

United States Senate
COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
WASHINGTON, DC 20510-6075

May 31, 1988

The Honorable Alan Greenspan
Chairman of the Board of Governors
Federal Reserve System
20th Street NW and C. St.
Washington D.C. 20551

Dear Chairman Greenspan:

Recent testimony before Congressional committees and published information in the press suggest that investor confidence has been shaken, that volume on the stock exchanges has declined substantially, and that the process of capital formation has been devastated in the aftermath of the Crash of 1987.

At our hearing on May 27th, we were very surprised to hear your response to Senator Donald Riegle's question which suggested that new equity issuance has revived since the crash of the stock market in October of 1987. You testified that net stock sold in the first quarter of 1988 was \$3.8 billion at a monthly rate.

Both before and after that hearing, Banking Committee staff worked with your staff at the Federal Reserve to develop quantitative estimates of the damage done to the process of capital formation by the stock market crash. That work revealed that, since the crash, the lion's share of new stock issuance can be accounted for by closed end investment companies (CEIC).

A closed end investment company is a financial intermediary that issues shares and then takes the proceeds and invests them in financial assets that are already in existence. New capital does not flow directly to the nonfinancial corporate sector as a result of this process. Real capital formation is not directly funded through the formation of closed end investment companies.

Based on staff estimates done at the Federal Reserve, one can see that our capital formation process has in fact been damaged. Data on stock issuance shows the following:

Value of New Stock Issuance
(\$ billion monthly average)

	Total	NonFinancial Corporate Issuers	CEIC	Total Net of CEIC
1984	\$1.89	\$1.08	\$0.00	\$1.89
1985	\$2.96	\$1.61	\$0.02	\$2.94
1986	\$5.15	\$2.52	\$0.34	\$4.81
1987				
Q1	\$5.49	\$2.74	\$0.95	\$4.54
Q2	\$5.70	\$3.46	\$1.03	\$4.67
Q3	\$5.07	\$2.36	\$0.70	\$4.37
Q4	\$1.52	\$0.73	\$0.23	\$1.29
1988				
Q1	\$3.83	\$0.79	\$2.13	\$1.70

As can be seen from this data, the picture of capital formation after the crash is quite different when one removes the effect of the issuance by the closed end investment companies.

One can see from this data that the decline in both overall and nonfinancial stock issuance is marked after the crash. When one adjusts the total stock issuance data for the effects of closed end investment, the recovery of stock issuance is very poor indeed.

This more detailed examination of the data is very important in light of your testimony at our hearing on this question. Your response to Senator Riegle at that time has been discussed quite widely in the media in recent days. We believe that it is important to provide the public with the correct analysis of the effects of the stock market crash on the process of capital formation because, as you know, we will be considering legislation in the very near future.

We believe that the aggregate data cited in your testimony has given the public a misleading impression regarding the adverse effects that have resulted from the market break.

We understand that at the time of your testimony the information on closed end investment companies was not yet available to you. We would appreciate it if you would revisit this question and provide us with your revised views in light of the information that is revealed by this data. Because of the importance of this issue, we ask that you provide us with your response in writing by June 7, 1988.

Sincerely,

Donald W. Riegle, Jr.
Chairman, Securities
Subcommittee

William Proxmire
Chairman