Newfane, Vermont
May 29, 1962

(dictated by telephone)

MEMORANDUM FOR THE PRESIDENT

SUBJECT: The Stock Market

The stock market slump is of consequence, and I venture some suggestions:

(1) The cause of the drop is that people have ceased to see an unlimited prospect for capital gains. This is partly out of respect for the Administration anti-inflation measures. That means that common stocks will not rise forever for reasons of inflation. And as the inflation danger lessens, so does the demand for stock as an inflation hedge. However, as always, speculation has vastly exaggerated this movement. The great reality is that you can make money out of the market when it is going up if you sell when it starts going down. Lots of people have been making money. They are now trying to sell. Yesterday's movement was one of the inevitable results.

(2) The argument as to whether stock movements foretell economic movements is a footless one. As you said rightly the other day, sometimes they do and sometimes they don't. But there is no question that a bad crack-up in the market can have serious repercussions on the economy. Although it was considered highly uncouth to say so -- and almost no one did -- the 1929 crash was a major factor in the collapse in the economy that followed. Investment decisions are sensitive to the market. Also people spend capital gains and are influenced in their spending by what is happening to capital gains. There was a readily traceable effect from the market to other middle-class spending in 1929 and the impact on all consumer spending was quantitatively considerable.

(3) Similar effects also significant in their effect must be expected as a result of recent market behavior. These will have a depressing effect on investment and on consumer spending. I would expect housing, real estate investment, automobiles, home furnishings to be especially affected.

(4) The Administration should adhere to the following rules in the present situation:

(a) keep down the number of reassuring statements. Everyone will be tempted to rush in with magic words to calm the fever. The words will quickly be discounted to zero, or -- as in the case of Mr. However -- to something less. Very soon everyone looks foolish.

(b) hold rigidly to the explanation that the market is accommodating itself to the end of inflation, the diminished prospect for capital gain, and the speculative disappointment associated with the latter. Say that for these reasons the termination of inflation was bound to bring a sharp readjustment. This explanation has the advantage of being valid; of separating the issue of inflation from that of employment, profit and production levels, and minimizing uneasiness about the latter; and it is the explanation most conducive to confidence in the dollar abroad.

(c) at the same time, everyone must recognize that the effect of the stock market drop will be depressing on the economy. Accordingly all forms of budget liberalization and any needed steps to keep money rates easy and encourage investment are of increased urgency. As usual, I would be against a tax cut.

I am sending you a copy of my history of the 1929 episode which, by the kind of foresight that can only inspire confidence, has just become available in a new and inexpensive edition.

J. K. Galbraith