

FROM: [REDACTED]
DATE: 10 March 1988

CC: [REDACTED]

STOCK EXCHANGE CRASH

I am finding it increasingly difficult to decide whether any significant public policy issues have emerged from the October crash, and the mountains of paper that have now been written about it. I would be grateful if you could let me have a note summarising your own conclusions: what we need at this stage is, of course, quality not quantity! It would be helpful to clear our minds on this subject before the next [REDACTED], Deputy, [REDACTED] trilateral on 23 March.

CEPR Seminar

2. This morning's seminar seemed to narrow the issue nearly to vanishing point. [REDACTED] theme was the appropriate response to very infrequent market convulsions. In contrast to [REDACTED], he defined the problem as one of disorderly markets, not sudden and sharp price falls. He argued (reasonably persuasively) that disorderly markets are bad because they create extreme uncertainty, which can undermine confidence in the solvency of market participants, thereby threatening the stability of the system. His answer was to devise "appropriate" circuit-breakers, conceived essentially as a way of disseminating information to restart the price mechanism when, for some reason, it seizes up. I also found him quite interesting - though rather vague - on the idea of tapping emergency supplies of capital in a crisis, through some form of Exchange insurance fund.

3. However, it seemed to me that he dismissed or sidestepped a lot of interesting and important questions. What caused the market to panic? How likely is this sort of event to recur?

How much disorder was due to the inefficiencies (and under-capitalisation) of the New York specialists? If it is true that London did not experience the same problems as the American market, why not, given that the price fall was every bit as steep? (Can we refute his off the cuff reaction that a more critical scrutiny of the evidence would have unearthed similar problems in London? Is it enough to point to the chart in the Q of M Report which shows actual transactions prices tracking screen quotes pretty closely through the crash period?)

4. The implications for normal capital requirements deserved more careful analysis: for example, as [REDACTED] commented, the need for crisis capital injections was met in London by bank parents. Maybe the need for an insurance fund in the States reflects Glass Steagall restrictions (as well as an academic desire on [REDACTED] part to produce an interesting idea). In any event, it is not clear how far a formal back-up insurance system is needed, if the Central Bank is able and willing to discharge its traditional role, as the Fed clearly did in October. Arguably capital requirements are set to absorb historic price volatility, within some probability range: it is a matter of judgement where that range should be set, but outside it the integrity of the system is implicitly guaranteed by the Central Bank rather than by capital held in the market.

5. Finally, it always comes as a shock to realise just how insular Americans can be: none of the US studies have seriously explored the global nature of the crash [REDACTED]
[REDACTED]

6. I should be interested to hear your account of the afternoon's discussion, which may have been more enlightening.

