

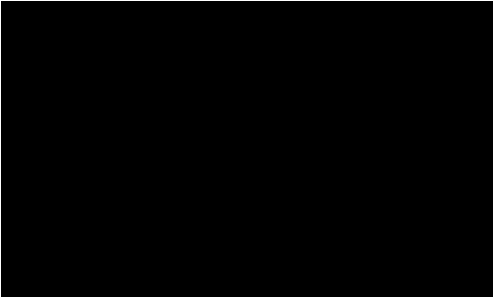
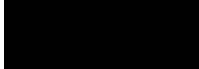


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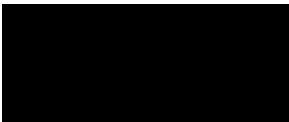
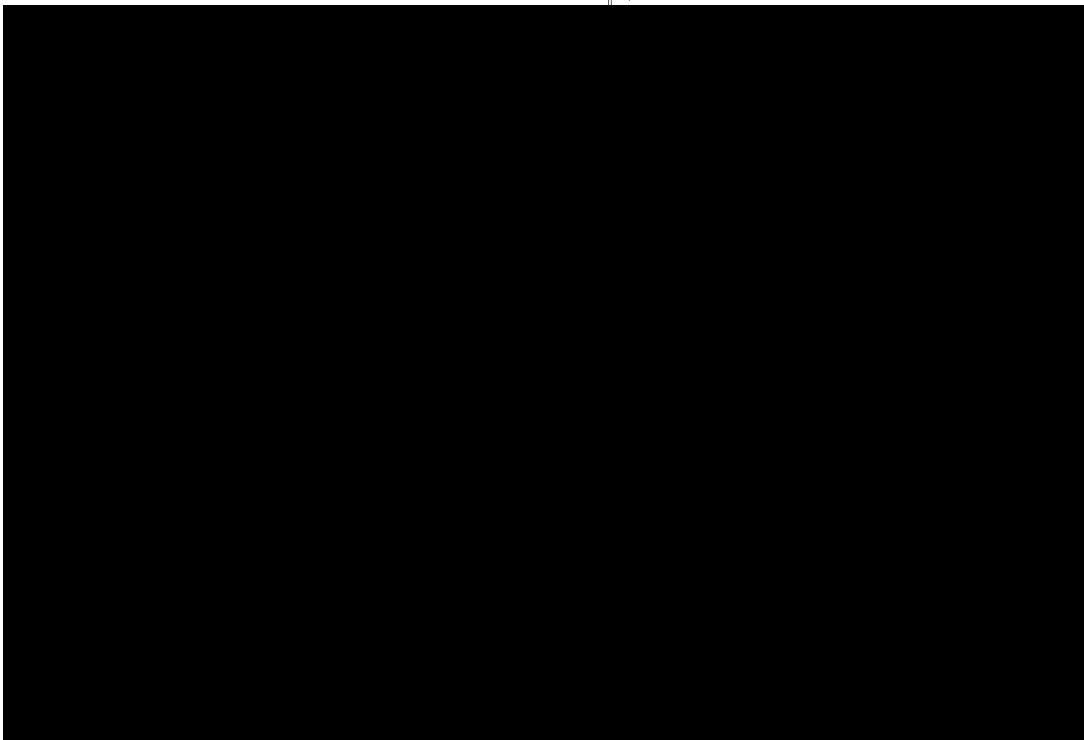


12 November 1987

Dear



... I attach a note in response to the record of the discussion with [redacted]. There are clearly some lessons to be learned. But there is also much about which we can feel satisfied in the performance of the London market.



## MARKETS

This note presents some evidence on how the London equity market has behaved in recent weeks. It also briefly describes the action the authorities have taken to underpin the liquidity of the markets.

2. We can be reasonably pleased with the way London's new market structure has performed during its first real test. The picture is still not complete. But we know enough to say that many of the stories circulating in the City and the press are ill-founded or exaggerated.

### How the equity market performed

3. The view that the new market structure worked relatively well, in extreme circumstances, is supported by the following facts:-

(a) On October 19 and 20 - the days which saw the most extreme price movements - Stock Exchange figures show a very substantial imbalance between customer sellers and buyers. This clearly reflected some very large institutional sales. On those crucial days the market makers took on stock and performed a stabilising function, whether or not they meant to. Contrary to some reports, they were certainly not the main source of early selling pressure.

(b) In the week beginning October 19, there was a record level of trading in UK equities, with the proportion of customer business about normal, in terms of bargains, and substantially above normal in terms of value trading.

(c) Sales accounted for only 20% of customer bargains, with average bargain size on some days of as much as £50,000, indicating that customer selling pressure was coming mainly from institutional (as opposed to private) clients.

(d) In subsequent weeks market makers have succeeded in shortening their books; but that has included periods when they have been able to sell into rallies.

(e) Over the whole period since 15 October average market turnover has averaged about £2 billion, split 60:40 between customers and intra market transactions. This is about the same average daily turnover as in the six months to September 1987, but that was at a higher average price and with a roughly 50:50 customer/market split. So, in terms of the number of bargains, turnover has actually increased.

4. The bear market has brought some changes. Market makers seem to have been acting much as jobbers did before the Big Bang, marking down share prices early in the day to protect themselves against customer-led price falls. Relative to September the ability to deal in size has been reduced, and spreads have widened.

<u>Average spreads</u>	<u>Average September</u>	<u>20 October</u>	<u>4 November</u>
Alpha stock	0.70%	1.37%	2.08%
Beta stock	1.58%	2.04%	3.28%
Gamma stock	2.68%	3.65%	3.58%

5. Market makers cannot however be expected to act as a short term shock absorber, with the commitment of capital that implies, without some widening in spreads. Nor is it reasonable to expect them to act as "buyers of last resort" over a prolonged period. Their job is to enable investors to deal, not to influence prices over the longer term.

6. The London market has in many ways compared well with others.

## Why did London fall so sharply?

7. We need to do more analysis before we can draw firm conclusions about why the market reacted so sharply to the fall in Wall Street. But it is already clear that some factors which helped to support the New York and Tokyo markets were missing here.

(a) In the US, companies have responded to the market collapse by buying back their own shares. UK companies cannot do this at short notice (since it involves seeking the Courts' consent, as well as shareholders' approval).

(b) We also lack the large private investor prepared to take a chance when the market has fallen.

(c) In Japan the long term investing institutions have provided buying support, prompted by the Ministry of Finance.

## Institutional liquidity

8. Institutional liquid assets in the UK have grown rapidly over the past couple of years. Figures are available for pension funds and unit trusts up to end-June; and provisional estimates for Life Assurance companies up to end-September. Pension funds alone held over £9 billion of cash and short term assets by the middle of 1987, an increase of nearly 40% on a year earlier. And at the end of September Life Assurance companies held around £5½ billion in cash and short term assets - more than double their level of liquidity a year earlier. The absolute liquidity of unit trusts was also at a high level in mid-1987 - at £3.2 billion nearly three times the level at the end of 1985.

9. But the picture looks different when liquidity is related to the size of total portfolios. The following table gives information about the liquidity position over time of the pension funds and life assurance companies - by far the two largest groups of institutional investors.

## Cash and short term assets as a percentage of total assets

	Pension Funds	Life Assurance Companies
<u>1971-1980</u>		
Average	6.2	3.4
Highest	15.9 (1974)	5.8 (1974)
Lowest	2.0 (1971)	1.0 (1971)
<u>1981-1986</u>		
Average	3.8	2.9
Highest	4.3 (1984)	3.6 (1981)
Lowest	3.1 (1982)	2.5 (1986)
Latest	3.8 (1987 Q2)	2.8 (1987 Q3*)

\* Provisional estimate

10. Soaring equity prices have inflated the size of the total portfolios managed by these institutions and relative to these totals institutional liquid assets look if anything to be rather low. Pension fund liquidity in particular has been much lower throughout the 1980s than was the norm in the 1970s. They had about 60 per cent of total assets invested in company securities in mid 1987, compared with around 45% in the early 1980s.

11. There is therefore some support for the view that the institutions did not have much scope for increasing their equity holdings. But it is also true that liquidity ratios have for short periods been below those which prevailed immediately before the share price falls, so it would have been possible for them to make further purchases had they wanted to.

12. It is easy to understand why they might not have wanted to buy. Institutional investors will have shared the general view that the market had finally peaked. They will have wanted to hold fewer equities and more cash and, to a lesser extent, gilts. While individual investors can liquidate their holdings of stock, large institutions can only do so at the risk of pushing

prices down further. This is what in these circumstances institutions mean when they complain of illiquidity - they find themselves holding less cash than they would now like, and they have to deal in a market that cannot easily absorb their transactions at given prices.

13. For completeness it is worth mentioning that there have been no signs of illiquidity in the banking system. One crucial lesson of the 1929 crash is that it is important not to allow the fall in equity prices to endanger the banking system. This is particularly important today given their links with securities business. The authorities would have stood ready to act as lender of last resort to any bank with liquidity (as opposed to solvency) problems. This was the assurance that Federal Reserve Chairman Greenspan felt it necessary to repeat publicly on "black Monday". The Bank of England's readiness to discharge this function is well known and has not been called in question.

#### Liquidity of the system

14. The overall liquidity of the economy is a matter of monetary policy, although the position of individual groups of institutions forms part of the picture.

15. The story for the private sector as a whole is similar to that for financial institutions. In absolute terms, liquidity has been expanding rapidly for a long period, with no sign of any slow down. Holdings of liquid assets have risen as a proportion of money GDP - from under 54% in 1980 to over 73% in June 1987. However total private sector wealth has been growing even faster: so liquid assets as a proportion of total wealth fell from 43% in 1980 to 35% in 1985 to under 31% earlier this year.

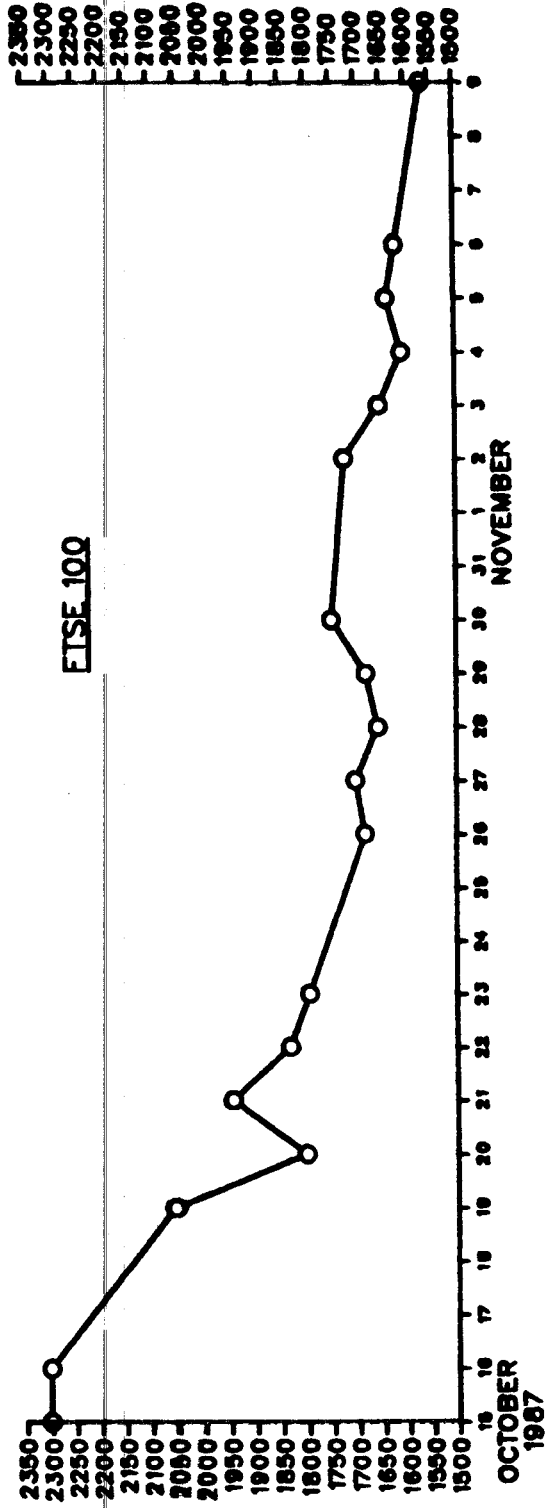
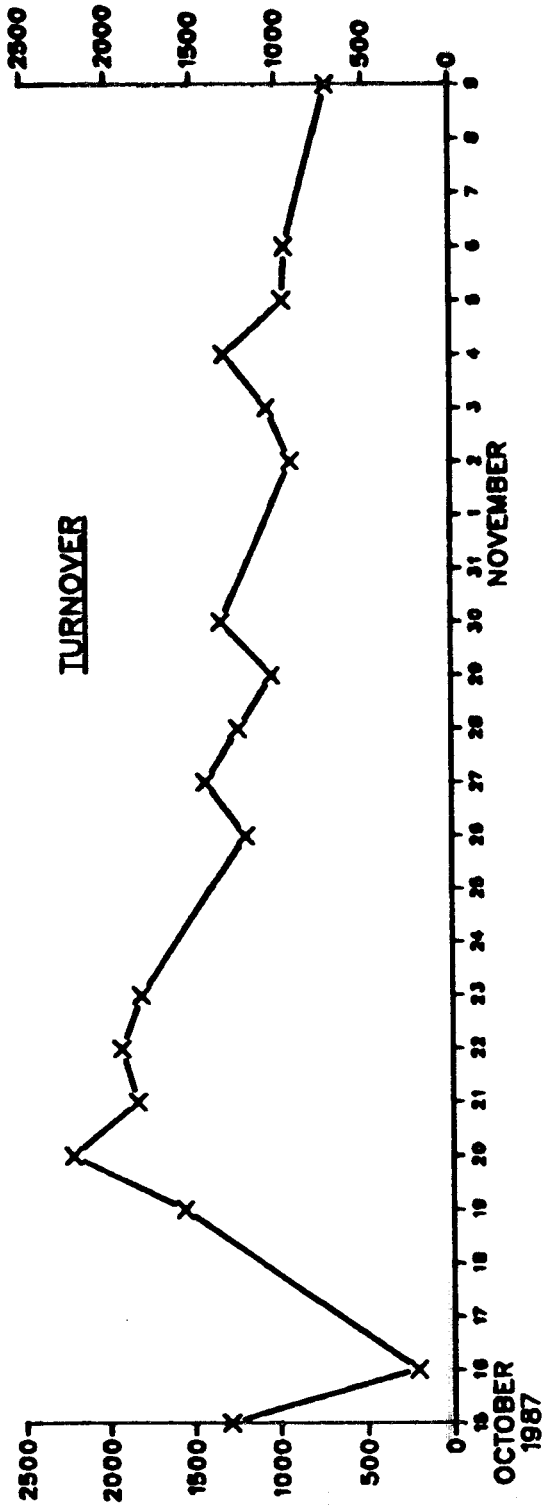
16. This ratio will have risen in recent weeks as a result of the fall in the value of equity holdings. But it seems likely that the private sector's desire to hold liquid assets (assuming unchanged interest rates) will have risen even more sharply.

17. In this situation there are two kinds of action the authorities can take, and have taken.

(1) Direct action to supply liquidity to the system. Largely as a result of exchange market intervention, the government borrowing requirement was "underfunded" in October by an estimated £1.9 billion. That is a measure of the extent to which the Government added liquidity to the system in October. The Chancellor made it clear in his Mansion House speech that October's intervention would be funded as and when appropriate; but that it would not be appropriate in current circumstances to extract liquidity by selling gilts on a major scale.

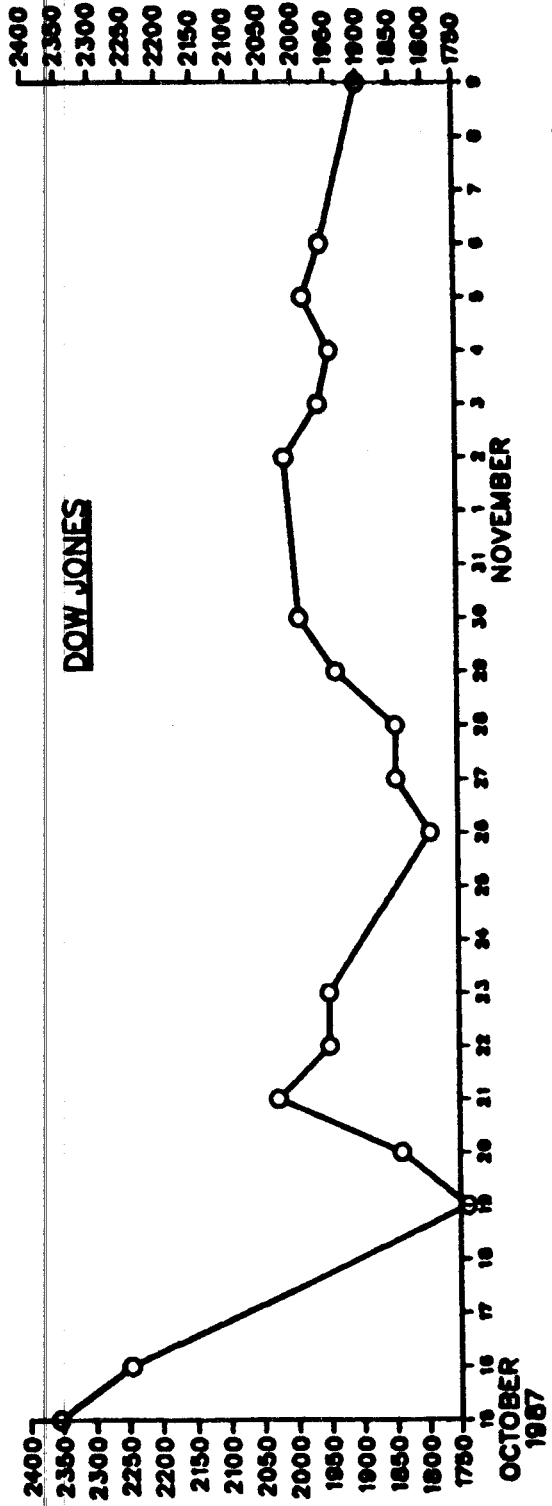
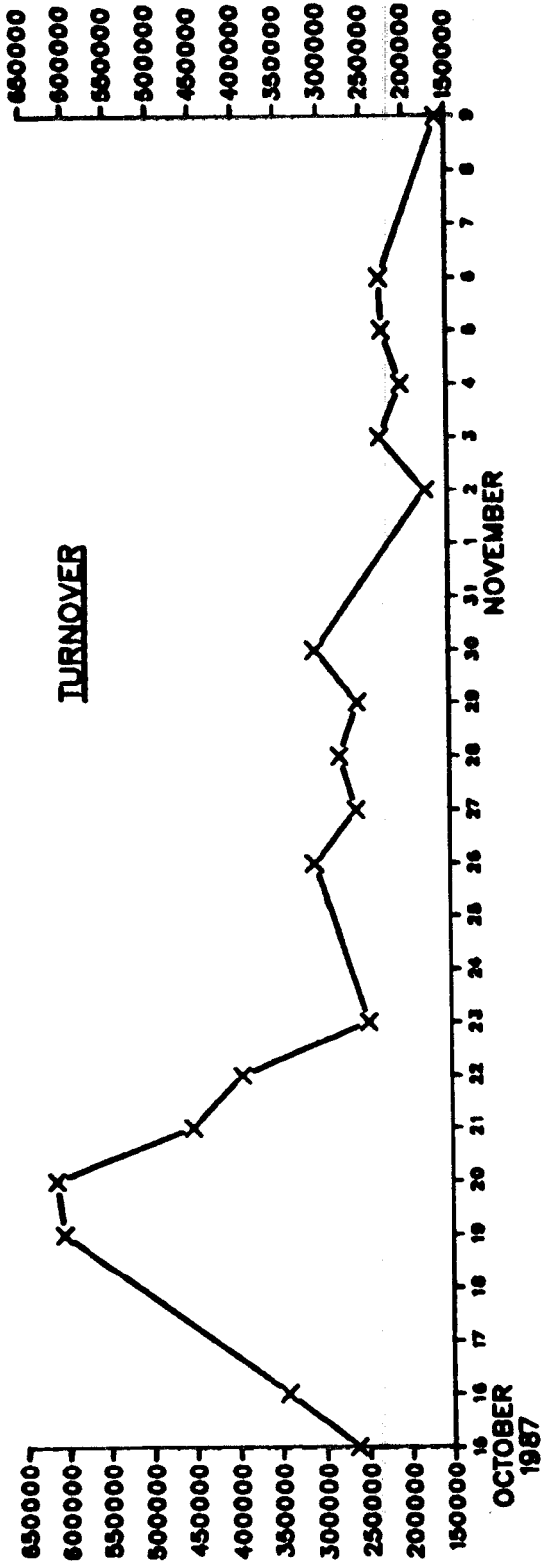
(ii) Action on interest rates. This is more important. Reducing interest rates and allowing gilt prices to rise (the latter will be helped by underfunding) reduces the demand for liquid assets and gilts, thereby providing indirect support for the equity market. In the circumstances interest rates can be cut without risk to future inflation, provided the authorities stand ready to raise rates again as and when confidence returns.

**UK LISTED EQUITIES**



CHARTS-CAPITALS

# US LISTED EQUITIES



CHARTS.CAPITALS

(a) Since mid-October prices in London fell a little more sharply than in New York and Tokyo). But over a longer period - eg in comparison with a year ago or the 1986 average - it is the rather old fashioned markets in Germany and France which fell the most.

### SHARE PRICES

#### Percentage changes

	US	Japan	Germany	France	UK
Oct 15 to Nov 11	-20	-20	-33	-20	-30½
Average 1987 Q1-Q3 to Nov 11	-20½	-13½	-31	-29½	-23½
Average 1986 to Nov 11	+ 5½	+29½	-33	-15	+ 5

Source: OECD, FT.

(b) In an operating sense, London also comes out well compared with the similar market in New York.

(i) In New York trading hours were shortened and dealing in 90 stocks was suspended. Stock Exchange hours have been maintained, and trading in all stocks has continued uninterrupted.

(ii) Turnover has fallen less in London than in New York (see chart).

(iii) Price volatility has been about the same in London as in Tokyo, and about half that in New York.