Commentary on 'The International Transmission of Asset Price Volatility'

Brian Quinn

I should like to offer some general observations stimulated by Charles Goodhart's interesting and impressive paper before looking at the particular analysis he offers. I might add that I have known Charles for many years, mostly as a colleague in the Bank of England. As this paper indicates, he combines a vigorous mind with a keen awareness of what is going on that is of interest to policymakers in the economic and financial world.

General remarks

First, technical though much of the paper may be—and both the logic and the econometrics demand much concentration on the reader's part—the issues addressed are of direct significance for those charged with the formulation and execution of public policy in the area of securities and banking markets. For example, the capital requirements set by the Securities and Investment Board and by The Stock Exchange in London for professional participants in securities trading will incorporate measures of volatility of the relevant asset prices. These measures are being reconsidered right now in the aftermath of the collapse of equity prices last year. Likewise, banking supervisors in the United Kingdom, exercised by the very large underwriting commitments which some British banks are taking on, are considering how,to set concentration limits on these exposures taking account, *inter alia,* of the recent movements in asset prices including, but not confined to, equities.

In coming to judgments on these matters a good deal depends on whether last October's events are to be regarded as a single, one-off phenomenon arising from a unique combination of external economic conditions, market conditions and technical operating features in particular stock exchanges; or whether they mark the arrival of a quite new and disturbing phase in financial markets. On the answer to this question, where the results of the work of Dickens, King and Wadhwani as well as Charles Goodhart are directly relevant, depends whether firms in London, New York and Tokyo have to reassess both the capital and the systems and controls which they employ in running their business; and whether that assessment is encouraged by the regulators and supervisors.

More generally, the more light that can be thrown on the events and aftermath of last October, the less difficult it will be for operators, regulators and monetary authorities to decide what kind of supporting supervisory and regulatory framework is appropriate to the evolving international banking and capital markets. Charles may doubt that these markets are more integrated than ever before and, by some definitions of integration, he may be correct. But something is going on out there. The Stock Exchange in London estimates that the turnover value of customer business in foreign equities in the London market in the first half of 1988 probably approached one-half of the value of turnover in domestic UK equities. Overseas client business represented about 20 percent of the value of all equity transactions in the London market last year. The value of non-British securities held by UK pension funds increased more than 30 times between 1980 and 1987, reaching 17 percent of total funds; and the proportion of UK investment trusts' and unit trusts' investments in overseas stocks in September last year reached 40 percent of the total.

Last October, when the collapse in equity prices first began to manifest itself, the Governor of the Bank of England established a small, ad hoc working group to keep a close and continuous watch on the evolving situation hour by hour and to advise on any measures that might need to be taken. That group, which consisted of both securities and banking supervisors, set up and maintained close and frequent contact with the corresponding authorities in other countries, notably the United States, Australia, Hong Kong and, to a lesser extent, Japan. From where I sat during that period, and from what I observed during and immediately after the week of October 16-23,

there was no doubt in my mind that, during that period at least and probably beyond, equity markets round the world influence and are influenced by one anothers' behavior. This is not to say that individual market structures, regulatory requirements and operating characteristics do not still play a major part in the determination of asset prices in each center even in turbulent conditions affecting world markets generally. But I believe the direction of developments is clear enough.

If this is so, there is little time to be lost in clarifying the lines of responsibility for the supervision of firms conducting business in a number of financial centers; in developing and securing lines of communication between the relevant supervisory and regulatory authorities; and in ensuring that these steps include banking as well as securities supervisors, given what our group observed last October about the nature of the close and growing links between banks and securities markets. I suspect Alexandre Lamfalussy may wish to say something about this important matter later today.

There is one further point I would like to make before turning to the content of Charles Goodhart's paper. Whether or not last October was an isolated case, it is clear that we could have had a very nasty accident indeed. In circumstances where markets had lost their composure and rumors were rife it was vital that the authorities in the countries concerned should take the correct action. The decision of the Federal Reserve to supply liquidity to the market, and the way in which this was done, was a model of its kind. I also believe that the solution adopted by Her Majesty's Government to deal with the BP issue, and the easing of short-term interest rates in the UK, played important parts in easing pressures at that time.

The Goodhart paper

Let me now offer some particular comments on Charles Goodhart's paper.

First, I want to make it clear that I was not one of the people in the Bank of England complaining about greater volatility in financial markets. As the person in charge of the Bank's Press Office for much of that time, I was too busy complaining about other people. What I do remember is that when we issued British Government stock in the mid-1970s, a movement of a half-point in that market in a day

was something that attracted comment. Not that I believe price volatility is, *per* se, bad. It probably means there is a real competitive market out there; but like some other participants at this conference, I do believe volatility has increased very substantially in most financial markets in the developed centers and that it may already be excessive in the terms which Professor Shiller specifies it.

I would add that the Quality of Markets Report of the International Stock Exchange in London for Winter 1987-88 is in no doubt that "significantly increased volatility is now the norm." That report contains much information reflecting studies of the crash and of a longer period. Among other things it concludes that much of the pressure in London last October derived from the international nature of the London market; that an open verdict is returned on whether foreign selling of UK stocks contributed greatly to the collapse of prices in London; and that, after the initial shock, the markets in most centers went their own way. These conclusions may not have been supported by analysis having quite the same degree of academic rigor as those contained in Charles Goodhart's paper, but they are interesting and informative nonetheless.

As a lapsed economist, I cannot offer any expert critical evaluation of the econometric work in the paper—if I ever could. However, I find the results of the Dickens and the King and Wadhwani work intuitively plausible. I can readily believe that markets go through prolonged periods when the frequency and range of price movements are fairly stable, followed by periods when because of changes in market structure like Big Bang or the abolition of fixed commissions, prices move around in a lively and unprecedented way. Even if nothing else changes, market fashions sometimes do. The cult of the equity certainly captured the imagination of both investors and suppliers of this form of security 'for a spell.

I also find it quite reasonable to believe that last October an unusual conjuncture of circumstances led to a collapse of prices and composure in the New York Stock Exchange, leading to a pinball machine effect in equity prices in other exchanges and back to New York. I do not go along with Charles' view that equity markets as a whole before that event were not overheated. I have not had the opportunity to look at yield gaps in the different markets but I do recollect considerable feverishness in equity markets, sometimes associated with takeover activity—real or imagined—notably in New York, Lon-

don and Sydney. Frankfurt is, I agree, less easy to explain but that may be because I know very little about that particular market.

This interpretation of the crash is, of course, not at odds with the results of Charles' own work, where he is looking for evidence of greater asset price links internationally on either side of the crash. However, I have to wonder whether it is realistic to look for meaningful results in the wake of a shock as severe and abrupt as any this century. Investors are surely right to be very cautious about committing themselves, especially to purchases of overseas assets or on overseas exchanges; advisers are licking their wounds; and market-makers are still sorting out their books, looking at their operating results and at those of their competitors and, more fundamentally, asking themselves whether this is the kind of business they wish to be in. People are, in brief, looking inward rather than outward.

Looking at the analysis in greater detail, I can understand Charles' disappointment with the inconclusive results of his work. I would offer three comments, most of which are reflected in his own paper:

1. The differences between the structures of the three markets he examines are, outside a traumatic event like last October, quite large enough to substantiate significant differences in a given class of asset prices, and in the extent to which news from "outside" affects prices in those markets, in anything but very abnormal conditions. There are differences in capitalization of participants, in the obligation to quote continuous prices, in the use of computer-driven techniques, in the duration of account periods, in funding arrangements, etc.

2. The relative results which his work shows for London, Tokyo and New York again broadly conform with my own a *priori* expectations. Since 1979, and more especially since 1986, London has sought to establish itself as a prime international equity market; more than 100 of the Stock Exchange's 360 member firms are under non-UK control and there are in London more than 40 large international houses making markets in the stocks of non-British companies. By contrast, the insularity of the Tokyo market is well known and its idiosyncratic characteristics well acknowledged. The results for the NYSE are interesting. Perhaps the experience of October has caused people in that market to look around themselves a little more.

3. Finally, I sympathize with Charles' suspicion that relating any other market observation to movements in nominal spot forex changes may be a misplaced act of faith. I understand why he chose to employ

it and admire his ingenuity. However, I do not think of that market as a paradigm for rational behavior, certainly not in anything like a short-term or even medium-term sense. Perhaps we should talk not of Random Walk behavior in that market but of Random Lurch or Random Stagger. However, I regret to say that I do not have anything better to offer at this stage.