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cc [REDACTED]

**OCTOBER STOCK MARKET CRASH - TREASURY INTERESTS**

Your minute of 10 March asked for my conclusions about policy issues which have emerged from the October crash. These are set out briefly in the attached note. I have included a little more detail about the issues relating to the operation of the stock market itself, since these have been less comprehensively covered in previous Treasury papers than have issues concerning systemic risk or macroeconomic effects.

[REDACTED]

[REDACTED] [REDACTED]

## THE OCTOBER STOCK MARKET CRASH - POLICY ISSUES

There are three areas in which the October crash could have had serious effects, and in which there might be implications for future policy. In descending order of importance they are:

- (i) Effects on industrial and consumer confidence,
- (ii) Systemic effects on financial institutions and the financial system,
- (iii) Effects, both temporary and enduring, on the operation of the stock market.

In each case, one needs to assess to what extent there has in fact been any damage, and to what extent policy responses already taken have been adequate. As for preparation for the future, the question is whether any structural reforms now or any contingency planning might reduce the likelihood of a similar crash recurring or the damage from it if it did. With this in mind the three areas listed above will be examined in turn.

### (i) Effects on industrial and consumer confidence

2. These are potentially the most serious effects. There was certainly a fear at the time that the October crash might trigger a major recession in the way that the 1930's depression followed the 1929 stock market crash. Sufficient time has already passed to say that that will not happen. However, there are still macroeconomic effects from the October crash to come, and in discussing them it is worth making a distinction between the effects which flow simply from a lower level of share prices and those, more difficult to predict, which could flow from a loss of confidence in the economic climate or in various governments' policies engendered by the speed and suddenness of a crash.

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To take the first of these categories. Lower share prices will have an effect on private consumption arising from their effect in reducing wealth. The consensus on such wealth effects - also a feature of the Treasury model - is that in the UK they will be relatively small and operate with quite a long time lag. Nevertheless, forecasts for private consumption and housing construction have been shaded down as a result. However, in view of the dangers of overheating that existed while the bull market was in full swing, such a development will not have been unwelcome. On some theories of investment (Q - theories, which emphasise the different costs in acquiring assets by new investment or alternatively by acquisition) the fall in share prices will lead to less investment and more take-overs: however, such theories have imperfect empirical support and are not reflected in Treasury forecasts (had they been used, the pre-crash Treasury forecasts of investment would have been higher).

4. Apart from such effects from share price levels, the fact of a crash might itself affect confidence. It was partly for this reason that the UK cut base rates by a total of 1½% in three steps in October, November and December. There is also an international dimension to this: the US was the origin of the crash, wealth effects are believed to operate more powerfully there, and there was concern about the US budget and trade deficits. It was therefore necessary to allow some monetary easing in the US without the dollar declining uncontrollably, and thus there was a case for other countries, including the UK, cutting their interest rates somewhat more than if they were reacting to purely domestic monetary developments.

5. The conclusion on the macro economic aspect is that, partly because of the underlying buoyancy of the economy at the time, partly because of a prompt monetary response here and overseas, the stock market crash has not caused an economic crisis. If there is a similar stock market crash in the future, the underlying economic conditions might not be so favourable, and the effects might be more severe. But

[REDACTED]

There are no clear policy lessons that can be learnt from dealing with the October crash. To prevent an overvalued share market in the first place would be an unrealistic aim for economic policy. At most, the government can aim to prevent the economy as a whole from overheating and not itself introduce uncertainties about government policies (as in October in the US concerning its exchange rate policy).

(ii) Systemic Effects on Financial Institutions and the Financial System

6. These effects are fully covered in the FIM2 paper, "Systemic Risk and the Securities Industry". What one is worried about here in the context of a stock market crash, is that one or more large securities dealers would fail and that there would be repercussions on the banking and payments system through defaults on bank loans and contagion to bank parents. The FIM paper identified several areas where securities supervisory techniques might be reviewed, as well as the links between banks and securities houses, and draw attention to the importance of international co-operation on the prudential supervision of securities dealers with operations in many countries. Some contingency planning of how the government and the supervisors might react to possible developments in a crisis was also desirable, although it could not be given to precise or public a form.

(iii) Effects on the Operation of the Stock Market

7. It is generally accepted that many macroeconomic effects and systemic financial effects, if they occurred, would represent true costs of a crash. It is by no means so easy to identify economic costs that flow from the operation of the stock market itself. Opinion seems to be divided according to which side of the Atlantic one is on. Most Americans see the cost as stemming directly from rapid, sharp price changes, particularly from rapid, large price fluctuations. These mean that an essential element of liquidity is lost, because at the time one decides to deal one is unsure of

the price at which execution will take place. One may therefore be dealing at a false price, with consequential inefficiency. In London, with a screen-based dealing system providing firm (but in "fast markets" only indicative) prices, concern has centered more on a possible inability to deal and on the increased cost of dealing represented by widened spreads and increased penalties for dealing in size.

8. The fact is that in a crisis - and there will inevitably be crises - the market will tend to degrade. What one needs to ensure is that the market degrades in an orderly and transparent way, so that those who continue to deal in it know the terms on which they are dealing. This explains the American predilection for "circuit-brakers": rather than deal at erratically fluctuating "false" prices, it may be better to close the markets, disseminate information on buy and sell orders and start the market off again in an orderly way. (Unfortunately, the price-limit halts to trading announced by Chicago and, for automatic execution trades, by New York may make things worse by having no mechanism for disseminating information and no certainty of an orderly re-start). In London, the Stock Exchange is probably correct to point to the relatively smooth changes in screen-based price quotes and the fact that most deals seem to have been reasonably close to those price quotes, although less close than in normal times. The harder question concerns the ability to deal. For all its faults, New York customer turnover was up by 150% in the week of the crash, whereas London managed only an 80% increase. (On the peak day, Tuesday 20th in each case, New York turnover was up by 235%, London by 100% over average daily turnover). In London there were a widening in the quoted spreads and in market touches - the difference between the highest bid and lowest offer price - which persisted for months after the crash, and still exists for the less liquid stocks.

9. This degradation of the market during the crash has economic costs. The direct cost is relatively small - turnover was very small as a proportion of total equity, so the economic

losses from trading at false prices or being unable to deal  
) size at quoted prices would be small, too. Even if one  
adds in those who were unable to contact their brokers or  
refrained from dealing because of uncertainty about prices,  
the costs are probably still low. What may be more damaging  
is the perceived lack of liquidity, which will make investors  
less willing to buy shares, particularly of smaller companies,  
and will raise these firms' cost of finance. Conversely,  
if London proved to be more liquid than some other markets,  
it might attract more business for that reason, with increased  
brokerage earnings in foreign equities, and some increase  
in foreign funding of UK companies.

10. The policy issues that arise from this analysis of market  
performance are rather different to those that follow from  
prudential considerations. In this case, the aim should  
be to ensure that the market-maker system continues functioning  
acceptably in times of crisis without imposing too heavy  
a burden in normal times. (What one should not try to do  
is prevent steep price falls - it is impossible to reverse  
the information technology which accelerates changes in market  
sentiment). This is brought out if one considers one aspect  
of regulation, namely capital adequacy.

11. One point which [REDACTED] (one of the authors  
of the Board report) made in the context of the New York  
specialist system, was that the specialists failed to take  
positions and smooth the buy/sell imbalances, not because  
they had little capital, but because they were unwilling  
to commit their capital (hence his own market insurance  
suggestion whereby insurance companies would pick up 80%  
of their inventories at cost in a crisis - to give them an  
incentive to hold inventory, not to protect them from  
bankruptcy). In London, market-makers did take a board £250  
million of stock on Monday 19th, perhaps to some extent  
inadvertently, With a number of market-makers having to  
receive capital injections from their parents, they might  
be running more tightly-controlled operations in future.  
Thus, the objective for policy would be to try to induce

market makers to deal uninhibitedly and to take open positions in turbulent markets, even if they did widen their quoted spreads as well. Such a course would be risky for individual dealers, even if market-makers on average did not make losses, and thus might be seen as counter-prudential. An increase in capital would be one way to reconcile both requirements, but would be expensive in normal times. There may be cheaper alternatives, such as strict requirements for market-making combined with some form of callable capital.

12. Another major policy issue which will need to be addressed concerns the international transmission of disturbances. Particularly if the Americans' circuit - breakers come into operation, London is likely to see increased volume, particularly in American shares, but perhaps in UK equities and futures, too, if these are used by Americans as an approximate hedge.


13. Clearly, these, are in the first place issues for the Stock Exchange and for the securities regulators to consider. But a wider concern with efficiency in the pricing of and dealing in shares should also inform their decisions.

### Conclusion

13.

(i) Although macroeconomic effects might potentially have been very important, the October crash has added little to the policy debate over macroeconomic and monetary policy or international macroeconomic co-ordination.

(ii) It is right to be concerned about systemic risk to the financial system from such a crash. Despite the relatively robust performance in October, some supervisory and contingency planning issues should be examined.



(iii) The crash itself exposed a lack of liquidity in the share market and some inefficiencies in its performance, and draw attention to the international transmission of shocks to investor confidence. Changes here are unlikely to reduce the chances of a similar share price crash, but might improve the markets' robustness during it.

