for a soft landing".[7]

Opinions After the Crash I

After the crash, the financial community's more visible members (Rene Rivkin, Larry Adler and others) were given ample opportunity to share their expertise. Their contributions were uniformly superficial, devolving to mere linguistic niceties as to whether 'crash' or 'technical correction' better depicted the event. If they possessed any insight of substance it was not passed on to the public. Post-mortems fell into two general categories. There were opinions of the institutional accident variety - the rapidity of information transmission in the computer age; the increasing use of portfolio insurance whereby automatic share sell-offs occur at a predetermined price rather than by a discretionary process; the 'irresponsible' closure of the Hong Kong exchange. These opinions fall into the 'scapegoat' category, involving the tacit denial that share indexes were unrealistic.

Other opinions looked to broader 'objective' forces - in particular, global imbalances centred on US budget and trade deficits, and the conflicting demands of US and West German monetary policy. Bain and Co's Don Stammer claimed that the (US) crash was a "strike by financial markets against US economic policy".[8] One would have hoped for a more sophisticated interpretation from Stammer, previously a senior economist with the Reserve Bank of Australia. Clearly the global imbalances have been of long duration. If market values had been tied closely to such forces there would have been no boom of such a magnitude to facilitate a crash of similar proportions.[9]

Some newly-sober spokesmen emphasised the need to look for 'real quality', to discount the paper entrepreneurs (with high gearing and unpredictable cash flows), and to be realistic about price-earnings ratios.[10] There was no admission that such practice was previously a rarity. The paper entrepreneurs were the near-universally adulated superstars of the boom.[11] Even the historically-staid superannuation

industry was impelled to seek high risk-high return investments, suffering badly in the post-crash fall in share values.[12]

No particular stockbroking firm distinguished itself in published opinion. Consider the variety of opinions emanating from Ord Minnett. In May 1987, Frank Shostak saw Armageddon ahead and predicted a massive crash, although not for a year.[13] In stockbroking, a year is forever and such sentiments evidently carried little weight with contemporaries. In September, Richard Mews believed that the market surge was objectively based in "excellent profit results". In December, Nestor Hinzack thought that "the valuation of the Australian market was out of kilter with other world markets".[14] Internal company communications evidently leave something to be desired - what kind of professional advice one receives may depend upon the accident of who answers the telephone.

Opinions After the Crash II

A different form of reaction occurred from key opinion-makers in business and finance and the economic journalists who represent such opinion - the necessity to cut wages and government spending.[15] These familiar propositions were the Anglo-Australian answer to the 1930s crisis. In the post-war boom years they acquired a reputation as snake-oil remedies. Textbooks described them as mistakes of judgment which could never be repeated.

The 1930s propositions are now commonplace. One senior Fairfax columnist opined that wages had to be cut simply because there were more workers than managers![16] Other columnists predicted that the crash would result in substantial **falls** in general consumer spending and tax revenues and urged wage and public sector cuts to combat such consequences.[17] By December, it was apparent to the most thick-skinned of economic journalists that the economy had not followed the stock-market into a nose-dive. Yet wage and public sector cuts were now being urged to counteract a burgeoning **growth** in demand.

Lessons from the Crash

Much of reported 'expert' opinion is bunk. The impoverished character of opinion from insiders is surprising. It would appear that there is either pervasive incompetence within the finance sector or that it is cynically dealing out pap to the inquiring public. Neither alternative reflects well on the sector's social accountability.

Spokespersons for the stock-broking community consistently claimed that the boom share market was objectively based and sustainable. After the crash, admissions of error were sparse; suggestions for mechanisms which would prevent a recurrence of 'hot air' booms were non-existent.[19]

The relation between capital flows and real processes seems to be interpreted through a crude dependence on changes in a handful of indices like the balance on current account, the consumer price index and the federal budget deficit. The fragmented statements of finance sector spokesmen indicate that such indices are interpreted through an extremely crude version of orthodox macroeconomic and international theory. Few 'market' participants appear to possess anything approaching an adequate conceptual grasp of the system which generates their bread and butter.

What matters in financial arbitrage is the centre of gravity of opinion regarding the movement in various indicators. But the centre of gravity of rubbish is still rubbish. Whether the beliefs are meaningful is less relevant to the players than to the broader society which must face the consequences of finance sector activities.

The sharemarket extravaganza of 1987 raises similar questions to those raised during the currency dealing extravangaza of 1985-86 (during which the Australian dollar was plunged to $US60c. in August 1986). In 1986, the competence and accountability of the currency dealers were widely called into question, including by no less a personage than Paul Keating.[20] The stock-broking community and its major clients evidently have the same cowboy mentality, but its more respectable membership has kept it relatively immune to public approbrium.

The obsfucation of the professional opinion-makers is more familiar. It would not be too much of a caricature to claim that this camp's sole contribution is to parrot a crude libertarian solution to all economic problems, real and imagined - that is, wage and public sector cuts and an eradication of all 'market imperfections'. The acceptance of such ideas as 'appropriate' policy is facilitated by a range of mutually-reinforcing elements - the marginalization and repression of alternative opinion; the constant reinforcement from seemingly independent sources; and the sheer simplicity of the 'free market' story. It is also noteworthy that the professional opinion-making fraternity has been augmented by a new breed. A range of large private institutions now employ economists essentially as public relations personnel with ready access to the media. Many are ex-Treasury employees who have traded an impoverished educational and bureaucratic experience for jobs as high-salaried and high-exposure propagandists.

There is a division of labour here. The response of insiders is oblique, often metaphorical ('fox-trotting on the Titanic', 'the market on a Kandahar ski run',etc). The economists rush into the void with the only thing they know - wage and public sector cuts as the universal palliative. Although the division is probably unconscious, it compounds the obsfucation and facilitates the redistribution of the consequences of the crash onto innocent parties.

The major adverse consequence of the October crash in Australia has been the further reduction of real wage growth for those whose incomes are determined by the National Wage Case under the Accord. The October 1987 hearing for a second instalment to the first tier (under the two-tier system established in March) was persistently deferred by the Arbitration Commission on flimsy grounds of economic uncertainty. Not until February 1988 was a meagre $6 increase granted, less than 1.5% of average weekly earnings. At the same time an aggressive campaign was waged by industry leaders in defense of a wholly discretionary remuneration procedure for the nation's executive class. This is the very class which generated the 'favourable' environment for the October 1987 extravagance and yet eschews any responsibility for its occurrence. If market forces are responsible for executive incomes, can we not expect that market forces will generate a performance commensurate with the incomes?

The push for wage and public sector cuts constitutes an aggressive resurrection of the Anglo-Australian response to the 1930s crisis. What we learn from history is how the same old dirty tricks are repeated with an air of both innocence and surety. This is disappointing news for the rationalist intellectual tradition which sees history unfolding (given the odd temporary setback) towards enlightenment. All the nineteenth century grand thinkers go out the window, but the casualties of most contemporary significance are Keynes and Keynesianism. Moreover, the push for wage and public sector cuts cannot be seen simply as a product of conscious class prejudice. Reactionary intervention both in the 1930s and the present circumstances has occurred through a process which fuses class prejudice and ignorance. It occurs in a way that denies both the rationalist voluntarism of liberal (Keynesian) reformism and the class-based functionalism of orthodox Marxism.

Behind the Obsfucation What?

Information on the inside workings of the relevant financial markets remains sketchy. For example, how was the expansion in global liquidity mediated and multiplied in

Australia? Several elements are clearly important - the deregulation of the finance system and the abolition of exchange controls in 1983; the rise of a $A-denominated eurobond market; and the perpetuation of a policy orientation which dictates an interest rate structure extremely high by international standards. Internationally-based financial institutions, having gained entry in the deregulated environment, have played a major role in facilitating offshore borrowings.[21] Private capital inflow into Australia increased from $10.7b. in 1984-85 to $15.6b. in 1986-87, but this was partially offset by Australian investment abroad, which increased from $4.5b. to $7.8b.[22] The All-Ordinaries Index went from about 1100 in mid-1986 to a high of 2300 in October 1987, reaching a market capitalization of about $300b. The figures on capital flows indicate an increased volatility and an integration into global capital markets on a new scale. Nevertheless, it appears unlikely that the share price boom can be attributed simply to such factors.

Information on the less savoury aspects of financial market activity in Australia is even more sketchy. What conflicts of interest exist and remain unpublicised in the provision of financial services to clients and the use of clients' funds? What is the extent of insider trading? What was the extent of borrowing on margin and who were the players? And so on. It is instructive to observe the type of information available in the mass-circulation tabloids, presumably aimed at 'small investors' whom the stock-broking community internally denigrates as 'bellhops'. Russell McKimm of Ord Minnett devotes a column to assuring the readers that the principles underling stock exchange behaviour are "equality of treatment of clients and openness of information". Observing the publicity given to insider trading in America, he claims, locals would be crazy to try it here. Given difficulties, "our share market works in a very fair and free manner".[23] This happy story is somewhat marred by the recent charging of two Sydney stockbrokers, Roger Bain and Ian Story, for insider trading.[24] And they appear to be the tip of the iceberg.

The possibility, indeed the likelihood, that the 'playing field' will be far from even is more readily discussed overseas. For example, Adrian Hamilton, a British finance journalist has claimed:

> "It was long considered reasonable practice for senior partners to take a tranche of any underwriting and for partners to deal heavily on their own account in issues in which they were involved and to put their friends and contacts on togood deals."

Hamilton quotes an 'eminent' British merchant banker to the effect that profiting from a privileged position has not been a recent product of market deregulation.

Rather deregulation has merely given a wider circle of people an opportunity to practise what was once confined to a select few. And again:

> "It has become accepted that brokers, investment advisers and agents will use clients' funds to generate interest income for their own use and that investment banks and securities houses will fail to reveal a conflict of interest in handling their clients' money."[25]

The relative secrecy with which brokers and merchant bankers in Australia ply their trade seems to be of little public concern. This is not by accident. Libel laws in Australia are atypically strict. The development of an effective regulatory structure has long been impeded by intergovernmental rivalry. The National Companies and Securities Commission has operated on a miniscule budget of about $5million. Yet it faces a huge backlog of cases, mostly from businesses disgruntled with 'foul play'.

It is significant that former Liberal Senator Peter Rae, a man with impeccable conservative credentials, has strongly criticised the current regulatory structures. Rae chaired the 1974 Senate Select Committee on Securities and Exchange, spawned by charges of insider trading and fraudulent claims in the Poseidon nickel boom, key recommendations from which have never been implemented.[26] In Rae's opinion, the integrity of the Australian financial community is clearly at stake.[27]

The industry itself appears to frown on being exposed to the public gaze. The Business section of the Sydney Morning Herald has been labelled the 'anti-business' section. Efforts to emasculate the reporting conventions of this section were at the centre of the recent fight for control of the Fairfax media empire, a fight which involved senior Labor Party politicians and key businessmen.

This aversion to the public gaze is a curious phenomenon. One might think that the business and financial community would envisage accurate information as crucial to its operation. So what fills the voluminous pages of the business media? Considerable space is devoted to gossip about corporate personalities and to economic reportage which is little more than a potage of recirculated prejudice. Most detailed and useful information about the business environment remains private, conscientiously so. Information of a kind that might expose one's competitors to public scrutiny could also similarly expose one's own operations. It seems that the business community would rather be fed a diet of gossip and propaganda than face potential adverse consequences from the loss of secrecy surrounding its day-to-day activity.

Nine months after the October crash, no systematic reevaluation by the stock-broking community of its *modus operandi* appears to have taken place. The mentality that

gave rise to the boom continues unrepentant. Consider a recent piece arguing the continued merits of the Japanese share market for funds managers.[28] The West is missing its chance to ride the Tokyo share boom, says the author. There is an admission that it is a gambler's game, because Japanese price/earnings ratios are extraordinarily high compared to the norm in Australia. This means that earnings on capital are miniscule, with the emphasis solely on potential capital gains. "The question is not how strong the Japanese market has been but how long the boom can last." Involvement is recommended because of the presumption that ultimately the Japanese Ministry of Finance will refuse to let the share market fall substantially. The procedure here is that those players most cavalier about risk dictate the play, and the more cautious feel compelled to follow. This is precisely the mechanism which brought disastrous capital losses to super funds managers buying heavily in the Australian share market.

This behaviour of the Australian financial community is not universal, as is implied by local media. An alternative conservative culture survives, for example, in West Germany.

> "West German corporations are cash rich and deeply conservative. While, in 1986 and 1987, Japanese corporations were investing all their spare cash in financial markets, West German corporations were keeping their cash in banks. German corporations could not care less about sophisticated financial instruments....The insurance companies serve policyholders who go where the capital seems safest."[29]

Deregulation of the Australian finance sector has reinforced the risk-prone and speculative tendencies which run counter to those prevailing in West Germany.

Deregulation itself remains unquestioned locally (save for "outsiders" like Rae). Yet in the U.S.A. and the U.K., precisely those centres from which the Australian financial sector and its Labor government supporters borrowed the vision, there is disenchantment with deregulation.[30] Bank failures, investment house fraud and the like have moved both the U.S. Congress and the Bank of England to press for a new regulatory environment.[31] Moreover, the Chairman of the London Stock Exchange has claimed that the international character of the banking and securities industries demands that the central banks assume responsibility for active and coordinated regulation.[32]

The crash has exposed a financial community that is not merely self-interested but in parts ignorant and cynical. This environment is an integral part of, and has been reinforced by, the broader libertarian culture which the Federal Labor Government has cultivated. There is a staggering contrast between the achievements claimed in

Mr. Keating's oratory and the sordid, inefficient and inegalitarian nature of the real product.

Notes

1. By contrast, some financial journalists, especially in The Sydney Morning Herald, are a more reliable source of information.
2. Sydney Morning Herald, July 17 1987.
3. SMH, Oct.16 1987
4. SMH, July 17 1987
5. Colleen Ryan, SMH, 27 June 1987.
6. "Bearish on the World", Barron's, Dec.8,1986.
7. See, for example, Ean Higgins, "Dancing on the Titanic", Times on Sunday, May 24 1987.
8. SMH, Oct.24 1987.
9. An editorial in the non-prestigious Times on Sunday Nov.8 1987, outclassed the financial press with an elegant articulation of this point.
10. Colleen Ryan, "Traders Take Lessons at the School of hard knocks", SMH,Oct.24 1987. 'Real quality' has to be understood from the perspective which pervades the finance sector - that is, adequate and sustainable profit rates regardless of their source.
11. "The Australian market has a much higher proportion of its market capitalization in large entrepreneurial stocks relative to other markets. In the top 20, we had Bell Resources and Bell Group, Industrial Equity, Elders IXL,AFP,and Bond Corporation, among others",Nestor Hinzack, Ord Minnett, SMH, Dec.26 1987
12. Anne Lampe, "Super Fund Managers caught out by crash", SMH, Dec.11 1987; Catherine Armitage, "Smitten super funds put the high-fliers on their toes", SMH, Jan.6 1988.
13. Ean Higgins, "Dancing on the Titanic", Times on Sunday, May 24 1987
14. quoted SMH, Sept.12 1987; Dec.26 1987
15. Cf. National Australia Bank, Times on Sunday, Nov.8 1987; Confederation of Australian Industry, SMH, Nov.13 1987.
16. Alan Mitchell, "What the crash means to your wage rise", SMH, Oct.29 1987.
17. Cf. Alan Wood, of 'leading economic forecasters'(sic) Syntec, SMH, Oct.22 1987; SMH, Oct.27 1987; Gerry van Wyngen, of Elders Finance and Investment, Australian Business, Nov.11 1987; Gregory Hywood, "Optimism about the crash may be the best cure", Australian Financial Review, Oct.20 1987.
18. Steve Burrell, "Second Wave fears sparked [Keating mini-budget] statement', SMH, Dec.11 1987; editorials, SMH, Dec.11, Dec.28 1987.
19. Finance sector intelligence will not be enhanced by the boom in new courses in finance being offered in tertiary institutions. These courses are generally submerged in an abstract formalism and a presumption of 'market' rationality.

20. Adele Horin, "The hungry cowboys who control our dollar", National Times, Dec.20-26 1985.

21. Australian Business/Ernst & Whinney, Australian Capital Markets, 1988,esp.pp.36-39.

22. Balance of Payments Australia, A.B.S. 5302.0

23. Russell McKimm, "Taking Stock", Daily Telegraph, May 11 1988.

24. Alan Deans, "Brokers charged on insider trading", SMH, June 3 1988.

25. Adrian Hamilton, The Financial Revolution, Penguin, 1986, pp.229,230.

26. See Australian Securities Markets and their Regulation, 3 vols., AGPS, 1974

27. reported SMH, May 16 1988.

28. Philip Rennie, "Japan in the driver's seat", Business Review Weekly, May 13 1988.

29. Peter Koenig, "Seven Men on the Twelfth Floor", Euromoney, March 1988 (on the Bundesbank, the West German central bank).

30. The International Currency Review, a UK-based finance journal, provides an excellent source of conservative opinion opposed to deregulation. See, in particular, "The Pandemic of Regulation",Vol.17, No.1, Oct. 1985; "The Globalisation of Financial Markets", Vol.17,No.4, May 1986.

31. Andrew McCathie, "World moves towards reregulation" AFR, July 7 1986;

32. SMH, Feb. 12 1988.