Stock Market Crash

A stock market crash is a sudden decline of stock prices in stock markets. It usually happens due to panic among stockholders and various economic factors. These crashes usually occur after a long period of rising stock prices (due to going speculations), when P/E ratios are far above their averages. According to Benjamin Graham, the father of securities analysis, there are three main forces behind the market crash: the manipulation of stocks, the lending of money to buy stocks and excessive optimism.

The most famous market crash, the Wall Street Crash of 1929, also known as Black Tuesday, happened on October, 29 1929. It is regarded as a start of the Great Depression. All of the three forces mentioned above contributed to this crash.

American economy was blooming in the 1920s. NYSE was the largest stock market in the world. From 1920 till 1929 many stocks quadrupled in value. Thus, many people invested their money in stocks, expecting to gain profit. It led to speculative boom that took place in late twenties: the rising share prices were encouraging people to invest even more. Many of the investors had to borrow money to buy stocks but they only had to have 10% equity and 90% margin to buy securities. Speculations on stocks stimulated further price rises and created an economic bubble. The P/E ratios in 1929 were far beyond historical norms. The high level of speculations increased anxiety of the investors, so when on October, 24 prices started falling, many investors decided to sell their shares. The leading Wall Street bankers tried to stabilize the situation on Friday, but could not find a proper solution. Over the weekend the market crash was discusses in the newspapers and arose the panic among the stockholders. Thus, on Monday Dow Jones fell more than 12%. To worsen the situation, telephone and telegraph lines could not cope up with the increase of their usage and collapsed , contributing to panic spread . On Black Tuesday, the day of chaos, people were desperate to sell their stocks to get at least something back. Besides, many of them had to get rid of the stocks due to margin calls. In two days Do w Jones Industrial Average fell 23%. This market crash inflicted huge financial los s on investors and companies. In 1932 and 1933 the stock prices hit the bottom, being down about 80% from their highs in the late 1920s. This had sharp effects on the economy. Demand for goods declined as people felt poor because of their huge losses in the stock market. New investment could not be financed through the sale of stock, because nobody would buy a new stock. The period of the Great Depression followed this crash brought destruction and bankruptcy to many companies. After this crash U.S. Congress passed several measures to prevent such disasters in the future . FDIC and SEC were created and several laws were passed to secure the market.

Another famous crash happened on October, 19 1987 , also known as Black Tuesday. Several factors contributed to it, however people do not agree what was the main one. This crash was also preceded by the period of strong economy. From 1982 to 1987 DJIA grew from 776 to 2722. World's markets were growing too. There are no obvious reasons for the crash: no major news or causes for panic. The prices started falling since October, 14: DJIA fell 3.82% on Thursday and 4.60% on Friday. It first began in Hong Kong, spread to Europe and affected the US markets as well. The main cause is believe d to be program trading, which is the use of computers to control the trading process and portfolio insurance strategies. Computers became an important part of the trading process in the USA, thus some specialists claim that program trading aroused speculative boom and contributed to market crash by allowing the investors blindly sell their stocks. However, this cause can not be the main one, because the crash started in Hong Kong, where program trading was not popular. Another cause of this crash can be political debates and decisions that made world's currencies unstable. Also there were some discussions about dollar devaluation in the future. Plus there were exaggerated fears of inflation. Many investors lost confidence in American economy, which led to panic among investors. Besides, during that time many people bought portfolio insurance. When the market started falling, those people began to sell their stocks because of margin calls and it accelerated the decline. Definitely a crash was caused by different interconnected events. High level of speculations, high P/E ratios, high oil prices, the influence of program trading and portfolio insurance strategies along with global loss of confidence in the stability of the US dollar - all these things created tension that led to the crash on October, 19 1987. This crash was a world -wide phenomenon: out of 23 industrial countries in 19 of them markets fell for more than 20%. Many people feared the crash is a sign of world's economic depression; however worlds markets could recover in a comparatively short time. For instance, DJIA regained all of its value in two years.

The market crash that we witnessed recently was not as big as the above two. The causes for it are similar to the crash of 1929. This stock market crash started in Shanghai Stock Exchange. The main reason for it was a high level of speculations. The P/E ratios were growing rapidly, tempting people to buy more stocks. The prices for many stocks tripled in the past year. These are unprecedented gains in stock values. The assets of the stocks were overvalued. Many people who have only a vague knowledge of investment strategies took huge loans and started buying stocks, hoping to sell them shortly for a bigger price. This strategy is called "Greater Fool's theory". The government was trying to raise interest rates on the loans and to enforce new taxes on stock gains. The rumors spread over the weekend and on Monday many people started selling their stocks in panic. When this market bubble broke the Shanghai's market dropped on February, 27 2007. The drop of the market in China affected the markets all over the world, as many investors who lost in China had to sell their stocks in other markets to cover the losses. Thus, on February 28 2007 world markets fell 2.3% to 4%. The consequences of the crash were not very dramatic and many markets were partially or completely restored in the few days. However, this crash shows us that a disaster can happen if people will keep on investing without caution.

Returning back to the three main forces of the market crash I have to admit that they are all present today: the manipulation of stocks is present, although it is more regulated by governments and special organizations like SEC; many people still borrow money to buy stocks and have to respond the margin calls is case the market falls; excessive optimism is present as well - P/E rations are above their historical averages and keep on growing. Thus, I suppose that another market crash might happen in the future, but, hopefully it will not be as huge as the ones in 1987 and 1929.