

Commentary on 'Policies to Curb Stock Market Volatility'

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The Edwards paper provides a strong and generally effective critique of many of the proposals for financial market reform which have emerged as a consequence of the **October** 1987 stock market crash.

Its initial suggestion that we do not really understand financial volatility is not only correct, it deserves more elaborate discussion. In analyzing the causes and consequences of the 1987 stock market crash, for example, there has been heavy emphasis on the various technical factors which contributed to the equity crash but little focus on how all financial asset prices would have fared in the absence of the October 19 break in equity prices. As a result, we have not asked to question was the volatility of equity prices during October a problem in its own right or a solution to some other problem? As should now be obvious from the robust growth of the U.S. economy during recent quarters, the October 19 equity market crash was, in part, a high speed discounting process in which investors recognized that rising inflation was going to push interest rates sharply higher and ultimately, set the stage for a stock market decline. Because of a breakdown in the **cash/futures** arbitrage process, caused partly by heavy portfolio insurance selling and partly by the inadequacies of the specialist system in New York, the price correction was compressed into a few days rather than spread over the traditional **six-to-nine-month** bear market which has characterized the post-war period. But because of the sharp break in equity prices, several other potentially negative developments did not materialize. Inflation **exppec-**

