MARKET RISK AND EFFICIENCY

# Triggering the 1987 Stock Market Crash

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On Wednesday, October 14, 1987, the U.S. stock market began the most extreme one-week decline in its history, culminating in the crash on Monday, October 19, when the Dow Jones Industrial Average fell 508 points (22.6%).

Questions about the crash fall into two main groups. First, what fundamental economic factors triggered the large stock-market decline? Second, what institutional and structural factors inherent in the trading strategies of investors and the market structures of the equities, futures, and options markets exacerbated the decline? This paper addresses the first question.

We examine the market decline of more than 10% that occurred from October 14–16, immediately preceding the October 19 crash. Surprisingly, none of the numerous market crash studies document that the October 14–16 decline exceeds any one-, two-, or three-day decline since May 13–14, 1940, when German forces broke through the French armies. Given the size of the October 14–16 decline and the possibility that it triggered the crash, a study of the crash is not complete without understanding the source of this precrash decline.

Several events and economic conditions are candidates, but we focus on proposed tax changes restricting takeovers introduced in the House Ways and Means Committee on the evening of October 13 and approved on the evening of October 15. The bill would have limited tax deductions for the interest on debt used to finance takeovers as well as other tax advantages associated with changes in corporate control.

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