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Why No Crunch  
From the Crash? (p. 2)

David E. Runkle

Economic Fluctuations  
Without Shocks to Fundamentals;  
Or, Does the Stock Market Dance  
to Its Own Music? (p. 8)

S. Rao Aiyagari

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## In This Issue

### The Stock Market Crash

On Monday, October 19, 1987, the Dow Jones industrial average stock price fell 23 percent, even more than on Black Tuesday in 1929. In this issue of the *Quarterly Review*, economists search for economic effects and potential causes of the greatest stock market crash of this century. Their findings are surprising.

### Phantom Effects

In "Why No Crunch From the Crash?" (p. 2), David E. Runkle studies the U.S. economy for effects of the stock market crash, but finds none. Runkle uses the latest version of a statistical model that researchers at the Minneapolis Fed have used to generate the national forecasts published in the *Quarterly Review* the last several years. This model learns from its past forecast errors, and one of its lessons has been that developments in financial markets have in the last decade or so become more loosely connected to the performance of the nonfinancial economy. Nevertheless, the October collapse in stock prices was so large that the model initially predicted a significant weakening of the economy in the first half of 1988. Of course, by March that didn't seem to be happening. Instead, the economy's strength since the crash had pulled the model's forecast back to its precrash path.

Why hasn't the stock market crash slowed economic activity? Runkle reviews several conceivable explanations, but concludes that this apparent puzzle has not yet been resolved.

### Psychic Causes

In "Economic Fluctuations Without Shocks to Fundamentals; Or, Does the Stock Market Dance to Its Own Music?" (p. 8), S. Rao Aiyagari considers the possibility that last October's crash, as well as other economic fluctuations in past times, was unrelated to changes in economic fundamentals. Standard theory led people to search for causes of the crash in terms of new information about economic fundamentals—shifts in policies, tastes, or technology. Yet, as the 1988 *Economic Report of the President* states, "no political or economic event occurred between the market's close on Friday and on Monday that appears capable of explaining such a huge revaluation of the net worth of U.S. corporations" (p. 40). The lack of fundamental causes has prompted many observers to consider psychological factors: sudden losses in investors' optimism or confidence, or what John Maynard Keynes called "animal spirits." Aiyagari shows that such psychic phenomena can be given economic meaning. That is, there exist coherent models—ones with rational individuals operating in markets that clear—in which economic fluctuations can be caused by changes in psychic factors. Moreover, in these models there is a role for economic stabilization policies.

Preston J. Miller  
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