Move Over, Adam Smith: The Visible Hand of Uncle Sam

John Embry, Andrew Hepburn

Move Over, Adam Smith: The Visible Hand of Uncle Sam

By John Embry and Andrew Hepburn

[John Embry and Andrew Hepburn provide a valuable entry into the world of finance. The two analysts illuminate the shadowy trail of the "Plunge Protection Team" in its apparent mission to rig the American stock markets. Their account is backed up by considerable indirect evidence as well as statements by credible insiders. If their account is correct, it means that US markets look a lot like the Japanese markets that were long derided for being a site of repeated official manipulation. A more important conclusion may be that US markets are even shakier than many believe.

The trail that the two analysts follow is long, dating back to just after Black Monday, October 19, 1987. On that day, the US stock market abruptly crashed. The Dow Jones average dropped by 508 points, to 1738. It threatened to do even worse the next day when, after a brief rally it went into reverse. The markets seemed on the edge of a meltdown, but the abyss failed to open up. This lack of a meltdown has generally been attributed to the Federal Reserve Board's (FRB) steady hand and promises of liquidity. But sophisticated research on the events of those two days indicates that a sudden and unprecedented rise in the Major Market Index (MMI) sparked a recovery across the board. There is good reason to suspect that this recovery was the result of concentrated buying by a few firms.

It was after this crash that the President's Working Group on Financial Markets was put in place to prevent destabilizing declines. The Plunge Protection Team was institutionalized in 1989 as a follow-up from this working group, and originally included the top public-sector financial authorities. Its role was apparently tested with the Friday, October 13, 1989 stock crash. In this case, too, a sudden rush of aggressive buying of index futures contracts via the MMI saved the day. There appear to have been a considerable number of interventions in the wake of that, with the group expanding to include the heads of major banks. Thus, for example, the markets after September 11, 2001, received a heavy dose of intervention. The need for this intervention was so great that its outlines emerged quite clearly in the press.

The Japanese, not surprisingly, appear to be part of the scheme as well. The authors show that there was plenty of consultation between Japanese financial authorities and their American counterparts in the lead-up to the Iraq War. There are also strong indications that the markets were not left unfettered, to render their own verdict on the wisdom of the war, in the anxious days leading up to its outbreak.

There is abundant evidence adduced in the article. It is important to note that the authors are not against intervention per se. They note that letting plunging markets fix themselves could result in economic chaos. But they do warn that the secrecy and growing involvement of private-sector actors threatens to foster enormous moral hazards. Major financial institutions may be acting as de facto agencies of the state, and thus not competing on a level
playing field. There are signs that repeated intervention in recent years has corrupted the system.

This aggressive manipulation of the system took place on Alan Greenspan's watch as Chairman of the FRB. The authors don't discuss the fact that Greenspan is to retire at the end of next January and the White House is having trouble finding a replacement the markets will believe in. It may be that no credible candidate wants to take the baton from Greenspan at a time when it seems likely that the market will implode. Observers note that earlier changes of the FRB chair have generally been followed by much buffeting in the markets as they test the new maestro. Market drops are common. Present risks include the American housing bubble blowing out, oil prices exploding, and inflation blowing in, at a time when the twin deficits of trade and budget are already in the troposphere. This situation points to the likelihood that the Plunge Protection Team will be working overtime early next year. [Japan Focus]

For the article click here