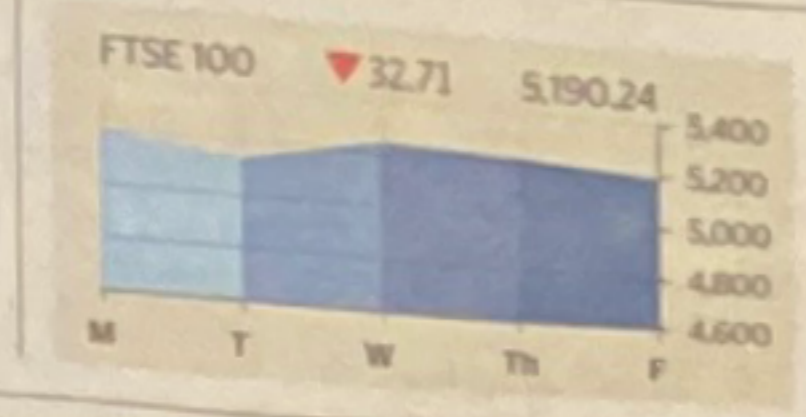


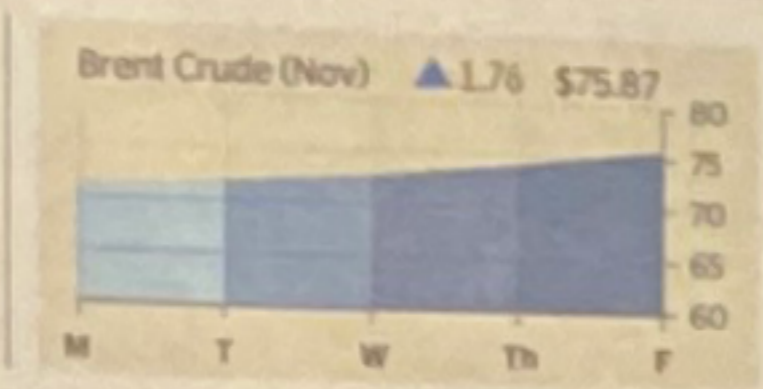
Stock markets

FTSE AIM	▼ 0.80	674.32
Dow Jones	▼ 67.03	9995.91
Nikkei 225	▲ 18.91	10257.56
Nasdaq Comp	▼ 16.49	2156.80
Eurofirst 80	▼ 52.57	3694.51



Commodities

Gold London	▼ 5.15	\$1052.09
Platinum	▼ 14.00	\$1342.50
Copper	▲ 83.75	\$6160.25
Carbon Eua Dec 09	▼ 0.08	€14.14
Carbon Cer Dec 09	▼ 0.24	€13.15



Currencies

\$ per £	▲ 0.0104	1.6352
€ per £	▲ 0.0103	1.0979
¥ per £	▲ 1.39	148.37
\$ per €	▼ 0.0055	1.4889
¥ per \$	▲ 0.31	90.77

Discovering if we learnt the lessons of Black Monday



Gerard Lyons
Economic view



October 19, 1987 — a day of disaster etched on the faces of Wall Street traders as the Dow Jones sank 22.6 per cent

Today is the twenty-second anniversary of Black Monday. On this day in 1987 stock markets around the world crashed. The Dow Jones fell 22.6 per cent in one day. London shed one fifth of its value over two days. The newspapers and television were full of pictures of traders in panic. Sound familiar?

Reflecting on 1987 is interesting in its own right and has lessons for today. Many of the factors that led to the 1987 crash are now being repeated around the globe: equity markets seen as out of touch with reality; concern about the twin US trade and budget deficits; and worries about the dollar.

Poor US trade figures on the preceding Thursday had spooked the markets, which had been worried already by a small interest rate hike by the Germans the week before. That rise had triggered worries that global policy co-ordination was at an end. The period from September 1985 to the summer of 1987 was the golden era of policy co-ordination, with the Plaza and Louvre accords marking a time when the G7 acted together to first weaken and then stabilise the dollar. By October 1987, co-ordination was at an end.

The crash led to fears of a depression and prompted central banks to pump liquidity into the markets and to cut interest rates. The Bank of England base rate was 10 per cent on Black Monday and reached a low of 7.5 per cent the following May. At the time, I wrote in *The Times* of the problems to come. A year later, in October 1989, base rate was up to 15 per cent. Boom then became bust.

Today's crisis has been worse, as the financial system almost collapsed, jobs have been lost, firms have gone bust. As a result, the policy response has been more aggressive. But, as in 1987, perhaps the stimulus may work better and quicker than initially expected.

If anything, Black Monday was a watered-down version of what we have experienced now and an early warning sign of the underlying volatility of markets. Then, there was talk of pro-cyclicality on the way up and down, triggered by programmed trading systems. Also, I remember a speech by Robin Leigh-Pemberton, the Bank of England Governor, in February 1988 in which he placed the blame on regulation and supervision and said: "This will have implications for the capital resources that participants must be required to maintain." Banks, we were then told, must learn the lessons about credit exposure and capital adequacy. How times change? Not much it would seem.

These issues were still centre

stage ten days ago at the International Monetary Fund (IMF) meetings in Istanbul, where the mood was one of optimistic caution. Relief that policy had pulled us back from the brink was mixed with fears of over-regulation and concerns that we may be sowing the seeds of the next crisis.

The global outlook depends on the interaction between three key factors: the economic fundamentals; the policy response; and confidence. In Istanbul, the outlook for policy was at centre stage. Central banks and policymakers in the West appear to be keen to co-ordinate their exit strategies from their stimulus. This is something they plan to discuss at next spring's IMF meetings in Washington. Yet the next six months might test this accord to the full. There is every

'Can any big exporting nation really tighten policy before the US?'

likelihood of a strong bounce over that time, as previous policy easing feeds through.

Just as we saw with the Bundesbank rate rise in early October 1987, coming months may force many countries to think about tightening policy to suit domestic needs. This great dilemma is already being played out across the world. In recent weeks Israel and Australia have raised rates. The further east one goes, the greater the temptation to tighten policy. Indonesia and India have already hinted at higher rates. South Korea is in two minds, while behind the scenes in China policymakers appear to be at odds. There, the worries of the Premier and State Council over exports and jobs may take precedence over central bank concerns about asset price inflation.

The dilemma for many countries is that tightening early may attract hot money inflows, as investors seek higher yields. Waiting, however, may trigger asset price inflation, with liquidity flowing into equities and property, as we have seen recently in China. The question is: can any large exporting nation really tighten monetary

policy before the United States, or indeed Europe, given that these are the destinations of the bulk of goods and services?

In view of such uncertainty, many countries appear keen to build up their defences, to be prepared for any eventuality. The lesson of Asia over the past decade has not been lost. After its crisis in 1997-98, Asia's holding of global currency reserves rose from one third to two thirds now, the bulk in dollars. Others look set to follow suit.

It is not in anyone's interests to actively sell the dollar, in case this triggers the collapse they fear. Thus, what I call passive diversification is taking place. As reserves rise, less and less are going into the dollar, although it still receives the lion's share.

Over time, more countries will want to manage their currency against the countries with which they trade. If foreign exchange reserves were to reflect trade patterns, then \$2.3 trillion of the present \$6.8 trillion of global foreign exchange reserves would have to move out of the dollar. The private sector is already cautious.

As the dollar declines, the gainers are commodity currencies, gold, the euro and the yen.

Not everyone is happy. This dampens recovery prospects in countries whose currencies are appreciating and adds to problems for the most fragile economies in the eurozone. It is also adding to pressure on Asian countries, particularly China, to let their currencies strengthen. Perhaps this merits a repeat of the 1985 Plaza Accord to prevent an inevitable currency crisis.

Yet one currency that seems unlikely to rally against the dollar is sterling. In part, this is because of market caution towards the UK. It is also because a weaker pound is seen as central to Britain's policy stance. This is alongside the need for a prolonged period of low interest rates and a much tighter fiscal stance.

The UK has had the biggest devaluation in its history. Yet there have been few squeals, as it has been gradual and is taking place in an environment where competition is tough and inflation is not a

problem. As history has shown us, sterling remained the world's reserve currency long after the UK's economic power had peaked. This is relevant in considering the dollar's prospects now. The general feeling in Istanbul was that there are no alternatives to the

'One currency unlikely to rally against the dollar is sterling'

dollar. Perhaps that is right, but the dollar and sterling face hard times ahead. If there is one thing this crisis and that of Black Monday have taught us, it is not to ignore the fundamentals.

© Gerard Lyons is chief economist at Standard Chartered

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