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PART D

Part - D.

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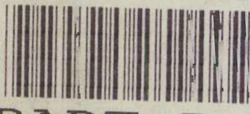


PART D

PO -CH /NL/0110
PART D

Chancellor's (Lawson) Papers:

THE WORLD FINANCIAL
MARKETS 1987 - 1988

Disposal Directions: 25 Years

[signature]

16/8/95.

4426/001/AC

CC PPS
Mr Scholar
Mrs Lomax
Mr Peretz
Miss Sinclair
Mrs Brookhams
Mr Cropper
PS/IR.

Treasury Chambers, Parliament Street, SWIP 3AG

P G B Willis Esq
Chairman
Sheppards Moneybrokers Ltd
20 Gresham Street
LONDON EC2V 7HT

12 November 1987

Dear Mr Willis

Peter Brooke has passed to me your letter of 14 September in which you suggest some minor changes, which could benefit the Gilt-Edged Market.

I can assure you that your comments will be carefully considered in the run-up to the Budget. However, I hope you will understand that it would be inappropriate to offer further comment at this stage.

Yours sincerely

Norman Lamont

NORMAN LAMONT

SECRET

MG NOON REPORT

FINANCIAL MARKETS — Thursday 12 November 1987

Opening	10 AM		NOON	1pm	Oil Price (10 AM)	
75.1	75.2	£ERI	75.2	75.3		
1.7710	1.7685	$/£	1.7680	1.7725	Dec	$17.95
2.9735	2.9773	DM/£	2.9773	2.9760	Jan	$18.05
1.6790	1.6835	DM/$	1.6840		Feb	$18.10
134.90	135.60	Yen/$	135.47			

UK interbank £			Eurodollars	
9 1/8	(-1/16)	7 day	6 5/8	(-)
9	(-)	1 month	6 13/16	(-)
8 29/32	(+1/16)	3 month	7 5/16	(-)
9 1/16	(+1/4)	12 month	7 5/8	(-1/8)

Figures in brackets show change since previous market close

MARKET COMMENT: In the foreign exchange market the dollar was little changed overnight ahead of the US trade figures out at 1.30pm today (Markets expect a deficit of 14.7bn compared with last months 15.7bn). It firmed early this morning as the result of some professional selling of sterling from the Far East, but now steady. Sterling opened easier and has continued to ease during this morning.
The Japanese and Hong Kong equity markets closed up. Nikkei 21546 +509, Hang Seng 2151 +104. The FTSE100 opened at 1648.5 +9.2 and is now at 1700.0 +60.7. 1pm +55.3
The gilts market is steady.

R J McRobbie

MARKET INTERVENTION ($m) — OTHER COUNTRIES INTERVENTION ($m)

Overnight -

Today so far -

Total -

GILTS

	Latest market movements	Price change since previous close
Shorts	Better	0
Mediums	Better	+2/32
Longs	Easier	-5/32

Gilt Sales since market opening: -£2.2 million

All Index Linked

Futures (Long Contracts) -14/32 (Vol:14872)

NAME: Miss R J McRobbie, MG1 Division
TEL NOS: 270 5557/5560

SECRET

SECRET

Alex,
if you're interested.
M.

FROM: R N G BLOWER

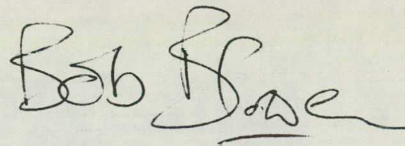
DATE: 12 November 1987

SIR PETER MIDDLETON

cc PPS
PS/Economic Secretary
Sir T Burns
Mr Cassell
Mr Peretz
Mr Grice
Mr Kelly
Mr Ilett
Mr Neilson

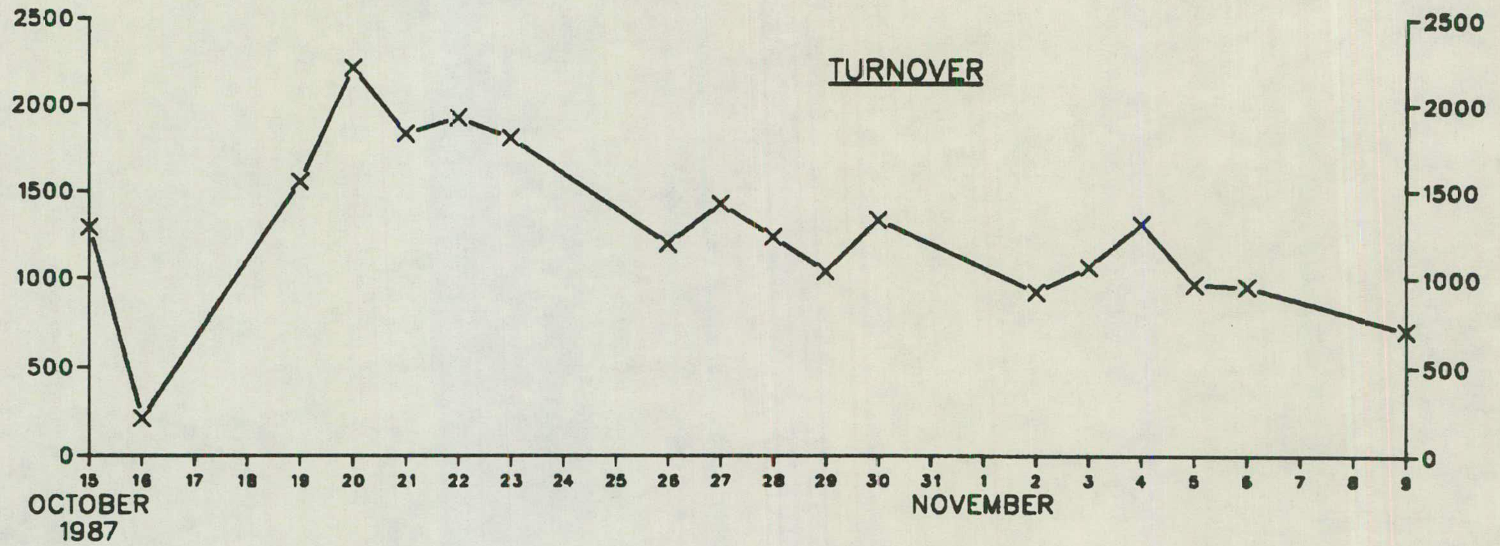
MARKETS: NOTE FOR NO. 10

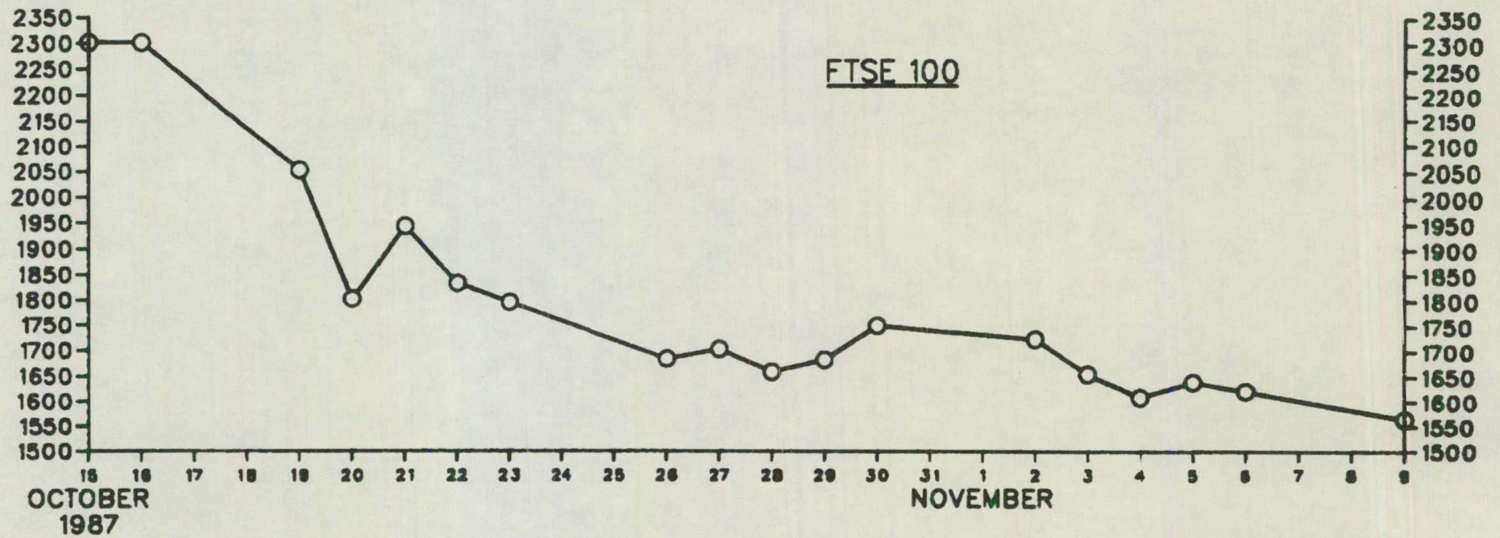
I attach a couple of charts which you might wish to draw on in the note for No.10. You will see that the UK figures (which exclude the USM and TTM) has experienced persistently high turnover compared to the US market.



R N G BLOWER

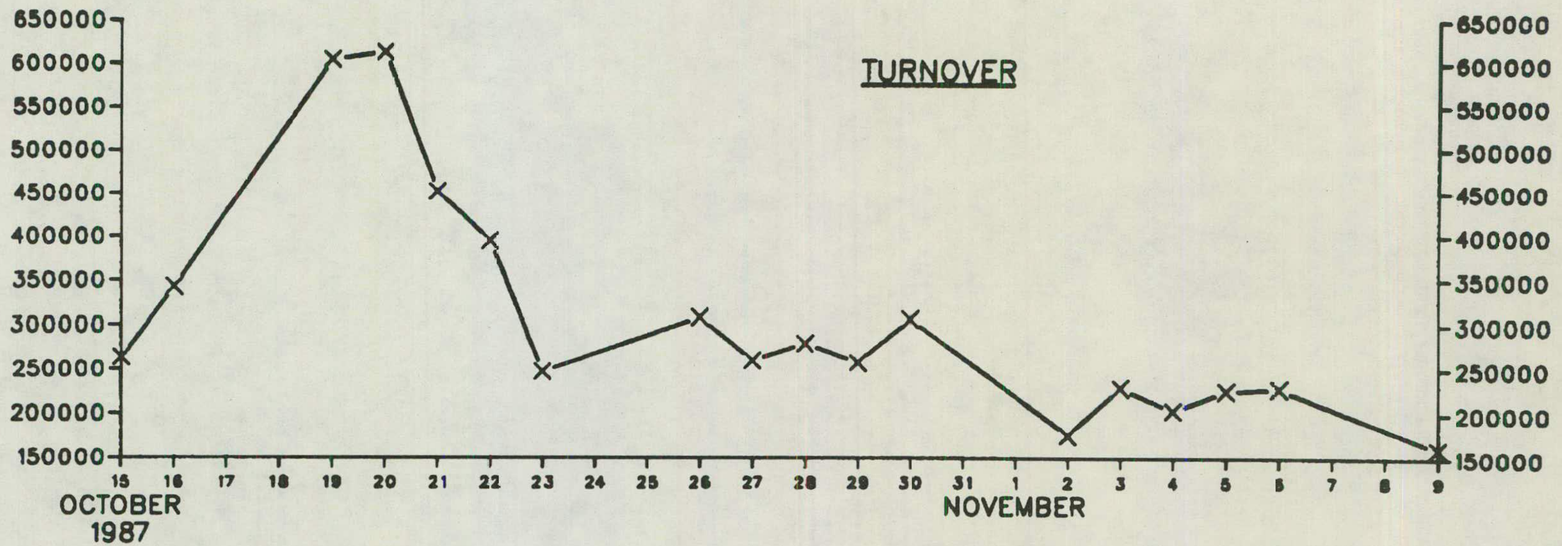
UK LISTED EQUITIES

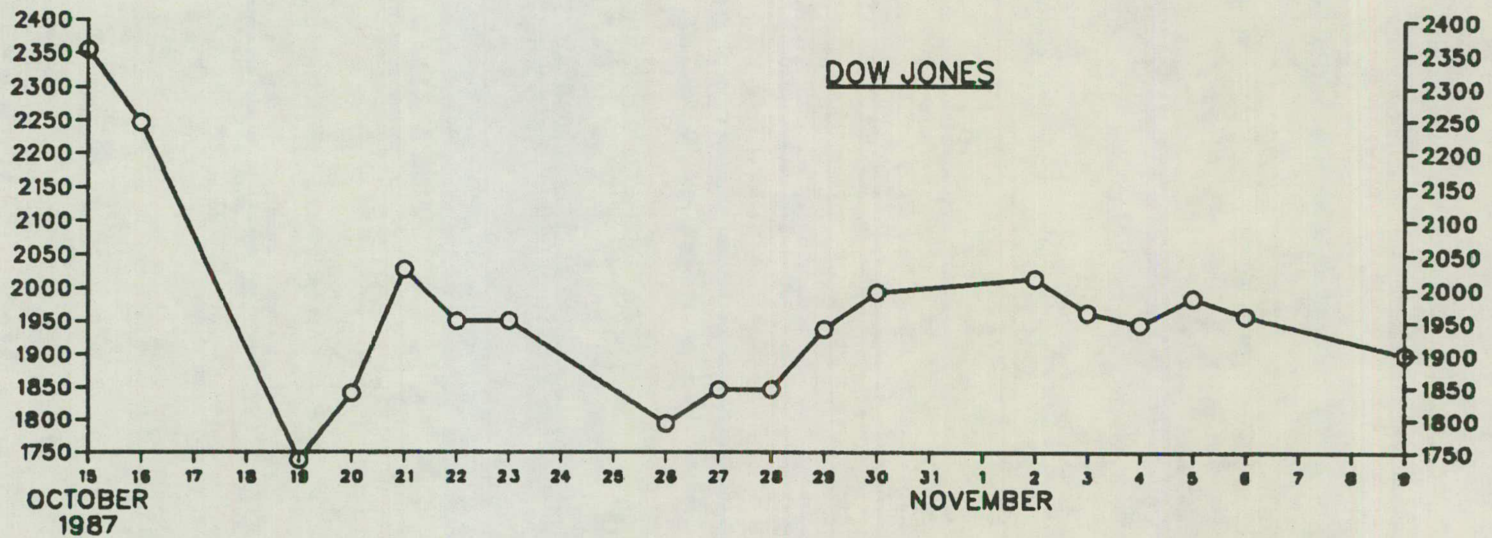




CHARTS.CAPITAL6

US LISTED EQUITIES





CHARTS.CAPITAL6

CONFIDENTIAL

130461
MDHIAN 5460

CONFIDENTIAL
FM TOKYO
TO IMMEDIATE FCO
TELNO 897
OF 120453Z NOV 87
AND TO IMMEDIATE HM TREASURY, BANK OF ENGLAND, DTI, WASHINGTON

TOKYO STOCK EXCHANGE.

1. DAVID GREEN (ADVISER, BANK OF ENGLAND) CALLED ON UTSUMI (DIRECTOR-GENERAL, INTERNATIONAL FINANCE BUREAU, MOF) ON 6 NOVEMBER. THE DISCUSSION PRODUCED SOME SIGNIFICANT NEW POINTERS ON THE TOKYO STOCK EXCHANGE (TSE).

2. GREEN POINTED OUT THAT UK/JAPANESE FINANCIAL RELATIONS HAD IMPROVED IN RECENT MONTHS, WITH ESPECIALLY CLOSE COOPERATION EVIDENT IN THE PROSPECTIVE AGREEMENT ON COMMON CAPITAL ADEQUACY STANDARDS IN BANKING SUPERVISION: BUT WE HAD BECOME SOMEWHAT CONCERNED IN RECENT WEEKS ABOUT THE SIGNALS EMANATING FROM THE MINISTRY OF FINANCE ABOUT THE TOKYO STOCK EXCHANGE. WE EXPECTED TO SEE OUR FIVE BRITISH CANDIDATES ACCEPTED AS MEMBERS IN THE CURRENT ROUND OF EXPANSION.

3. UTSUMI REFERRED TO THE UK'S ORIGINAL DEMAND FOR THREE SEATS, AND TO THE LACK OF OPERATING EXPERIENCE OF SOME OF THE NEW APPLICANTS. GREEN REPLIED THAT THE MOF SHOULD MAKE A DISTINCTION BETWEEN THE NEW US APPLICANTS, ALL OF WHICH WERE OFFSHORE SECURITIES SUBSIDIARIES OF BANKS AND LACKED WORLDWIDE EXPERIENCE, AND A MAJOR DOMESTIC SECURITIES COMPANY SUCH AS BZW. HE ADDED THAT IF ANY APPLICANTS SHOULD BE DISAPPOINTED THIS TIME IT WOULD BE IMPORTANT FOR THE TSE TO GIVE SOME DEFINITE STATEMENT ABOUT FUTURE EXPANSION PLANS. UTSUMI SAID THAT IT WOULD BE EXTREMELY DIFFICULT TO PREFER BZW OVER THE US FIRMS IN THIS ROUND, BUT ADDED THAT HE WAS URGING FUJITA (SECURITIES BUREAU) AND TAKEUCHI (TSE) TO SAY SOMETHING SPECIFIC ABOUT THE FUTURE.

4. UTSUMI THEN REFERRED TO THE REGIONAL BANKS' EAGERNESS TO OBTAIN BANKING LICENCES IN LONDON, POINTING OUT THAT ONE APPLICATION HAD BEEN OUTSTANDING FOR OVER TWO YEARS (THE HOKURIKU BANK). HE REAFFIRMED THE MOF'S WILLINGNESS TO OPERATE QUOTE TRAFFIC CONTROL UNQUOTE FOR THE APPLICATIONS. GREEN SAID THAT BANKING LICENCES FOR THE REGIONALS WOULD HAVE TO WAIT UNTIL THOSE FOR THE TWO REMAINING

SECURITIES COMPANIES WERE OUT OF THE WAY: BUT HE EXPECTED THAT THIS LATTER COULD BE ACHIEVED ON THE TIMETABLE ENVISAGED IN THE BILATERALS, PROVIDED THE TSE ISSUE DID NOT LEAD TO ANY DETERIORATION IN THE CLIMATE. UTSUMI CLEARLY REGISTERED THE CONNECTION.

5. GREEN ALSO CALLED ON DAIWA AND NIKKO. AT DAIWA, YAMANA, DEPTUTY PRESIDENT, RAISED THE QUESTION OF THE STOCK EXCHANGE, NOTING THAT THE JAPANESE THOUGHT THEY HAD BEEN SHOOTING AT A FIXED TARGET OF THREE SEATS, BUT NOW FOUND THE TARGET WAS MOVING. GREEN REHEARSED OUR VIEW OF THE PAST HISTORY AND DESCRIBED OUR PRESENT POSITION ON THE FIVE SEATS. YAMANA REFERRED TO THE POSSIBILITY OF FURTHER ROUN DS AND SAID THAT IT WAS VERY DIFFICULT FOR THE STOCK EXCHANGE AT THIS STAGE TO SAY ANYTHING OFFICIALLY ABOUT FURTHER ROUNDS. THERE WERE TWO REASONS FOR THIS : THE FIRST WAS THE POSITION OF THE SMALLER MEMBERS, EACH OF WHOM HAD AN EQUAL VOTE, WHO WERE OPPOSED TO YET FURTHER OPENING UP. THE SECOND RESULTED FROM A SUSPICION THAT IN ANY CASE MORE THAN 22 NEW SEATS WOULD NOT ULTIMATELY BE NECESSARY. AS PRESENT MEMBERS AND PUTATIVE APPLICANTS SAW JUST HOW ROUGH THE GOING WAS. YAMANA THOUGHT THAT BY THE TIME BARCLAYS WAS GENUINELY READY TO BE UP AND GOING, SAY IN 12 MONTHS, THEY WOULD ACTUALLY FIND THE SEAT DID NOT MAKE SENSE. EQUALLY OTHERS WOULD EITHER WISH TO WITHDRAW APPLICATIONS OR WOULD BE WANTING TO SELL TO OTHERS SEATS ALREADY PURCHASED. (SUCH THOUGHTS HAVE ALSO BEEN MENTIONED TO GREEN AND RAIKES BY SOME STAFF IN FOREIGN HOUSES.)

6. THERE WAS SOME GENERAL DISCUSSION ABOUT FORMULAE ENVISAGUING A FURTHER ROUND IF APPLICANTS FOR FURTHER SEATS STILL EXISTED OR AN EXTENSION OF THE PRESENT ROUND TO ADMIT IN A YEAR'S TIME APPLICANTS WHO HAD APPLIED THIS TIME (BUT NO OTHERS). BUT GREEN RE-EMPHASIZED AT THE END THAT WHAT WE STILL EXPECTED ALL BRITISH HOUSES WHICH WERE QUALIFIED TO OBTAIN SEATS.

7. AT NIKKO, MATSUKAWA, SENIOR ADVISER TO THE PRESIDENT, (AND A FORMER VICE- MINISTER IN MOF) REFERRED TO NIKKO'S BANKING LICANCE APPLICATIONS. THEY WOULD BE READY TO OPEN WITHIN A WEEK OF A QUOTE GREEN LIGHT UNQUOTE BEING GIVEN. GREEN SAID THAT THE LICENCE WAS A MATTER FOR THE BANKING SUPERVISORY AUTHORIES BUT HE UNDERSTOOD THAT PROGRESS WAS BEING MADE. HOWEVER, HE IMAGINED THAT THE GENERAL CLIMATE OF RELATIONS, INCLUDING DEVELOPMENTS ON THE TOKYO STOCK EXCHANGE, MIGHT BE A FACTOR INFLUENCING THE SPEED OF PROGRESS. MATSUKAWA SAID THAT HE WAS SEEKING TO INFLUENCE THE CLIMATE AT THE STOCK EXCHANGE.

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WHITEHEAD

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FINANCIAL NAD
FED [-]

NNNN

Chief Economic Adviser to the Treasury

Alex

The Chancellor will be interested to read the attached article – sent to me by Gus O'Donnell this morning. I have sent a copy to David Norgrove.

Thanks.
Some relief: from commentators whilst [illegible].
G 8/7/87

Stephen Marris

And What If the Dollar Overshoots?

James Baker has signaled his desire "to hold down interest rates and let the dollar fall," according to The Post. Distinguished economists call for only small cuts in the budget deficit; anything larger could "topple the economy into recession." Martin Feldstein, writing in The Wall Street Journal, says that America should "explicitly but amicably abandon the policy of international policy coordination." Taken together, this advice is a recipe for disaster.

Why? America is living beyond its means. As long as foreigners were prepared to lend massive sums to the United States, there was no problem. But the supply of willing private lenders has dried up. The world's central banks have stepped in to buy up the excess of dollars, effectively printing money to finance the U.S. trade deficit. This cannot continue indefinitely.

But the trade deficit cannot be eliminated overnight. *Somebody* will have to be induced to lend the United States $10 billion to $15 billion a month for many months to come. The only question is at what *price*—in other words, how far the dollar will have to fall and U.S. interest rates will have to rise to rekindle enthusiasm for lending to America.

Many American economists see a simple solution. Let the dollar fall quickly to the "right" level. Then, since foreigners will know that it is at the "right" level, they will start lending to America again.

They are wrong. First, until we know how long it will be before decisive action is taken to cut the budget deficit, nobody knows what is the "right" level for the dollar. If American spending rolls on unchecked, higher inflation will offset the competitive gains from a lower dollar, pushing the "right level" for the dollar farther and farther down. On the other hand, if American spending is cut back quickly, either by budget cuts or by a recession, then the dollar will not have to go much farther down.

Nobody knows which outcome is more likely. What the foreign exchange markets *do* know is that since 1973 the dollar has been going up and down, each time overshooting the "right" level by increasing amounts. And since last time the dollar overshot upward by 30 percent to 40 percent, it could overshoot downward by a like amount—which would mean that it still has a hell of a lot farther to fall.

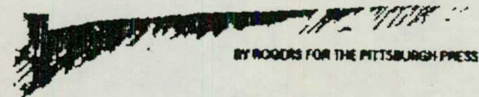
Federal Reserve Chairman Alan Greenspan has inherited an impossible situation. Investors are losing confidence, both at home and abroad, and they are looking to the Fed for diametrically opposite signals. American investors want it to pump money into the economy to stave off recession. Foreign investors want it to let U.S. interest rates rise to defend the dollar and protect the value of their investments.

So far the Fed has steered a fairly skillful course between Scylla and Charybdis. The Sept. 5 discount rate hike helped reassure foreign investors. Aggressive provision of liquidity since Black Monday has helped reassure domestic investors. But now the foreign exchange markets are waiting to see how far the dollar will be allowed to fall before the Fed will let U.S. interest rates rise again—which could set off another slide on Wall Street.

Baker is an astute politician who is reputed to be a good poker player. He has been playing for time. Trying to prop up the dollar at an unsustainable level gained about six months. Unfortunately, letting it go may not gain more than a few weeks. His hand lacked one key card—decisive action to cut the budget deficit.

The arithmetic is simple. Both the country as a whole and the federal government are spending roughly $150 billion a year more than they are earning. If America is to stop going into debt for a while, as it should, then the only way to bring spending down in line with income in a controlled and manageable way is to cut the budget deficit to around zero. This need not be done overnight, but should be done over, say, the next three years.

Would this tip the economy into recession—as argued by many American economists from both ends of the political spectrum? They fail to realize that once the inflow of foreign savings dried up, a recession, or at least a sharp slowdown, became inevitable. They have also not learned a lesson from Europe: when you lose the confidence of the financial markets, Lord Keynes has to be turned upside down.


BY ROGERS FOR THE PITTSBURGH PRESS

What this means is that if decisive action were taken to cut the budget deficit quickly, the boost to the economy from improved confidence, lower interest rates and a dollar stabilized at a somewhat lower level would, in a matter of months, outweigh the negative impact of higher taxes and lower federal spending.

The classic example of an anti-Keynesian fiscal policy was Margaret Thatcher's March 1981 budget, which cut the structural budget deficit by 3 percent of gross national product when the economy was already in recession. This prompted 365 economists to write a letter to the London Times protesting that she was committing economic suicide. In fact, however, the second quarter of 1981 was the turning point. Because of Thatcher's draconian budget, the Bank of England was able to pursue an expansionary monetary policy and orchestrate an orderly decline in the pound. And it was the boost from the lower pound and lower interest rates that pulled the economy out of recession.

There is an important lesson here. After the stock market crash in October 1929, governments almost everywhere tried to cut budget deficits, and the Fed pursued a restrictive monetary policy. This, together with Smoot-Hawley and competitive devaluation, led to the Great Depression.

History need not repeat itself. First, the United States should cut its budget deficit so that the Fed can pursue a relatively easy monetary policy, without setting off a free fall in the dollar. Second, other countries with trade surpluses should increase, not cut, their budget deficits. Third, all countries, not just the United States, must not try to opt out of the impending world recession by putting up barriers to imports. Fourth, international macroeconomic cooperation must be strengthened, not abandoned.

The issue now is whether the U.S. trade deficit can be corrected without inducing a world recession. Europe and Japan, with a combined GNP nearly double that of the United States, will have a crucial role to play. Equally, even after America has got its act together, massive international support will probably be needed for the dollar: it is, after all, the world's currency.

The writer is a senior fellow at the Institute for International Economics.

12/11/87

12.10

PMP

URGENT

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

Washington D. C. 20433
U.S.A.

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DATE: November 12, 1987

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FROM: Alan A. Walters, VPDEC

Extension 33767 Dept/Div., No. 641/05

TO: COMPANY/ORGANIZATION: NO.10 DOWNING STREET, LONDON, ENGLAND
CITY AND COUNTRY: LONDON, ENGLAND
FOR ATTENTION OF: MR. DAVID NORGROVE - URGENT

cc BG
Sir Terence Burns
HM Treasury

GOUGS

FAX NUMBER/ MACHINE TYPE: LONDON 222-8141

Prime Minister 2
DRN
13/11

SUBJECT: WORLD ECONOMY

PER OUR DISCUSSION, ATTACHED ARE MY THOUGHTS ON THE CURRENT SITUATION.

Ch
Clearly influencing PM
AA

REGARDS,

Right. What he appears to propose – allowing the $ decline to overshoot the policy – is precisely the policy he has lambasted the Treasury for. X.

ALAN WALTERS

Attachment

cc:

Transmission Authorized by: Alan Walters, VPDEC

Original to be returned to: A. Walters

Room No.: S-9029

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74/2

Date: November 12, 1987

To: Mr. David Norgrove

From: Alan Walters

Fears of 1929-1933

The stock market crash has recalled cathartic comparisons with 1929. But the crash of 1929 did not cause the great depression of the 30s. That was due to the perverse government policies which were used to deal with the recession that followed the crash. In all countries these intially took the form of (a) contracting the money supply "to defend the exchange rate", (b) fiscal stringency. and (c) protection. Britain changed her policy with respect to (a) and (b) with dramatic results in 1931, but the United States continued its defence of the dollar until 1933/4 - and saw its money supply, price level, and real GNP collapse by one third.

A recession or at least a substantial slowdown in growth is likely next year. The important job for governments is to avoid the errors made in the 1930s so that a modest recession does not become a disastrous depression. That is the short run task of governments. The long run task is to ensure that, in dealing with the short run, the goal of inflation-free growth is not jeopardised.

A good start has been made. Monetary authorities have properly responded to a potential liquidity crisis by supplying cash and easing monetary policy. This, however, came into conflict with the Treasury Secretary's view that the United States, Germany, Japan and the U.K. should "defend" the dollar against further fall. A defence of the dollar was rationalised in terms of promoting confidence in international markets (just as in 1930) and has lead to various forms of international accords which would have immobilised monetary policy. Fortunately the Louvre accord and the attempt to use monetary policy to support the dollar have been, I hope, permanently shelved.

The loss of nominal wealth associated with October 19th is likely to slow household and business spending. We enter a recession. A decline of interest rates is a natural concomitant - and it would help sustain investment, lower the dollar, encourage exports and so promote recovery - with beneficial effects on the rest of the world. If a policy of pegging the dollar were pursued, the reduction in the current account deficit would be slowed down and interest rates would have to be high, perhaps

and that expectation wouldn't arise + $ went into free fall? 747/3

much higher, to compensate for the expectation that, despite the government's temporary success in pegging the dollar, the value of the dollar must decline.

The dilemna is that there is an apparent contradiction between this short run monetary policy of transitory ease and the responsible long run policy of containing inflation. So often in the past, an expansion of the money supply and restrained interest rates, adopted for sensible liquidity reasons, have become politically too attractive to forgo. They have then fueled inflation, with all its corrosive effects and the final result "stagflation". The pervasive long run objective must be one of stable financial conditions consistent with non- or at least low- inflation. We must not allow policy to degenerate again to staggering from one financial crisis to another.

X

But what does he propose?

An even greater dilemna confronts the United States in fiscal policy. The federal deficit is has been and is far too high in these full employment years. In the long run the federal deficit must be reduced so that it is at least not unsustainable. With the onset of a recession, however, the deficit may well expand, in the short run, and, as "automatic stabilizers" offset some of the effects of the recession. In the long run we want the deficit down, in the short (recession) run we want it up. Unfortunately the United States has increased the deficit in past recessions, but failed to reduce it during the recovery. So it has burgeoned, and there is little room left for short run policy.

Again the issue is to fashion a credible policy of long term deficit reduction with a short term flexibility of response to varying economic activity, (like our MTFS). I do think that the reduction of the deficit by some $23 - 40 bn has become such an issue of confidence in government that it is desparately needed. But what is required for the long run is some institutional arrangement (such as a line item veto) for restraining congressional spending. There is a danger that in the United States we shall get the worst of both world.

With protectionism, fortunately, there is no such dilemna. Short and long run policies call for the same medicine - free trade. But political temptations are another matter. There is a real danger that we shall repeat the great error of the Smoot Hawley tariff of 1930 and the tide of world wide protection that accompanied it. It is remarkable that after five years of quite strong growth and full employment, the tide of (congressional) protectionism is waxing, not waning. It can only become a flood if even a mild recession occurs. The power of the president to veto such demands has been much reduced. For my part I doubt if we shall get anything so disastrous as a Smoot Hawley; but it will be serious.

747/4

In short, the stock market collapse may be seen as a blessing if it forces the United States and the OECD countries to develop more responsible monetary, fiscal and exchange rate policies. With suitable and sensible government policies, any recession could be rendered mild and bearable. The wrong policies could bring an inflationary depression, both severe and intolerable.

H M Treasury

Parliament Street London SW1P 3AG

Switchboard 01-270 3000

Direct Dialling 01-270 4360

Sir Peter Middleton KCB

Permanent Secretary

cc PPS
PS/Economic Secretary
Sir T Burns
Mr Cassell
Mr Peretz
Mr Grice
Mr Kelly
Mr Ilett
Mrs Lomax
Mr Neilson

N L Wicks Esq
10 Downing Street
LONDON
SW1

12 November 1987

[illegible red handwritten annotation]

Dear Nigel

I attach a note in response to the record of the discussion with Lord Stevens. 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.

Yours sincerely

Dick [signature]

pp P E MIDDLETON

PS. And take a p3 on St update.

a

I will make sure this is copied to Lord Young!

AT

- 1318/16

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.

Average spreads	**Average September**	**20 October**	**4 November**
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.

(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.

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 £5¾ 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 mid1987, 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.

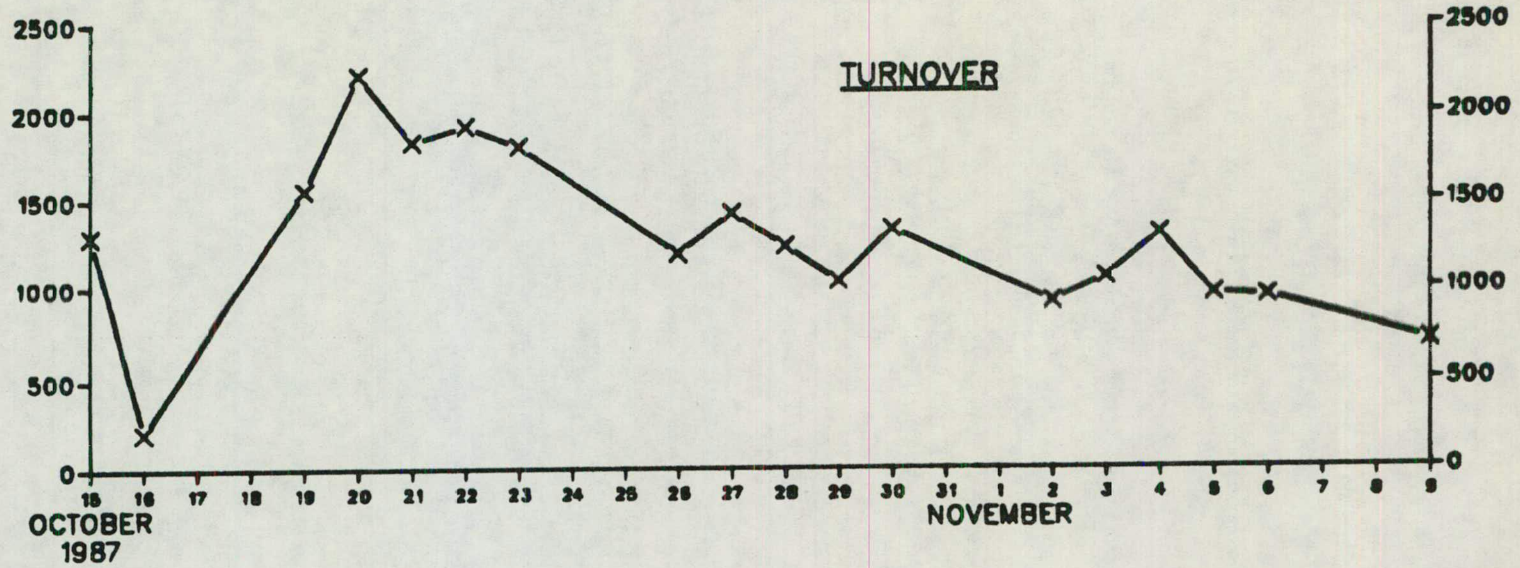
17. In this situation there are two kinds of action the authorities can take, and have taken.

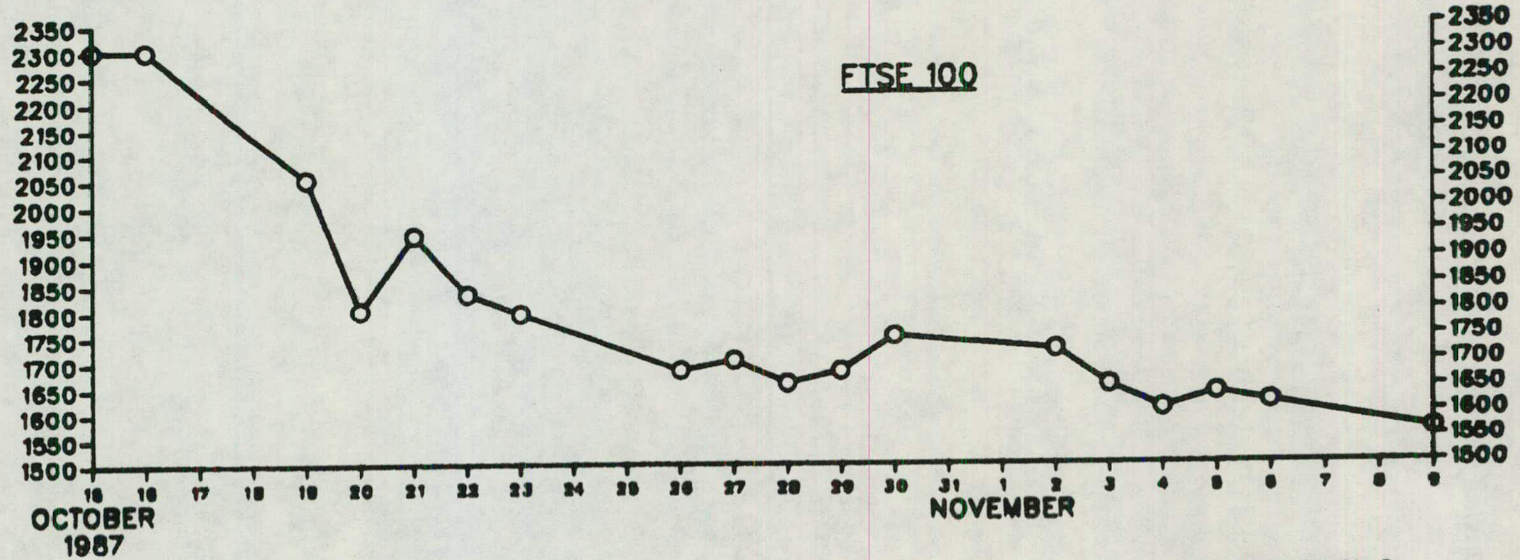
SECRET until 11.30am 19 November

(i) 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.

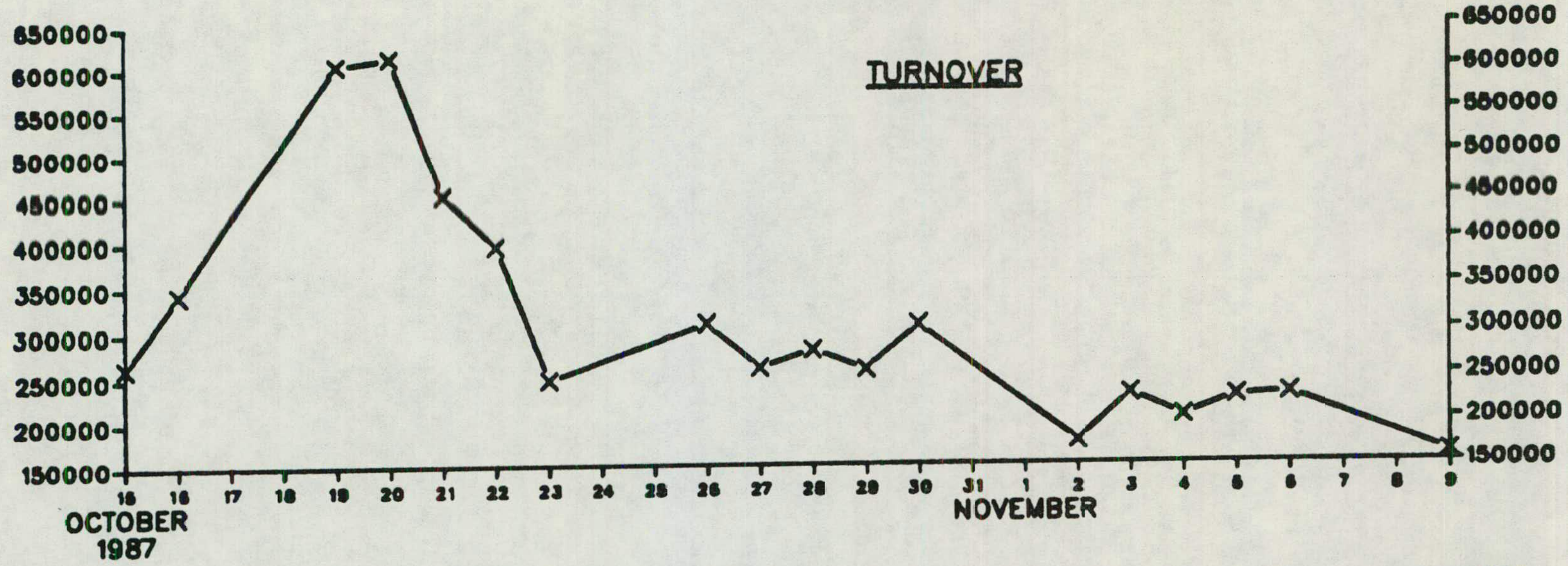
UK LISTED EQUITIES

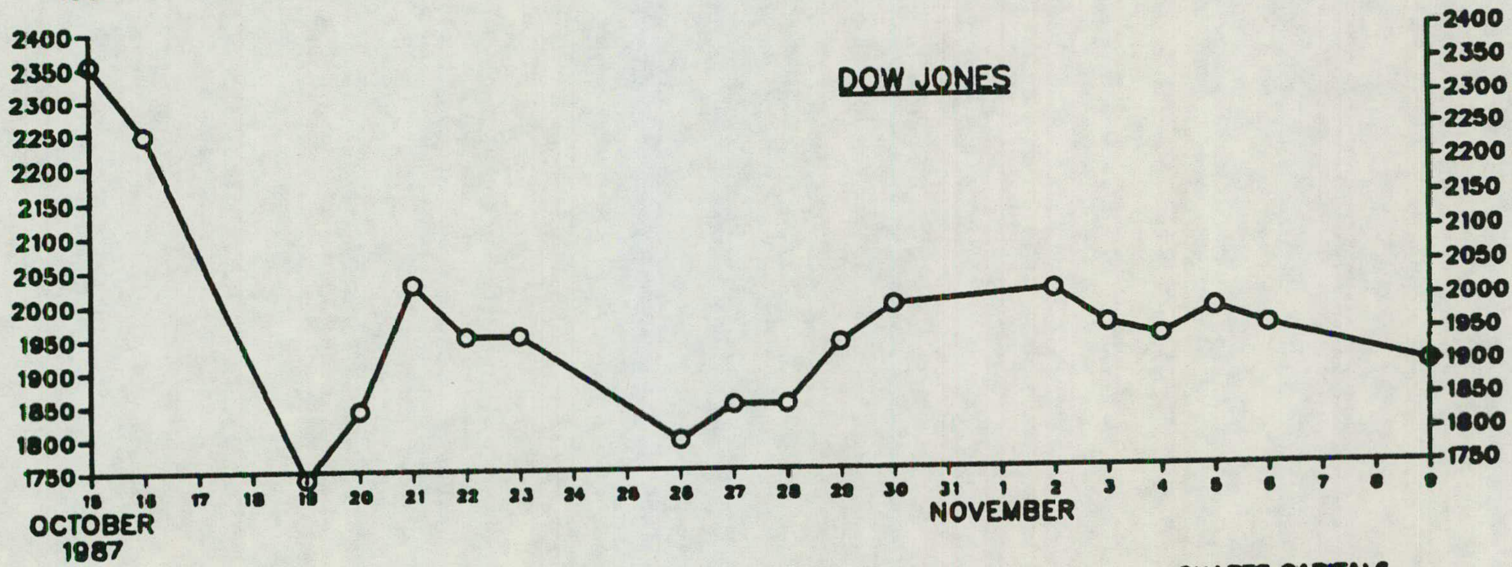




CHARTS.CAPITALS

US LISTED EQUITIES





CHARTS.CAPITALS

PH1/179

pmp

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

13 November 1987

Jack Hennessy Esq
Chairman
Credit Suisse First Boston Ltd
2A Great Titchfield Street
LONDON W1P 7AA

Dear Mr Hennessy,

The Chancellor was most grateful for your letter of 28 October. He read your article for the European edition of the Wall Street Journal with much interest, and agrees with many of your points.

Yours sincerely
Alex Allan

A C S ALLAN
Principal Private Secretary

STOCK EXCH.
STUDY

A[illegible] Lo[illegible]

Restricted Until Release

13/11/87.

PRELIMINARY REPORT

ON THE QUALITY OF ISE MARKETS

OCTOBER 19 - NOVEMBER 13, 1987

A Study of ISE Markets During A Very Volatile Period

1. Introduction

Forming part of a much wider examination of the performance of the London securities market in the period from 19th October to 13th November, this preliminary report outlines major findings to date. Together with quantitative analyses and an examination of the statistics available, this report also highlights views and comments of market participants and observers during the turbulent weeks immediately following the crash on 19th October.

The wider analysis will include a fuller examination of the effect of market structure, trading patterns, liquidity and the impact of derivative product markets (options and futures) on past weeks' activity and performance. Special attention will be given to the examinations of intra-day movements and interactions of prices and transactions in an attempt to understand the dynamics which resulted in the extent of market falls.

A final report is planned to be available by mid December.

2. Summary of Findings

Key results from the preliminary analysis of available statistics and data indicate the following:

1. Despite the sharp falls in prices, volumes reached unprecedented levels in the week of the 19th October, peaking at over 100,000 bargains on two days. Much of the higher turnover of recent weeks has been in alphas. Alphas have been running at an average of 63% of turnover value in the last three weeks compared to 50% earlier. The levels of trading in betas, gammas and deltas (despite being a lower proportion of total turnover) rose in the week of 19th October but have since declined.

2i. There has been a reduction in liquidity as measured by the touch. For all SEAQ categories, touches have increased significantly while quotation sizes have reduced over recent weeks. This is an expected response to a time of great uncertainty and represents the increased cost of running a market making operation under very volatile conditions.

While such an increase in transaction costs is undesirable - it represents a reduction of market quality - it is unavoidable. The alternative, which other exchanges have adopted, is to close or restrict trading. While higher costs to users are unfortunate, the costs to users of a closure would be much greater; London remained open throughout the turbulent period.

ii. Alpha touches have increased almost three fold - from an average of 0.76% to currently 2.17%; maximum size of quotations for alphas averages £120,000, a 50% reduction on more normal times.

iii. Beta and gamma touches have also increased significantly but by less than alphas. Beta and gamma touches have doubled to 3.45% and 5.37% respectively, while maximum quotation size in both categories has been reduced by about two-thirds.

3. More surprising is the fact that some 80% of these customer transactions were buy orders, predominantly from private clients.

4. Intra-market trading accounted for a much lower proportion of overall activity. Normally half of the total turnover value is intra-market activity. Since October 19th, the intra-market share of total turnover value has reduced to about one third.

5. The "crash" and the level of activity arising from it have accentuated the strength of London's electronic competing market maker system. UK equity market makers were able to hold substantial long positions - over £250 million on October 19th - a reflection of their valuable stabilising role in being able to absorb the weight of selling pressure.

Press Association
UK File on 13-11-87 at 12:40

ECONOMY Lawson

LAWSON BACKS ECONOMIC SUMMIT

By John Crossland, Press Association
Chancellor Mr Nigel Lawson today called for a summit of world finance ministersonce the US has formulated a package to cut its budget deficit.

Mr Lawson said he had already spoken to some of his counterparts and was confident a summit would be held "to try to get everyone on the right track".

He added: "I think it is sensible

7+ More 4 Headlines 6← 00↑ < >

Press Association
UK File on 13-11-87 at 12:40

that the ministers of the major industrial nations should get together. I think that it will happen - but I can't tell you when."

Mr Lawson said fears of a world recession were "grossly exaggerated", and Britain did not have much to fear because the economy was strong.

Asked about today's announcement that the Hong Kong and Shanghai Bank was to take a stake of around 15% in the Midland Bank, the Chancellor pointed out that British interests controlled some foreign banks, and there had to be some "two-way traffic".

7+ More 4 Headlines 6← 00↑ <7 >

UK File on 13-11-87 at 12:40

Mr Lawson was at Telford, Shropshire, to lay the foundation stone of a new computerised Inland Revenue centre.

end df

7+ More 4 Headlines 6← 00↑ <7 >

Reference..

cc PS/Chancellor
Mr RIG Allen

MR CORNISH

cc HMCG, NY
Mr J Rhodes, IBB, NY
Mr S Judge, PS/Paymaster General

BUSINESS WEEK

1. I attach an article in the 16 November edition on the British economy by Richard Melcher, the London correspondent. It is generally very helpful though it does not hide possible pitfalls ahead. We did not expect to see any direct reporting emanating from the Paymaster General's lunch at Business Week on 29 October, but this sort of article shows how useful it is to ensure that the editorial staff in New York are apprised of our policies. Business Week devotes about 15% of each issue to international news, and British news competes for space with news from Japan and the Pacific Rim as well as the rest of the EEC.

2. High level contact at the editorial level is particularly important at magazines like Business Week where the "computer revolution" has given New York editors greater control over their London based correspondents. Today, a Business Week editor can send detailed textual corrections and substantive comments on the first draft of a correspondents copy by direct computer transfer to London in a matter of seconds. Thus, if the New York editor's thinking has been influenced by background discussions with a minister - as it clearly was in this case - he can shape the tone and form of his correspondents copy at an early stage.

3. Dr Raymond, who accompanied the Paymaster General to Business Week, believes the article was influenced significantly by discussion with the Minister at the editorial luncheon. The rest is a positive assessment of the achievements of British economic policy which will be read by over 876,000 middle and upper level managers throughout the United States.

David Snoxell

D R Snoxell

13 November, 1987

BRITAIN

THATCHER AFTER THE CRASH: CARRY ON, THEN

Sure of Britain's economy, she remains as committed as ever to her conservative agenda

Nobody seemingly had more to lose in the October crash on Wall Street than British Prime Minister Margaret Thatcher. After all, she had bet Britain's economic future on growth in financial services, widespread share ownership, and an open, deregulated economy.

Much is still at stake. Huge questions remain about how the stock market collapse will affect Britain and other economies. But five months after winning reelection to a third five-year term, Thatcher is as convinced as ever that she has led Britain in the right direction. And she's firmly committed to pushing her conservative agenda further. Recent examples:

- Despite fierce foreign opposition, the government in late October went ahead with a $12.5 billion flotation of its holdings in British Petroleum Co.
- On Nov. 3, Thatcher's chief economic adviser, Chancellor Nigel Lawson, announced in his annual autumn economic forecast that the government will hold to its disciplined policies: Although spending will rise in 1988, borrowing will fall, and taxes will stay at current levels.
- Thatcher has redoubled her efforts to achieve her major third-term goal—to reform the social welfare system by turning more of it over to private groups.

The key reason for Thatcher's confidence lies in her belief in Britain's economic resurgence. Current growth is 4%, and unemployment, though still high at 10%, has fallen for 15 months. Thatcher has fought consistently to keep Britain's budget deficit down. Despite the collapse in the London market, which has fallen 30% since Oct. 19, Lawson is expecting the economy to grow 2.5% next year and government borrowing to fall to just ¼% of output. Still, in an effort to reassure investors, the Bank of England on Nov. 4 cut interest rates from 9⅜% to 9%.

With increasing self-confidence, Thatcher is raising her voice on the international stage. Recently, she lectured President Reagan to slash the U. S. budget deficit and raise taxes. Even though Britain cannnot play the same role as the U. S. and West Germany, Thatcher is winning respect from new quarters. "Thatcher's Britain is a demonstration that fiscal prudence can bring results," says Philippe Moreau Defarges of the French Foreign Relations Institute.

WELFARE CUTS. But her conservative crusade is still largely aimed at a domestic audience. Despite international opposition to its BP share issue, for example, the government could not be seen to bail out investment banks that stood to lose money by underwriting the deal. As a compromise, Thatcher decided to limit underwriting losses by ensuring that the Bank of England would buy BP shares if their price fell below $1.22 each. The danger is that if the price plummets,

the government will face huge costs.

In education and housing, Thatcher aims to strip power from what she regards as left-wing, free-spending local administrative bodies and turn management control over to groups of teachers, parents, and residents. To further weaken the local councils, she plans to eliminate the property taxes that they levy and replace them with a flat tax, set by the national government, on every adult. Although the changes will face a rough ride in the House of Commons, Thatcher can draw on the Conservative Party's 101-seat majority to muscle her programs past a divided opposition.

U.S. EXPOSURE. But the government's main worry must be that the tumult in the world's markets will take the British economy down and that unemployment will again mount. In its push to become a major market for international equities, London has opened itself to the whims of foreign investors, who are now pulling their money out of the market.

British companies are also paying for their growing international strength. Helped by rising profits and the earlier bull market, they have so far this year spent $26.3 billion on U.S. acquisitions. But stocks with heavy U.S. exposure, such as luxury carmaker Jaguar PLC and aircraft engine maker Rolls-Royce Ltd., have been battered.

Caught in the downdraft, too, is Britain's leading industrial company, Imperial Chemical Industries PLC, which earns 25% of its $17.7 billion in sales in the U.S. Its shares are down 36%. Says Chairman Denys H. Henderson: "There is no fundamental change in the outlook to justify this kind of share-price change. It is very disturbing."

More bad news for Britain is almost certainly on the way. Even with a market recovery, employment is likely to stop growing in financial services. Nine banks have announced job cuts in recent months, and more are awaited. Thatcher has been counting on a continued boom in London's deregulated markets to help offset the prolonged fall in manufacturing. "Both the U.S. and the U.K. are paying the price for relying too long on building up financial services and ignoring basic industry," says Labor's trade and industry spokesman, Bryan Gould.

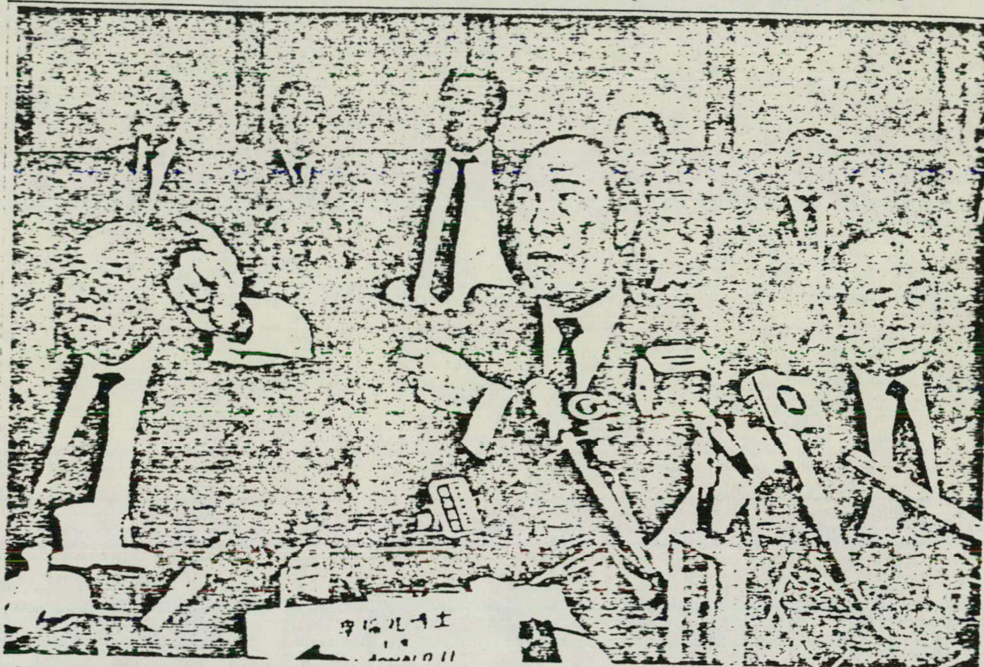
For now, British politicians and managers are, like leaders elsewhere, hoping that U.S. efforts to cut its budget deficit will keep the world economy from sliding into recession. Few in Britain can forget the nightmare of 1976, when Britain's own deficit forced it to turn to the International Monetary Fund for a bailout. Britain has come a long way since then. But so have a powerful array of global forces that could still sabotage the country's overhaul.

By Richard A. Melcher in London

HONG KONG

THE PALL IN HONG KONG MAY NOT LIFT SOON

Collapsed markets cast doubts on the colony's economic future



STOCK EXCHANGE CHAIRMAN LI: CRITICS SAY CLOSING THE MARKETS MADE THE PANIC WORSE

The phones have fallen silent at the Hong Kong Futures Exchange, and with the price monitor rarely blinking, floor traders spend most of their day reading newspapers. In the wake of Bloody Monday, nearly a third of the exchange's 127 member firms have been suspended from trading after defaulting on $230 million in stock-index futures. Before the Oct. 19 crash, Hong Kong handled 30,000 contracts on a typical day, making it the No. 2 stock-index futures market after Chicago. Now trading has evaporated. The exchange floor, once littered with green confirmation slips, is so bare that "you can do your aerobics there," says an official.

Picking up the pieces will be harder for Hong Kong than for most other financial centers. That's because its stock and futures exchanges were the only ones to close their doors at the height of the worldwide crisis. When the four-day shutdown ended on Oct. 26, the stock index plunged by 33% and the futures exchange collapsed, forcing the government to arrange a $512 million rescue fund. Confidence was so shaken that Hong Kong's communist neighbor, China, moved in to bail out one of the world's most laissez-faire markets.

All that intervention has tarnished Hong Kong's image as a financial center and raised doubts about the free-wheeling system under which it has thrived. Moreover, Beijing's role in the market rescue was an unsettling reminder that China will take over the capitalist enclave in 1997. "The damage is deeper in Hong Kong," says Arthur Lai, head of ChinTung Holdings Ltd., a hard-hit securities firm that had to sell out to Standard Chartered Bank. "Other people's damage was only in market value. But our whole system is being questioned."

FELL SWOOP. Taking the heat is Ronald Li, the feisty chairman of the Hong Kong Stock Exchange. Several local lawmakers and many international financiers say Li, who planned to step down in December, should resign immediately. They contend that Li's decision to close the markets worsened the panic and that he acted to protect local brokerages, including his own, from huge trading losses. Denying charges of impropriety, Li says the closure was needed to "cool down" the markets, and he vows to continue running the stock exchange, though he has left his post as vice-chairman of the futures exchange. Clearly snubbing Li, the Hong Kong government arranged for Robert Fell, former London Stock Exchange chief executive, to become the local stock exchange's senior chief executive.

China's involvement is viewed as a mixed blessing. The Bank of China anted up $42 million for the rescue package, and brokers say Chinese enter-

psl/75A

WT spotter

STOCK MARKET INDICES CLOSE 12/11/87 (or latest)

[n 13/11/87]

% change on

Index	(a) year earlier	(b) 1987 high	(date of high)	(c) 15 October 1987
FTSE 100	+3 [+2]	-30 [-31]	(16 July)	-26 [-27]
Dow Jones Industrial	+3 [+4]	-28 [-28]	(25 August)	-17 [-17]
Nikkei Dow	+32	-19	(14 October)	-13
CAC General (France) (10 Nov)	-28	-41	(26 March)	-25
Commerzbank (Germany)	-33	-34	(17 August)	-28
Hang Seng (Hong Kong)	-3	-45	(1 October)	-42
All Ordinaries (Australia)	-14	-48	(21 September)	-44

Ch

Couldn't get these fully updated, — no figures for France yet

Ans: Close 1275.5 +70.5

Hong Kong 2226.74 +75.87

Frankfurt 1379.0 +17.1

STOCK MARKETS

November	LONDON Level	LONDON Change	NEW YORK Level	NEW YORK Change	TOKYO Level	TOKYO Change
Wednesday 4	1608		1945		23061	
Thursday 5	1639	+31	1985	+40	22630	-431
Friday 6	1621	-18	1959	-26	22795	+165
Monday 9	1565	-56	1900	-59	22418	-377
Tuesday 10	1573	+8	1878	-22	21686	-732
Wednesday 11	1639	+66	1899	+21	21037	-649
Thursday 12	1702	+63	1960	+61	21547	+510
Friday 13	1678	-24	1949	-11	22448	+902
Changes on week earlier		+63 ~~+31~~		-25 ~~-40~~		-1083

Ea[illegible] (ending Thursdays)

Oct [illegible]	2302		2[illegible]		2642[illegible]	
[illegible]	1[illegible]	-46[illegible]	[illegible]	-405	2[illegible]	-2[illegible]
Oct. 29	169[illegible]	-151	19[illegible]	-12	22[illegible]	-23[illegible]
November 5	1639	-43	1985	+47	22630	+596
November 12	1702	+63	1960	-25	21547	-1083

ps1/76A

EXCHANGE RATES
(London Close)

November	DM/$	Y/$	$/£	DM/£
Wednesday 4	1.7080	137.00	1.7467	2.9834
Thursday 5	1.6845	135.55	1.7705	2.9824
Friday 6	1.6730	135.05	1.7870	2.9897
Monday 9	1.6628	134.45	1.7912	2.9784
Tuesday 10	1.6655	134.50	1.7875	2.9771
Wednesday 11	1.6760	135.30	1.7800	2.9833
Thursday 12	1·6860	135·70	1·7680	2·9808
Friday 13	1·6920	136·02	1·7665	2·9889

Stock Market Indices Close 10/11/87

% change on

Index	a) 7 Nov 1987	b) 1987 high (date of high)	c) 15 October 1987
FTSE	- 5.0	-35.6 (16 July)	-31.6
Dow Jones	- 0.4	-31.0 (25 August)	-19.6
Nikki Dow	+32.4	-18.6 (14 October)	-12.8
Cac generale (France)	-28.0	-40.7 (26 March)	-25.4
Commerzbank (Germany)	-39.5)	-40.8 (17 August)	-35.8
Hang Seng (Hong Kong)	- 7.9	-48.2 (1 October)	-44.7
All 100 (Australia)	-14.2	-47.8 (21 September)	-43.9

1702 =
(1 - .356)x

2643

MARKETS

CH/EXCHEQUER
REC. 13 NOV 1987 13/11
ACTION Mrs R. Lomax
COPIES TO CST EST
Sir P. Middleton
Sir T. Burns
Mr Cassell
Mr Peretz Miss O'Mara
Mr Hudson Mr Cropper

13/11/87.

Ch

This seems a bit over the top to me.

AA

PRIME MINISTER

MARKETS

I have seen your Private Secretary's letter reporting the complaints made by Lord Stevens about the performance of London as a financial centre during the crash in share prices. I have also seen the Treasury's note (enclosed with Peter Middleton's letter of 12 November): I agree with its broad conclusions.

2. We must not let difficulties encountered by particular dealers cloud our judgement as to the overall efficiency of the stock market in London. I shall be seeing Lord Stevens to discuss other matters when he returns to the country next month, but this will be an opportunity to discuss his firm's complaints in more detail. There may be substance in his suggestions that there were strains in the system but none which cause me to doubt that the City has coped very well with an unprecedented crash in share prices. Indeed, I believe from all I have heard that the new systems performed as well as anywhere else in the world - and in many cases better.

3. It is striking that The Stock Exchange was handling over 100,000 bargains daily - over twice the normal daily average. No member firm has defaulted on its obligations. The new screen-based system has meant high visibility for the market makers' quotations and within the European time-zone orders were being routed to London as the most liquid market.

4. Even if we had a Stock Exchange floor and fixed dealing commissions, with separation of the functions of brokers and

JG5BLB

jobbers and exclusion of foreign-owned firms - as before Big Bang - London would not have been insulated from the crash.

5. The Chairman of the New York Stock Exchange and the Chairman of the United States SEC were both surprised by the speed and severity of the share price fall and have been reported making critical remarks of the systems in the USA. In London, we did not have to close our markets or restrict trading - although several of Lord Stevens comments have been echoed round the world, particularly those about the difficulty of getting good prices during the most hectic trading periods.

6. It is remarkable that on many days, more than three quarters of orders were to "buy", mainly from private investors who judged prices were now realistic. Furthermore, among the shares which suffered most were those of companies with considerable dollar business in the USA. Many others, with domestic UK business, have done proportionately better.

7. This has confirmed our own optimism about the fundamental strength of our own economy but more especially in the ability of the markets - including the financial markets - to reflect reality. I am asking for further work to be done in analysing The Stock Exchange's performance since Big Bang but my interim conclusion is that the new systems have performed remarkably well.

8. I am copying this to the Chancellor of the Exchequer and the Governor of the Bank of England.

D Y

13 November 1987

DEPARTMENT OF TRADE AND INDUSTRY JG5BLB

1318/30

Alex.

FROM: MRS R LOMAX
DATE: 13 November 1987

SIR P MIDDLETON

cc: PPS
PS/Economic Secretary
Sir T Burns
Mr Cassell
Mr Peretz
Mr Grice
Mr Ilett
Mr Hall

MARKETS

I attach Alastair Ross Goobey's latest circular which has some very timely footnotes to points made in our note for the Prime Minister. Particularly interesting is his suggestion that a number of UK companies already have authorisation to buy back up to £800 million of their own shares, and more are considering such a move. We are doing some more work on this. Alastair also takes the general market view that UK institutional portfolios were pretty fully stuffed with equities by the beginning of October, both relative to past experience, and relative to institutional portfolios elsewhere.

As you know both the Bank and the DTI are doing further work in this area, though I have not yet seen the results. I think the DTI may have it in mind to offer their own comment on Lord Stevens' remarks to the Prime Minister.

RL.

RACHEL LOMAX

FROM YOUR SIDE OF THE DESK
NO.18

ALASTAIR ROSS GOOBEY

SO CHEAP, I CAN'T AFFORD IT

One of the problems faced in a bear market is that there are plenty of natural sellers but not many natural buyers. In the US in recent years there has been a substantial source of buying which other markets have not seen: the corporate sector. Since the end of 1984, it is estimated that over $150 billion of equity has been bought back or authorised to be bought back by US corporations. In the same period in the UK, there has been net investment of about £19 billion in UK equities and £12 billion in overseas equities by institutions and although £5 billion of Government bonds have been purchased, since the fourth quarter of 1986 up to £2 billion of that paper has been sold net.

The consequences for portfolio distribution in the two markets is strikingly different. In the US, that doyen of investors, Warren Buffet, was pointing out in September how the craze for buybacks had reached epidemic proportions and that the process was not being conducted for logical reasons, even those as basic as increasing earnings per share. Some companies were buying in their own shares despite the fact that the pre-tax return which they were buying was less than the cost of money, and the earnings and assets per share of the company were actually *falling* as a result. The cash flow of the US institutions has perforce been channelled into bonds, and, to a lesser degree, into foreign equities. Since no net cash flow was flowing from the institutions into domestic equities, it was primarily the corporations who were driving up the market at the margin. Even after the recent initial fall, the market was steadied by further announcements of repurchase programmes; the deep-pocketed buyer was still present. The average US pension fund has no more than 60% in equities, about 25% in bonds and the balance in real estate, venture capital and buyouts. In addition, it has not been apparent that the US institutions have undertaken a wholesale flight from bonds which would have left them open to criticism and defensive action after the dramatic reversal of fortunes between bonds and equities of the past month.

In the UK, all these factors are transposed. The corporate sector, and the Government, has taken every opportunity to sell stock to the institutions, while the institutions themselves have reacted to this potential crowding-in by shunning the domestic bond market. As a result, the balance of UK institutional portfolios has reached an historic high level of equity exposure. The reversal of this trend will be uppermost in the minds of investment managers before 31 December; even a modest switch of portfolios towards bonds will involve some fairly hefty equity sales. The CAPS survey of UK pension funds at the end of 1986 showed the distribution of the average UK pension fund as follows:

	%
UK equities	55 } 79
Overseas equities	24 }
Index-linked gilts	2
UK fixed interest	12
Property	4
Cash	3
	100

Making fairly modest assumptions about the year up to the beginning of October, the equity share at the peak was 82% of the total; the subsequent market fall will already have reduced this to 76% and increased the bond share to 15%. The attempt to achieve a 20% bond percentage would involve a further switch of up to £10 billion from equities, or a fall in equities of a further 35% forthwith, or investing all pension fund cash-flow in gilts for a year. Put in the context of total

institutional cash flow, including unit trusts, running at an annual rate of £26 billion in the first half of 1987, this would substantially limit the money going into equities from UK investors. In addition, the strong cash flow of the unit trusts has already been materially curtailed.

Such a rebalancing of portfolios would be typical of bear markets, and will probably be undertaken through a combination of switching, cash flow investment and relative asset performance; it will be easier to do when we are in a rally, which will make it more difficult for that rally to be sustained. It is also worth noting that, as a consequence of continuing pension contribution holidays and the increasing influence of unit-linked business in life assurance, 1987 may see the cash flow of insurance companies overtaking that of pension funds for the first time in many years; life offices tend to be more predisposed to investing in fixed interest stocks than are the pension funds, although if the growth really is attributable to unit-linked funds, this may be changing.

We have looked at the potential scope for buybacks in the UK market. The 1981 Companies Act enabled UK companies to engage in this process for the first time, and this is the first real bear market since the provisions came into force in 1982. There are technical problems for the companies: in order to prevent the creation of capital distributions out of income, the tax laws treat buyback sums like a dividend for the company and Advanced Corporation Tax is payable. This may be used to offset excess mainstream corporation tax, but many companies do not have such an excess. Even those companies in a tax position which enables them to consider buybacks may be loath to act: their shareholding structure, or the fact that they have just had a rights issue not far above this level may constrain them. Nevertheless, we see the first inklings of a potential buyer of last resort. Of the FTSE 100 Index constituents, we have already identified companies who have authorisation to buy up to £800 million of their own stock, and more are considering such a move. This represents 11% of the money poured into UK equities in an average year over the past two-and-a-half years. Naturally, not all this stock will in fact be purchased, but it indicates the potential size of the buyer of last resort.

Institutional liquidity has been adversely affected by the string of recent rights issues and privatisations. The good news is that there is no necessity for a new privatisation for a year or so. Calls on British Gas, BP and BAA together with the probable redemption of British Telecom preference shares already add up to £4,957 million in the bag for 1988/89. Institutional liquidity will take time to build up, and meanwhile only small portions of cash flow will end up in equities, particularly overseas.

We now seem to be in the good tradeable rally I had hoped for in last week's note, (how I hate journalists, yes, and stockbrokers, who say "I told you so", but only selectively), but this should not be confused with a new bull market; we might expect the rally to continue to a point at which the market's valuation will again give us pause, at around 1850-1900 on the FTSE Index. Stocks are currently still cheap, but not many shoppers feel they can afford them.

FT Actuaries All Share Index:	817.83	12 November 1987
S&P Composite Index:	241.90	
Tokyo New Index:	1730.59	

The publication day for this document is being brought forward by a day to prevent the probability that it will be made of nugatory value by events over the weekend.

CIGNA Corporation

Hartford, CT 06152
(203) 726-7538

Edward Guay
Chief Economist

November 13, 1987

Mr. Samuel Brittan
The Financial Times
Bracken House
Cannon Street
London EC4P 4BY

Dear Mr. Brittan:

You are probably right to state that James Baker helped to trigger the crash ("Beware the coming of the false dawn," FT 11/12/87). His press conference on October 15 accelerated the decline of the dollar and added to bond and money market strains. But what triggered Mr. Baker? Nigel Lawson deserves as great a share of the blame for the financial market strains and for the crash.

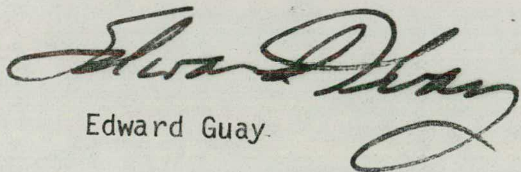
In August, when the United Kingdom was already experiencing a large capital inflow, the Bank of England raised money market rates, accelerating the inflow. The purpose was to cool off a consumer and property boom, but the result was to increase the attractiveness of the pound to foreign investors. Foreign investors borrowed dollars to buy pounds, effectively raising dollar short-term rates and shorting the dollar. Because the pound was pegged to the DM, the Bank of England, to maintain the DM/pound exchange rate, and continuing its established policy of diversifying its reserves, sold dollars to buy DM. The Bundesbank, sensing a stronger flow into the DM that would disturb their rigid monetarist stance, tightened domestic policy through sterilized intervention. At the same time, the markets in the United States reacted to the increased dollar sales. Commodity traders increased commodity futures positions anticipating that the weaker dollar would lead to a rise in commodity prices. Bond traders sold Treasury futures, anticipating that the weaker dollar and higher commodity inflation would lead to higher interest rates. Arbitrage between the cash bond market and the futures market intensified selling in the Treasury bond market. The Federal Reserve reacted to the weaker dollar, rising commodity prices, and the impact of "inflation expectations" on the bond market by tightening an already moderately restrictive monetary policy. It was during the late stages of that tightening, when bill rates exceeded the nominal growth rate of the U.S economy, usually a precursor of recession, that Baker publicly and undiplomatically expressed his irritation with the Germans.

The U.S. had agreed to tighten credit to stabilize the dollar, conditional upon an agreement by the Germans and Japanese to stimulate growth. Both the Germans and the Japanese defaulted, but the Germans did so in a visible way. The Japanese used quantitative credit controls; the Germans used tighter monetary policy. But Baker's ire should have been directed at the British. Nigel Lawson contributed to the crash by starting a general tightening in Europe when the UK was already experiencing a capital inflow. This is not meant to be a personal criticism of Nigel Lawson. It is meant to be a criticism of an inherent instability, a dangerous weakness, in the design of an international monetary and credit system based excessively on one national currency as the reserve currency, the credit currency, and the intervention currency.

It is interesting to note that the Federal Reserve's behavior was remarkably similar to their behavior during 1931, when they turned a serious recession into a lasting depression. This time, however, the Federal Reserve aborted the suicide mission before the system broke. After the British went off the gold standard in 1930, the United States and France foolishly tried to remain on the gold standard at the old parity. When the United States began to experience an outflow of gold during 1931 because of speculation that it would be forced to devalue, the Federal Reserve raised the discount rate to protect the gold reserve. Higher interest rates in a deflationary environment led to a credit collapse in the banking system that was only reflected in the money supply with a lag. As it is today, bank credit was then a multiple of the narrow money supply. The weakness that did appear in the money supply during 1931 the Federal Reserve attributed to the loss of gold and to the collapse of "unsound banks." It was merely a sign that the Fed should tighten further to achieve stability. The result was nearly stasis (in the physical sciences meaning).

The central bank management information signals given off by a predominantly dollar reserve system, a predominantly dollar international credit system, and a predominantly domestic national currency money system almost brought us to disaster. Hopefully we can and will reform the system before the next opportunity for a crash.

Sincerely,



Edward Guay

ta

SECRET

MG NOON REPORT

FINANCIAL MARKETS — Monday 16 November 1987

Opening	10 AM		NOON	2PM	Oil Price (10 AM)	
74.9	74.9	£ERI	74.9	74.9		
1.7445	1.7440	$/£	1.7411	1.7425	Dec	$17.97
2.9901	2.9892	DM/£	2.9881	2.9858	Jan	$18.05
1.7140	1.7140	DM/$	1.7162	1.7147	Feb	$18.07
137.00	137.05	Yen/$	137.19	137.05		

UK interbank £			Eurodollars	
9	(-)	7 day	6 3/4	(-)
9	(-)	1 month	6 7/8	(+1/16)
9	(+1/16)	3 month	7 3/8	(-)
9 1/8	(-)	12 month	7 7/8	(+1/16)

Figures in brackets show change since previous market close

MARKET COMMENT: The dollar remained quiet in New York. It rose in the Far East after Reagan statement that an $80Bn deficit cutting package was probable outcome of discussions. This triggered technical short-covering. The dollar has now steadied. Sterling is easier on the firmer dollar but on the sidelines. US industrial production out 2.15PM, markets expect +0.6%.
The US equity market closed down with the Japanese and Hong Kong markets closing up. Dow Jones 1935.0 -25.2, Nikkei 22615 +167 and Hang Seng 2310.9 +84.1. The FTSE100 opened 1707.5 +29.2 and is now 1731.1 +52.8. The gilts market is fairly quiet at slightly lower levels. [signature]

MARKET INTERVENTION ($m)

Overnight	+25$ New York
Today so far	-25$
Total	0

OTHER COUNTRIES INTERVENTION ($m)

2.40PM FTSE +56
Wall St +34

GILTS

	Latest market movements	Price change since previous close
Shorts	Steady	-6/32
Mediums	Easier	-10/32
Longs	Better	-8/32
Futures (Long Contracts)		-11/32 (Vol:8012)

Gilt Sales since market opening: +£3.0 million

All Index Linked

NAME: Miss R J McRobbie, MG1 Division
TEL NOS: 270 5557/5560

SECRET

ps2/14M

UNCLASSIFIED

pmp

FROM: MISS M P WALLACE
DATE: 16 November 1987

MRS R LOMAX

cc PS/Economic Secretary
Sir P Middleton
Sir T Burns
Mr Cassell
Mr Peretz
Mr Grice
Mr Ilett
Mr Hall

MARKETS

The Chancellor has seen your minute of 13 November attaching Mr Ross Goobey's latest circular. He will be most interested to see the further work you are doing in this area. He would also like to know what procedures companies have to go through in order to buy back their own shares.

MPW.

MOIRA WALLACE

psl/84A

pmp

Treasury Chambers, Parliament Street, SW1P 3AG
01-270 3000

16 November 1987

G E Grimstone Esq
J Henry Schroder Wagg & Co Limited
120 Cheapside
LONDON EC2V 6DS

Dear Gerry

Many thanks for your letter of 10 November. The Chancellor, too, was amused to see the comment in the circular you enclosed.

Yours
Alex

A C S ALLAN

psl

PRINCIPAL PRIVATE SECRETARY 12/2

pp

SHARE PRICES FOR THE MAJOR COUNTRIES: WEEKLY SHEET

In the light of interest shown in the table on share prices given in the World Economic Developments note (circulated by IF2 on 9 November), it has been decided to distribute a sheet regularly updating the figures every Friday. The share price indices used are published daily in the Financial Times.

Comments or queries to D Savage (5546) or P Sullivan (5548).

Mr Neilson

Isn't there duplication of effort here? And it is v confusing that this uses different indices from FIM's.

ACS

16/11.

SHARE PRICES FOR THE MAJOR COUNTRIES: WEEKLY SHEET

	US Standard & Poor's Industrials	**Japan** Tokyo SE New	**Germany** Commerzbank	**France** CAC General	**UK** FT. All share index	**Italy** Banca Com Ital	**Canada** Composite (Toronto)
1986 (Average)	261.67	1311.92	1996.39	356.15	779.23	689.03	2993.07
1987 Jan	273.99	1562.55	2016.4	392.0	836.29	726.16	3067.8
Feb	311.53	1762.07	1782.5	421.5	913.67	704.09	3378.7
Mar	321.19	1805.61	1711.7	435.2	986.25	679.37	3510.1
Apr	337.13	1902.24	1832.0	454.4	988.79	719.89	3742.2
May	342.71	2114.92	1776.1	452.6	1032.4	766.4	3730.3
Jun	336.35	2156.68	1787.6	430.4	1108.8	688.77	3659.6
Jul	351.53	2042.53	1841.2	402.8	1149.1	685.56	3740.2
Aug	372.32	2018.89	1990.4	414.0	1188.4	687.41	4030.4
Sep	378.26	2153.2	2033.3	430.4	1155.72	624.88	3982.3
Oct	305.14	1917.5	1802.3	364.9	1079.8	616.4	3290.8
15 Oct	343.57	2158.61	1902.6	366.1	1189.9	665.5	3674.9
13 Nov	281.12	1842.73	1379.0	292.0	840.33	496.76	2946.1
Percentage changes							
1986-13 Nov	+7.4	+40.5	-30.9	-18	+7.8	-27.9	-1.6
15 Oct - 13 Nov	-18.2	-14.6	-27.5	-20.2	-29.4	-25.4	-19.8

The monthly data are closing prices on the first day in each month, except for October which is the average of daily rates.

Contact point: P SULLIVAN (5548).

SECRET

MG NOON REPORT

FINANCIAL MARKETS 17 November 1987

Opening	10 AM		NOON	Oil Price (10 AM)	
74.9	74.9	£ERI	75.0		
1.7550	1.7550	$/£	1.7572	Dec	$17.72
2.9809	2.9800	DM/£	2.9823	Jan	$17.82
1.6985	1.6980	DM/$	1.6972	Feb	$17.85
136.10	136.05	Yen/$	136.05		

UK interbank £			Eurodollars	
8 7/8	(-1/16)	7 day	6 7/8	(-)
8 29/32	(-3/32)	1 month	6 7/8	(-)
8 15/16	(-1/16)	3 month	7 7/16	(-)
9 1/8	(-)	12 month	7 13/16	(-1/32)

Figures in brackets show change since previous market close

MARKET COMMENT: After last nights close the dollar fell back on the Reagan statement that raising taxes would be the wrong way to trim the US Budget deficit. It continued to ease in the Far East on the uncertain outcome of the Budget deficit talks. The market is quiet with sterling on the sidelines.
The US equity market closed up with the Japanese and Hong Kong markets closing down. Dow Jones 1949 +14.0, Nikkei 22344 -271 and the Hang Seng 2290 -11.0. The FTSE100 opened at 1673.0 -11.0 and is now 1687.8 +3.1.
Gilts market opened slightly stronger as the equity market was lower. It then traded quietly and improved further after the PSBR figures.

MARKET INTERVENTION ($m) OTHER COUNTRIES INTERVENTION ($m)

Overnight -

Today so far -

Total -

GILTS

	Latest market movements	Price change since previous close
Shorts	Better	+5/32
Mediums	Better	+10/32
Longs	Better	+13/32
Futures (Long Contracts)		+22/32 (Vol:12032)

Gilt Sales since market opening

£0 million

NAME: Miss R J McRobbie, MG1 Division
TEL NOS: 270 5557/5560

SECRET

THE
STOCK
EXCHANGE

cc. PPS
PS/EST
Sir P. Middleton
Mr Cassell

18th November 1987
No 89/87

QUALITY OF MARKETS: OCTOBER 19TH - NOVEMBER 11TH 1987

The International Stock Exchange is undertaking a study of the performance of London's securities markets in the period from mid-October to mid-November.

The study will examine thoroughly the effect of the market structure, trading patterns, liquidity and derivative products (ie options and futures) on the performance of the markets in this period. It will include a very detailed look at the effect of intra-day price movements and trading activity, especially on October 19th and 20th when the FTSE indices fell most dramatically.

The aim of the study is to understand more fully the processes at play which produced such dramatic price volatility, as a basis for considering what changes, if any, to present arrangements might be desirable.

The findings of the study will be published in the Quality of Markets Quarterly, next January.

For further information: Anne Coleman, Chief Press Officer; Teresa Hodges, Gill Ackers, Press Officers;
Telephone: 01-588 2355; Fax 01-256 8972
Issued by: The International Stock Exchange of the United Kingdom and the Republic of Ireland Limited
Old Broad Street, London EC2N 1HP. Registered in England & Wales No. 2075721.

NEWS RELEASE NEWS RELEASE NEWS RELEASE NEWS RELEASE NEWS RELEASE NEWS RELEASE

MG NOON REPORT

FINANCIAL MARKETS

Wednesday 18 November 1987

Opening	10 AM		NOON	Oil Price (10 AM)	
75.1	75.1	£ERI	75.1		
1.7600	1.7605	$/£	1.7603	Dec	$17.30
2.9832	2.9832	DM/£	2.9855	Jan	$17.47
1.6950	1.6945	DM/$	1.6960	Feb	$17.55
136.05	135.75	Yen/$	135.92		

UK interbank £			Eurodollars	
8 1/8	(-7/16)	7 day	6 7/8	(-)
8 7/8	(-1/16)	1 month	7	(-)
8 15/16	(-)	3 month	7 1/2	(-)
9 1/16	(-1/16)	12 month	7 15/16	(-)

Figures in brackets show change since previous market close

MARKET COMMENT: The dollar remained little changed in New York. It firmed on short covering in the Far East as the result of a rumour about a conference on the US budget deficit package(later denied). A comment by Folley that an agreement is close to being reached also helped the dollar.It has drifted down this morning as markets await a US statement. Sterling on the sidelines.
The US and Hong Kong equity market closed down with the Japanese market closing up. Dow Jones 1922.2 -26.8, Hang Seng 2285.1 -5.2 and Nikkei 22734 +390. The FTSE100 opened at 1679.1 +19.0 and is now 1688.8 +28.7. The gilts market is easier.

R J McRobbie

MARKET INTERVENTION ($m)

Overnight	-
Today so far	-
Total	-

OTHER COUNTRIES INTERVENTION ($m)

GILTS

	Latest market movements	Price change since previous close
Shorts	Steady	-5/32
Mediums	steady	-10/32
Longs	Easier	-17/32
Futures (Long Contracts)		-20/32 (Vol:8592)

Gilt Sales since market opening

£0 million

NAME: Miss R J McRobbie, MG1 Division
TEL NOS: 270 5557/5560

SECRET

MG NOON REPORT

FINANCIAL MARKETS

Friday 20 November 1987

Opening	10 AM		NOON	Oil Price (10 AM)	
75.6	75.6	£ERI	75.6		
1.7850	1.7860	$/£	1.7847	Dec	$17.55
2.9890	2.9907	DM/£	2.9888	Jan	$17.72
1.6745	1.6745	DM/$	1.6747	Feb	$17.77
135.05	134.90	Yen/$	135.08		

UK interbank £			Eurodollars	
9 1/16	(-)	7 day	6 3/4	(-1/8)
9	(-)	1 month	6 7/8	(-1/8)
8 15/16	(-)	3 month	7 1/2	(-)
9 1/16	(-)	12 month	7 15/16	(-)

Figures in brackets show change since previous market close

MARKET COMMENT: The dollar continued to drift downwards overnight as markets await a budget deficit package. It remained steady this morning with markets in a bearish mood. Sterling firmer but on the sidelines. US CPI out at 1.30PM, markets expecting +0.2% (unchanged from last month). The US and Hong Kong equity markets closed down with the Japanese market closing up. Dow Jones 1895.4 -43.7, Hang Seng 2214.7 -42.9 and the Nikkei 22706 +36.0. FTSE100 opened 1610.5 -28.6 it is now 1623.8 -15.3. The gilts market opened a little firmer on declining equities. It has remained quiet and steady at the better levels. The index linked 2001 tranchette has been activated.

MARKET INTERVENTION ($m)

Overnight -

Today so far -

Total -

OTHER COUNTRIES INTERVENTION ($m)

Spain +56$
Belgium -45DM
Holland -60DM
Canada +82$ (19.11.87)

GILTS

	Latest market movements	Price change since previous close
Shorts	Steady	+3/32
Mediums	Steady	+7/32
Longs	Steady	+11/32
Futures (Long Contracts)		+11/32 (Vol:9438)

Gilt Sales since market opening

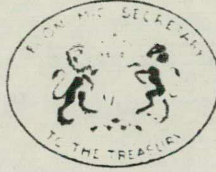
+£51.2 million

All Index Linked

NAME: Miss R J McRobbie, MG1 Division
TEL NOS: 270 5557/5560

SECRET

CONFIDENTIAL cc PPS, Sir P. Middleton, Sir G. Littler, Mr Cassell, Mr Ilett, Mrs Lomax, Mr Peretz, Miss Noble, Mr Neilson, Ms Ryding, Mr Cropper, Mr Hyett - T.Sol.



Treasury Chambers, Parliament Street, SW1P 3AG

The Hon Francis Maude MP
Parliamentary Under Secretary of State
Department of Trade and Industry
1-19 Victoria Street
LONDON
SW1H

20 November 1987

Dear Francis

FINANCIAL MARKETS BILL

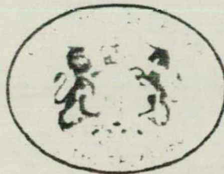
Thank you for your letter of 6 November.

As you say, we would have to decide at the time whether a default in the financial markets justified making this Bill retrospective and, if so, whether a statement on the lines of your draft was appropriate in all the circumstances. In present circumstances, a statement of this kind could have devastating effects on confidence.

While one can never be sure, there must be some grounds for assuming that if the consequences of a default were unacceptable, the market as a whole and maybe even the authorities would have to take rather more immediate steps to cope with it than retrospective legislation of this kind. If, on the other hand, the market could live with the default, it could live with any uncertainty about the insolvency law until your Bill was actually in place.

Either way, retrospection would, I hope, not be necessary, so we could avoid the political price that it might carry. In any event, there should be no retrospection, and so no statement, unless a major player has failed and the statement clearly makes a significant contribution to coping with the consequences.

In short, while I am grateful to you for sharing your contingency planning on this subject with me, I think we should keep our options open for the moment.



I am sending copies of this letter to Lord MacKay, Patrick Mayhew, the Governor and Sir Robert Armstrong.

Yours ever
Peter

PETER LILLEY

TELEGRAPH

Trusts count losses

LATEST statistics from the Association of Investment Trust Companies reveal the extent of damage caused by the crash across the sector.

Investors who picked the wrong trust a year ago have lost up to a quarter of their money.

One of the worst performers was F&C Eurotrust, where £100 invested a year ago was worth only £67·10 by the end of October, including reinvestment of any dividends.

A similar £100 in Edinburgh American Assets was down to £75·90 by the same date, against £79·10 in London American Ventures or £79·30 in German Securities Trust.

However, the Association pointed out that more than two-thirds of investment trusts managed a positive total return. The Trust of Property Shares did best, turning £100 into £254·40 over the year.

Next in rank were North British Canadian at £184·10 and Kleinwort Smaller Companies at £179·40.

With an implied swipe at unit trusts, the Association also notes an advantage of investment trusts in difficult market conditions: "They are not subject to pressure from holders wishing to redeem."

Crash toll slows

COMPANY liquidations and bankruptcies in October rose from the September levels but were down on the corresponding period a year ago, according to provisional figures from the Department of Trade and Industry.

Liquidations at 1,175 were the second highest so far this year but were below the comparable 1986 level of 1,489 while bankruptcies totalled 670 (707).

TELEGRAPH

Trevor Smith changed his investment strategy in September and soon found himself with an enormous bill—as one of the victims of the Crash of '87

The £298,000 risk factor

A SELF-employed painter and decorator who, until the beginning of last year, had bought only penny shares through his branch of National Westminster bank now finds he owes a subsidiary of the bank £298,000.

Trevor Smith, 29, of Sutton in Surrey who received a letter this week from NatWest Stockbrokers stating he owed the money says he had no idea that writing options was so risky.

He also claims that he would never have moved from buying options to the much riskier "writing of options"—granting them to others—normally undertaken by financial institutions if he had not been telephoned by a dealer and persuaded to do so.

He was, in effect, gambling on the level of the 100 share index at the end of October and November, but his potential gain of £13,000 became a devastating loss with the collapse of the stock market last month.

The telephone call, which changed his investment strategy and exposed him to enormous risk, was in September.

It was at about the time the dealers who had dealt with private clients at County NatWest were transferred over to the retail stockbroking subsidiary, NatWest Stockbroking, together with most of the private clients.

"I had been dealing through County NatWest since February last year, buying options in the shares of blue chip companies like Marks & Spencer, Woolworth and Trusthouse Forte. But I had not been very successful; I had lost about £14,000 over the period.

"My dealer rang and said he had an ideal opportunity for me to recoup my losses. He said it would pay for Christmas as well."

He suggested writing two options, which should have limited the potential damage, but the extraordinary 500 point collapse of the index on October 19 and 20 left Mr Smith with enormous debts. The first two options he wrote required the index to finish October between 2150 and 2400, whereas it stood at 1749·6.

"From what I can gather from reading books, I think this is called a straddle," said Mr Smith. "I now realise that the risk is limitless, but it was not explained to me. Even when the market crashed, I did not know how much I was down: I had no idea how to calculate it."

He first realised how serious his situation was when his dealer contacted him and told him that NatWest Stockbrokers had a problem with his account. That was on October 29—10 days after the crash.

"I said, 'You got me into this, how can you get me out of it?' And he said, 'We want to come round and see you.'

"I had been relying very heavily on the expertise of the broker because I did not know how the index would go. It was very different from looking at the future of a single company.

"The dealer came round that night to my home with Godfrey Jillson the deputy chief executive of NatWest Personal Finance Management.

"They kept saying that NatWest was not a vindictive bank. But they had a form with them, a legal charge, and wanted me to sign the deeds of the house to them on the spot.

"I refused. I said that I wanted to speak to a solicitor first.

"They had computer printouts and said that I owed £111,000. I told them I did not have that sort of money. If I sold everything I had in the world —my house, my furniture and my car—I would only have about half that amount.

"The next day I rang my solicitor and told him about the meeting and, a few hours later, NatWest Stockbrokers telephoned and said I owed a quarter of a million pounds.

"It took a couple of days for it to sink in. It was beyond my comprehension really. If I worked for the rest of my life I could probably pay it off, but there's no point."

Mr Smith says that the bank did not ask him for any credit references when he opened his options account. But, as he banked with NatWest, he expected that the brokers would have had access to the fact he had an overdraft on his business account and that his total turnover last year was £16,000, including materials.

He says that when he started buying options he was prepared to risk £1,200 to £1,500. Before that, he had only dealt in penny shares.

"I did not even apply for any of the privatisation issues until Rolls Royce because I felt they were too much of a gamble," he said.

"I asked at the Sutton branch of the bank, where I bought my penny shares, how I could buy options in shares and I was put in touch with my dealer at County NatWest.

"I would never have written the options if he had not suggested it. I had never considered it. The way it was put, it was such a juicy carrot. It was an opportunity that could not be missed.

"About a week and a half after I agreed to write the first two, he telephoned and suggested I write a call and put option for November.

"I was allowed to start writing options with no money at all to write the option. I expected to make about £7,000 if it all worked out. The November one was expected to make £6,000.

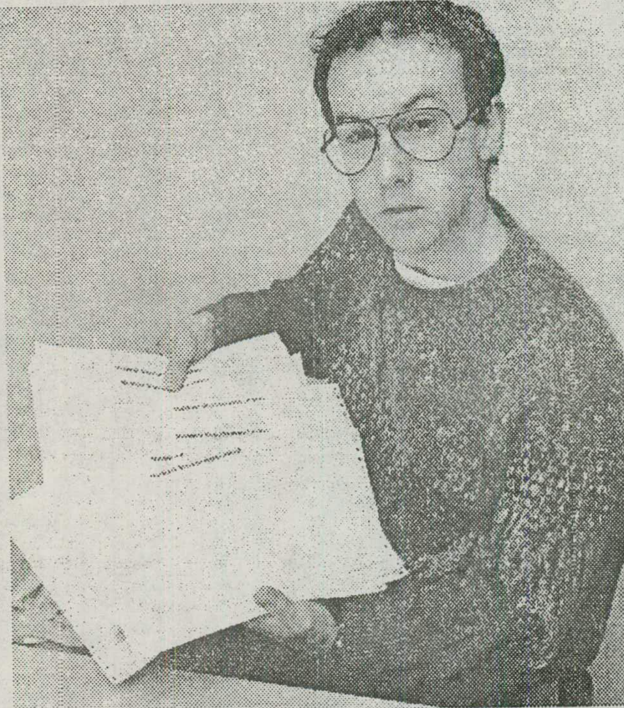
"He said his analyst said the current prediction was that market would not go wild, that it would continue and that I would recover some of the year's losses. Later, on he suggested another October 'straddle' using a narrower band on the index of 2250 and 2350."

Mr Smith says that he does not blame the dealer concerned. "I think he was doing what he thought was best for his clients, but somebody should have warned us of the possible risk."

NatWest Stockbrokers tape records all dealers' calls, as does County NatWest, but a spokesman was unable to confirm or deny Mr Smith's recall of the conversations.

A spokesman for NatWest group said: "We cannot discuss individual customers' business. We are now in contact with Mr Smith and his legal adviser."

Lindsay Cook



Trevor Smith . . . had no idea how to calculate his loss

Saturday, November 21, 1987

THE INDEPENDENT

Simple guide to Lloyd's underwriting

TIME was when the ultimate financial status symbol was membership of that exclusive club, Lloyd's of London, the insurance market. Today, when two-bedroomed flats in Notting Hill or a yuppie apartment in Docklands costs £250,000, the requirement to show wealth of £100,000 as the entry fee for joining means that many more individuals are eligible.

Accountant Clark Whitehill has produced a booklet, *Underwriting at Lloyd's*, which sets out the requirements for joining and the somewhat complicated tax situation of Lloyd's membership.

The most important aspect of joining Lloyd's, however, is to find the right Members Agent who can get you on to the good syndicates. The Association of Lloyd's Members produces syndicate performance figures and for anyone thinking of becoming a Lloyd's underwriter, membership of the association should be the first step.

Copies of the Clark Whitehill book are obtainable free to existing clients or for £3 to non-clients from Clark Whitehill Publications Department, 25 New Street Square, London EC4A 3LN. Tel: 01-353 1577.

Membership of the Association of Lloyd's Members costs £50 for UK residents and the address is The Association of Lloyd's Members, Lloyd's, Lime Street, London, EC3M 7DQ. Tel: 01-283 4026.

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THE WALL STREET JOURNAL

Lloyd's of London Proposes Rules For Brokers in Its Insurance Market

9=

By TOM BUERKLE
AP-DOW JONES NEWS SERVICE

LONDON – Lloyd's of London outlined a broad package of proposals for regulating insurance brokers who operate at the insurance market.

Although the government has separated regulation of Lloyd's from the rest of Britain's financial markets, the proposed regulations for Lloyd's brokers echo rules being imposed on other financial-services firms. They include standards on suitability of owners and directors, capital backing and accounting and a code of practice stipulating disclosure of information to clients and insurers.

The package is the first comprehensive body of rules for Lloyd's brokers as empowered by the Lloyd's Act of Parliament in 1982, said Barry Gibson, general manager of the market's broking department. Lloyd's traditionally has regulated brokers but previously used more informal rules that lacked the statutory backing of Parliament, he noted.

Uniform Application

The new rules also will apply uniformly to all brokers, Mr. Gibson said. In recent years, the market has applied more stringent requirements to new brokers than to long-established firms.

The proposals would identify anyone owning 15% or more of a broker as a controller and require that party to be approved by Lloyd's. The market also would be able to rule on whether directors and partners of brokers are "fit and proper" to serve in their roles.

Among other provisions:

- An existing ban on any insurance company owning more than 26% of a broker would be abolished. However, a broker would have to inform clients in writing if it places insurance with an insurance company with which it is connected.
- Brokers are advised not to be "unduly dependent" on any one insurer or small number of insurers for placing their business, nor on just a few sources of business.
- Capital and solvency requirements would be established, including a minimum of £250,000 ($443,500) for each firm.
- Brokers would be required to hold assets equal to at least 5% of brokerage revenue for their first £1 million of revenue. The percentage would decline as revenue increases. The rules also stipulate minimum requirements for net current assets and net assets.
- Brokers would be urged under a conduct code to provide advice objectively and to safeguard clients' confidentiality. They also would be asked to disclose commissions and other charges and be fully open about risks to insurers.
- Finally, noting concern about the cost of regulation in all of London's financial markets, the proposals call for periodic reports on the costs of the regulatory measures. Alan Parry, deputy chairman of Lloyd's, said that the Broker Regulation Committee doesn't plan to add resources to implement the proposals and that the cost burden on brokers shouldn't rise.

The proposals have been approved by the Ruling Council of Lloyd's for consultation until Jan. 22, 1988. The Broker Regulation Committee then will make any amendments and draw up final rules for council approval in March, Mr. Gibson said, and final rules should be implemented by April or May.

THE TIMES

SYDNEY

Standard 'is mystery buyer of Bell shares'

From Richard Battley, Sydney

Standard Chartered Bank is the mystery buyer of Bell Resources shares, market sources claimed yesterday. They pointed out that Bell Group, Mr Robert Holmes à Court's flagship, holds 14.9 per cent of Standard. He was one of three white knights to help it fend off an unwelcome £1.3 billion takeover bid from Lloyds last year. Thus, the interpretation is that he is owed a favour.

In addition, Cazenove, the London broker, and the local broker EL&C Baillieu have been keen buyers of Bell Resources and Standard is known to have dealt with both. Finally, most of the shares have gone overseas. Of the 5.24 million Bell Resources shares traded yesterday, 4.2 million were for foreign orders.

The market took a lead from Wall Street, with the all-ordinaries index down 27 points – 2 per cent – at 1,256.

pw Standard Chartered pays.

S E C R E T

pmp

MG NOON REPORT

FINANCIAL MARKETS — Monday 23 November 1987

Opening	10 AM		NOON	2.30 PM	Oil Price (10 AM)	
75.7	75.8	£ERI	75.7			
1.7920	1.7945	$/£	1.7918	1.7913	Dec	$17.70
2.9873	2.9864	DM/£	2.9864	2.9843	Jan	$17.82
1.6670	1.6642	DM/$	1.6667	1.6660	Feb	$17.85
135.05	134.50	Yen/$	134.60	134.55		

UK interbank £			Eurodollars	
8 15/16	(-1/16)	7 day	6 3/4	(-)
8 15/16	(-1/16)	1 month	6 7/8	(-)
8 15/16	(-)	3 month	7 7/16	(-)
9 1/16	(-)	12 month	7 7/8	(-)

2.30
FTSE +27
Wall St -8

Figures in brackets show change since previous market close

MARKET COMMENT: The dollar continued firm in New York Friday night until after Reagan announcement of Budget deficit package. The package announced $76bn deficit cut over 2 years; less than the markets expected. The dollar then fell in a dissapointed market and has continued easier this morning. Sterling at a five year high in effective terms on the falling dollar. Norwegian score done to support Kroner on political uncertainties and lack of confidence in Norwegian economy. The US equity market closed up with the Hong Kong market closing down. Tokyo on holiday. Dow Jones 1913.6 +18.2 and Hang Seng 2141.7 -72.9. The FTSE 100 opened at 1627.7 - 5.7 it is now 1660.3 +26.9. The gilts market is easier.

[signature]

MARKET INTERVENTION ($m)

Overnight	+31$ New York
Today so far	-
Total	+31$

OTHER COUNTRIES- INTERVENTION ($m)

Germany +38$
Spain +71$
Norway -99DM
" -250$
Canada +11$ (Friday)

GILTS

	Latest market movements	Price change since previous close
Shorts	Easier	-5/32
Mediums	Easier	-10/32
Longs	Steady	-13/32
Futures (Long Contracts)		-26/32 (Vol:11348)

Gilt Sales since market opening

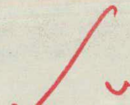
-£2.1 million

All Index Linked

NAME: Miss R J McRobbie, MG1 Division
TEL NOS: 270 5557/5560

S E C R E T

DATE:



9.0am MARKET REPORT

	£ERI	$/£	DM/$	DM/£	Yen/$	Yen/£
NEW YORK CLOSE		1.7785	1.6790	2.9861	135.55	241.08
LONDON (8.30am)	75.7	1.7920	1.6670	2.9873	135.05	241.13
9.00am	75.7	1.7912	1.6680	2.9877		

	opening	change from previous close
3 month interbank rates	8 15/16	–
3 month eurodollar rates	7 7/16	+ 1/16
1 month interbank	8 15/16	–

Intervention:

UK +31 in NY

Oil 17.70 (+15) 17.82 (+7) 17 .85 (+5)

Comment:

RA3.73

RESTRICTED

FROM: A C S ALLAN
DATE: 23 November 1987

SIR T BURNS

cc Sir G Littler

LETTER FROM MR GUAY

... The Chancellor thought you might be interested to see the attached letter from Mr Edward Guay to Sam Brittan. He thought you would be amused by the reference to the Chancellor's part in the Stock Market collapse.

2. In fact, the letter is full of factual errors - for example we have been net buyers, not net sellers, of dollars; dollar interest rates pre-collapse were too low, not too high; and our purchase of Deutschemarks had nothing whatever to do with the behaviour of the Bundesbank. (And, of course, our August interest rate hike was in any event necessary.) But he would be interested in your comments on the criticisms of the system.

ACSA

A C S ALLAN

Monday November 23 1987

THE WALL STREET JOURNAL
EUROPE

1. pp

Terrible Tuesday

How the U.S. Market Almost Disintegrated A Day After the Crash

Credit Dried Up for Brokers And Especially Specialists Until Fed Came to Rescue

Most Perilous Day in 50 Years

By JAMES B. STEWART
and DANIEL HERTZBERG
Staff Reporters of THE WALL STREET JOURNAL

NEW YORK – Just over a month ago, the New York Stock Exchange died. But within an hour or two, it was raised from the dead.

Oct. 19, when the Dow Jones Industrial Average plunged 508 points in history's largest one-day loss, has been dubbed Black Monday. But it was on Tuesday, Oct. 20, that the U.S. stock market – and by extension all the world's financial markets – faced one of their gravest crises.

Full details of what happened that fateful week only now are emerging and are the subject of major inquiries by a presidential commission, congressional committees and others. But minute-by-minute scrutiny of the events of that Tuesday, plus scores of interviews with key stock, commodities and futures market participants, the Federal Reserve, and investment and commercial bankers, shows that:

- Stock, options and futures trading all but stopped during a crucial interval on Tuesday. Many major stocks, such as International Business Machines Corp. and Merck & Co., couldn't be traded. Investors large and small couldn't sell their stock; there were no buyers. The industrial average was meaningless because many of its component stocks weren't trading. The Big Board's market makers, or specialists, were overwhelmed by unfilled sell orders, and their capital was devastated.

- Many banks, frightened by the collapse in prices of stocks that were collateral for loans to securities dealers, refused to extend sorely pressed dealers any more credit. They also called in major loans, imperiling some securities firms.

- Some big investment-banking firms, facing catastrophic losses if the market panic continued, urged the New York Stock Exchange to close.

- Only the intervention of the Federal Reserve, the concerted announcement of corporate stock-buy-back programs, and the mysterious movement – and possible manipulation – of a little-used stock-index futures contract saved the markets from total meltdown.

The story of that Tuesday discloses large weaknesses in the U.S. financial system and raises the specter that such a crisis could strike again. "Tuesday was the most dangerous day we had in 50 years," says Felix Rohatyn, a general partner in Lazard Freres & Co. "I think we came within an hour" of a disintegration of the stock market, he says. "The fact we didn't have a meltdown doesn't mean we didn't have a breakdown. Chernobyl didn't end the world, but it sure made a terrible mess."

* * *

Monday, Oct. 19, 11 p.m. This day was the worst in Wall Street's history – and worst of all for the Big Board's specialists. The specialists, more than 50 little-known but powerful firms, are required by Big Board rules to buy and sell assigned stocks during volatile times to keep prices as orderly as possible. They usually profit handsomely by shrewd trading – a franchise that long has been the envy of large, publicly oriented securities firms prevented by Big Board rules from becoming specialists themselves. Specialists are supposed to provide the last bastion of liquidity; in normal times, they are the reason an investor can buy or sell a stock when no other investors are in the market. On this day, at least, they clearly were not up to the task.

As the market plunged on Monday, the specialists bore the brunt of the fall. "From 2 p.m. on, there was total despair," says James Maguire, chairman of Henderson Brothers Inc., a big specialist firm that makes markets in about 70 stocks. "The entire investment community fled the market. We were left alone on the field." Forced to buy stock himself when there were no other buyers, Mr. Maguire ended the day with $60 million in stock – three times his usual inventory. Like other specialists, he had to pay for this stock five business days later, the following Monday. To do so, he would have to borrow.

Mr. Maguire phoned his bank, Bankers Trust Co., one of New York's biggest and an important lender to Wall Street. He asked for a $30 million loan, even though Henderson is one of Wall Street's best-capitalized specialist firms. He was stunned by the response. "They stated they were in no position to make commitments," Mr. Maguire says.

Mr. Maguire phoned the bank five times between 11 p.m. and 12:30 a.m. It wouldn't budge.

Other specialists report similar experiences. One, A.B. Tompane & Co., similarly turned down by Bankers Trust, was hurriedly forced into the arms of well-capitalized Merrill Lynch & Co. The two firms shook hands on the merger at 3 a.m. By dawn, nevertheless, the worst was yet to come for the markets.

Tuesday, 6:30 a.m. Big Board Chairman John J. Phelan met a neighbor going down in the elevator of his Manhattan apartment building. The neighbor was concerned not

Please Turn to Page 7, Column 1

about M[illegible]day's 508-point plunge but about rumors that the Big Board might close. "He said, 'My God, if things were bad enough to close the market, things were really bad,' " Mr. Phelan recalls.

Tuesday, 8 a.m. Bank credit is the lifeline of Wall Street securities firms, and specialists weren't the only ones rushing to arrange more of it Tuesday morning. Large securities firms had swollen stock inventories, accumulated to accommodate major clients who wanted to sell, or in some cases held as part of the firms' holdings of stocks that they expected to be involved in takeovers. Demand for credit was further fueled by an explosion of trading in the government-securities market. Trading by big government-securities dealers surged by $58 billion to a daily average of $173 billion that week. In addition, arbitragers, who had accumulated billions of dollars of takeover stocks, were also getting squeezed by margin calls.

The big firms fared little better. Phone calls started pouring into officials at the Big Board and the Federal Reserve Bank of New York. Angry securities dealers reported that foreign and U.S. regional banks were cutting back credit to the securities industry. Bankers Trust told Wall Street firms that it would stop extending unsecured credit – loans not collateralized by assets.

Executives at one big Wall Street securities firm were shocked when another U.S. bank Tuesday refused to deliver promptly $70 million in West German marks that it had sold to the firm in a foreign-exchange trade. Apparently, the bank feared that it might not be paid promptly – if at all – for the marks. Securities firms "were beginning to have trouble getting extended credit," Big Board Chairman Phelan says. "Japanese banks threatened to stop" lending, adds the head of one of Wall Street's largest securities firms.

Tuesday, 9 a.m. As the credit markets came to life in the U.S., Federal Reserve officials were swinging into action. In the early-morning hours, from a hotel room in Dallas, Chairman Alan Greenspan had decided to issue a one-sentence statement that in effect would reverse the course of policies that he had set into motion upon taking office two months before. He canceled a speech and headed back to his Washington office.

Meanwhile, E. Gerald Corrigan, the beefy president of the Federal Reserve Bank of New York and a protege of Mr. Greenspan's predecessor, Paul Volcker, was in close touch with the stock exchanges – due to open in half an hour – the banks and the bond market. As the head of the Federal Reserve's key operating unit, which daily buys or sells huge amounts of government securities and international currencies, he is the Fed official most closely in touch with Wall Street. He was to become the agency's point man in dealing with the developing crisis.

After learning of the credit squeeze facing Wall Street, Messrs. Greenspan and Corrigan feared that something far worse than a stock-market panic might be in the offing. If credit dried up, securities firms could start to collapse, much as the banks did after the 1929 crash. Fed officials saw a real threat of gridlock developing in the markets: Even the simplest financial transaction might have become impossible.

To avert that risk, Mr. Greenspan agreed to suspend, at least temporarily, the tightening grip that the Fed had imposed on credit in order to head off inflation fears that he had seen building up in the economy. Signaling clearly its determination to prevent a market disaster, the Fed issued its extraordinary statement affirming its "readiness to serve as a source of liquidity to support the economic and financial system."

Even that was an understatement. Acting as the ultimate supplier of funds, the Fed flooded the banking system with dollars by buying government securities and thus quickly driving down short-term interest rates. "The Fed opened the floodgates of liquidity," says David Jones, chief economist of Aubrey G. Lanston & Co., a major government-securities dealer.

Alerted by calls about the developing credit crisis from Mr. Phelan and others, the Fed leaned heavily on the big New York banks to meet Wall Street's soaring demand for credit. Mr. Corrigan and key aides personally telephoned top bankers to get the message across.

"Right from the beginning, Corrigan understood there was a major problem in the system," says Mr. Phelan, who spoke repeatedly to the New York Fed chief. Mr. Phelan sums up the Fed's strategy as he saw it: "The banks would be kept liquid; the banks would make sure everyone else in the system would stay liquid."

The banks were told to keep an eye on the big picture – the global financial system on which all their business ultimately depends. A senior New York banker says the Fed's message was, "We're here. Whatever you need, we'll give you."

Tuesday, 9:30 a.m. The New York Stock Exchange opened. But many important sectors were at a standstill. Two-thirds of the specialists' total $3 billion of buying power had been wiped out on Monday. Some

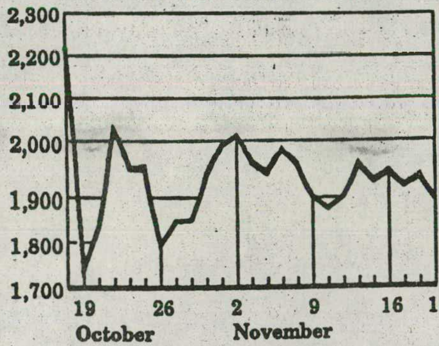
Monday November 23 1987

The Difference One Month Makes

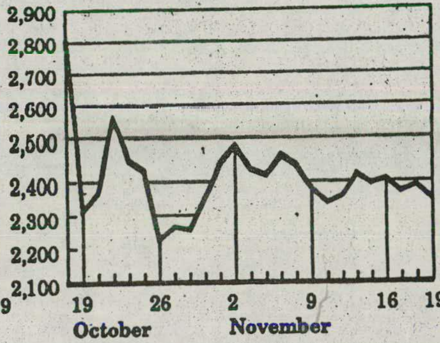
U.S. Stocks

Since the morning of Black Monday the DJIA has lost close to 14% of its value; the Wilshire Equity Index, the broadest measure of U.S. stocks, is off 12.5%.

Dow Jones Industrials



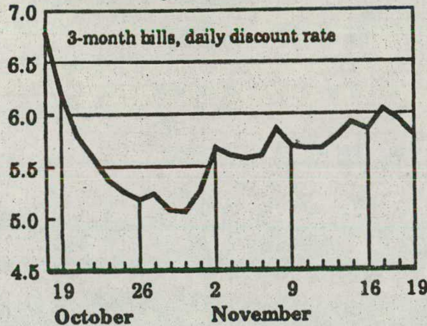
Wilshire 5000



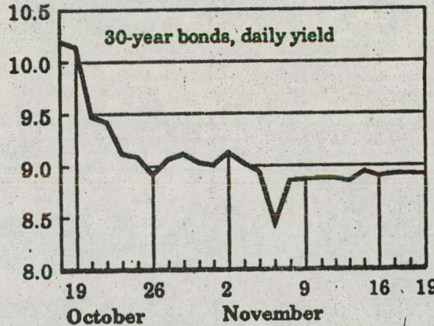
U.S. Interest Rates

The Federal Reserve Board pushed interest rates lower. Three-month Treasury bill rates have fallen to 6%; Treasury bonds that were yielding 10.25% are now at 9%.

Treasury Bills



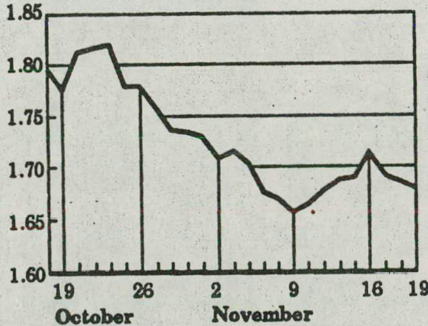
Treasury Bonds



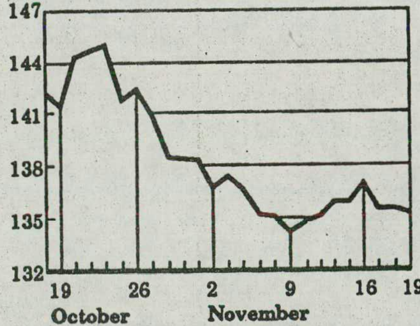
Foreign Currencies

The dollar has mirrored the decline in interest rates. The U.S. currency has lost about 6 % of its value against the German Mark,about 5% against the Yen.

Dollars vs. Mark



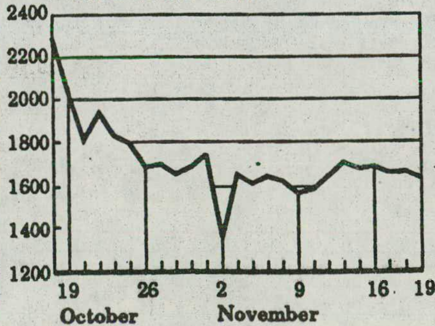
Dollars vs. Yen



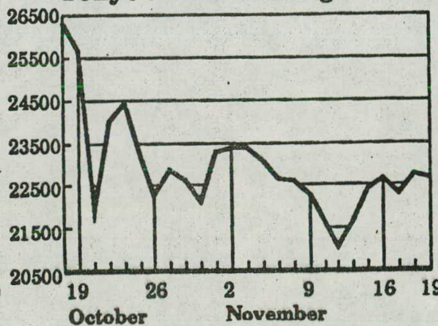
Foreign Stocks

While all major foreign stock markets haven fallen, London is one of the hardest hit, down 29% in the past month; Tokyo's decline is a more modest 14%.

London 100-share



Tokyo Nikkei Average



specialists refused to open trading in stocks until they had enough buy orders to enable the shares to trade at higher prices. Many stocks took more than an hour to open. When they did, they were mostly up from Monday's close. The Dow opened about 200 points higher, an extraordinary gain.

But the euphoria was short-lived. Specialists and major firms quickly unloaded some of their huge inventories, and buyers evaporated. Stock-index futures began to plunge on several exchanges. Program traders and portfolio insurers, whose computer-generated trading had accelerated Monday's fall, were largely absent from the market. Program traders switch money between stock-index futures and the underlying stocks, depending on which is cheaper. Portfolio insurance is a method of hedging a stock portfolio, usually by selling futures contracts on stock indexes when the market falls.

Ordinarily, the huge discount of the futures contracts to the cash value of the underlying stocks would encourage selling of the stocks and buying of the futures. That, in turn, theoretically could trigger some buying of stocks at bargain prices. But as the morning continued, everything was being sold – stocks and futures alike.

Tuesday, 11:25 a.m. Of all securities linked to stock-market indexes, the Major Market Index has been the most secure, even in turbulent markets. It is pure blue chip: 17 of the 20 stocks in the index also are in the Dow Jones Industrial Average. Indeed, the MMI was created to mirror that average.

On Monday night, after the market turmoil that day, Ronald Shear, the American Stock Exchange's likable, balding senior specialist for the MMI, couldn't sleep. At 4 a.m., he gave up trying, and he went to the Brasserie, a 24-hour French restaurant in midtown Manhattan. Later, as the markets opened, he could hardly believe what he saw. One after another, major stocks broke down and couldn't be traded. By 11:30 a.m., when IBM stopped trading, the pace of closings was so fast that Mr. Shear had trouble keeping track.

Big Board printouts of the morning's trading paint a harrowing picture of a market in disarray. By 11:25, even Du Pont hadn't opened. Merck opened at 9:46, was overwhelmed by sell orders and closed eight minutes later. Sears closed at 11:12; Eastman Kodak at 11:28; Philip Morris at 11:30; Minnesota Mining & Manufacturing a minute later. Dow Chemical shut at 11:43; USX at 12:51. Many other major stocks also weren't trading. Those that were did so only sporadically, in small numbers of shares or on regional exchanges. Over-the-counter market makers stopped answering their phones.

Specialists didn't have any buy orders, and many simply stopped making markets. Many thought that their capital, much of it in stock that looked as though it couldn't be sold, was gone or nearly gone. The specialists had run out of buying power.

Suddenly, Mr. Shear heard rumors coursing across the Amex floor. One turned out to be true: Tompane, the USX specialist on the Big Board, was about to be taken over by Merrill Lynch. Another later proved to be false: SEC Chairman David Ruder was about to announce the closing of the exchanges.

Sensing a similar imbalance in the options trading, Mr. Shear called a floor supervisor to check the rules for index-options trading on the Amex. The supervisor confirmed that if stocks representing more than 20% of the underlying capitalization of the index aren't trading, then options trading should stop. From what Mr. Shear saw, well over half the stocks in the index had stopped trading.

Mr. Shear got on the loudspeaker and halted trading in the MMI options.

Tuesday, 12:15 p.m. Leo Melamed, the short, dark-haired, kinetic chairman of the Chicago Mercantile Exchange, was on the phone to Mr. Phelan in New York. The Merc trades the Standard & Poor's 500, the principal futures contract used by program traders and portfolio insurers. Mr. Melamed was alarmed by the unprecedented breakdown in trading of the stocks making up the S&P 500. The Chicago Board Options Exchange, which trades options, had already closed because so many stocks weren't trading. "I was told there were no buyers," Mr. Melamed says. Then, he received a jolt: Mr. Phelan told him that Big Board directors were convening to decide whether to close the stock exchange. Mr. Phelan told him that "a decision was close," Mr. Melamed recalls.

Mr. Melamed suddenly envisioned a selling onslaught of the futures that could exhaust every bit of liquidity on the Merc floor. "We were exposed in a very dangerous way. We couldn't bear the brunt of any panic," he says. At 12:15 p.m., the Merc ordered a halt in trading of S&P 500 futures contracts.

A few blocks away at the Chicago Board of Trade, Chairman Karsten Mahlmann, known by his nickname, "Cash," also was on the phone to the Big Board. His exchange was still trading futures contracts on the MMI. But the situation was worsening: The MMI futures, already trading at the deepest discount to the underlying cash value of the index in its history, plunged further on the news that Mr. Shear had halted options trading on the Amex.

Mr. Mahlmann also was told that the Big Board was thinking of closing. But the Board of Trade was a little better off than the Merc. Trading of the relatively little-used MMI futures contracts had almost ground to a nervous standstill; MMI traders didn't seem to face a flood of orders.

Moreover, Mr. Mahlmann calculated that 17 of the MMI's 20 stocks still were trading, albeit sporadically, on some regional stock exchanges. Just the day before, Mr. Mahlmann had received a phone call from Beryl Sprinkel; the chairman of the President's Council of Economic Advisers urged him to keep the Board of Trade open. And there was the fierce longstanding rivalry between the Board of Trade and the New York exchange, a rivalry that has given rise to a generally defiant attitude at the Board of Trade toward any action adopted by the Big Board.

"We felt we had to stay open to do our job, to provide liquidity," Mr. Mahlmann recalls. Then he and his executives made what turned out to be one of the most critical decisions of the day: They kept the Board of Trade open and continued to trade the MMI futures contract.

Tuesday, 12:30 p.m. Mr. Phelan, Big Board President Robert Birnbaum, other top exchange officials and floor directors representing shellshocked specialists had gathered in Mr. Phelan's office to consider an extraordinary step: closing the New York Stock Exchange. The mood was grim. Mr. Phelan recalls that during the morning the market "was off 100 points and looked like it had potential to drop another 200 or 300. It looked like it would go again; it would be faster and heavier than the day before because there would be panic in the system." Exchange officials feared that selling would cascade as investors were hit with margin calls and big mutual funds dumped stock in the face of huge shareholder redemptions.

Behind the scenes, other pressures on Mr. Phelan to close the Big Board were multiplying. Several big securities firms "called the SEC and asked them to tell us to close," says Mr. Phelan (only the U.S. president and a stock exchange – but not the SEC – can order a closing). Mr. Phelan won't name the firms, but market sources say Salomon Brothers Inc. and Goldman, Sachs & Co., major firms with huge inventories of securities that were being rapidly devalued, were among those pushing to shut the exchange.

A Goldman official says the firm did discuss the possibility of a temporary closing with SEC Chairman Ruder but didn't recommend it. A Salomon spokesman didn't return a phone call.

"There were pressures from all firms that day to cut hours – to close," Mr. Phelan says. Donald Stone, a Big Board director, says there was also a discussion of a plan – broached on Black Monday – for big Wall Street firms to raise a $1 billion fund to keep specialist firms from going broke.

Mr. Phelan denies suggestions by Mr. Melamed and Mr. Mahlmann that he or other officials gave any indication that the Big Board was on the brink of closing. He says he had talked during the morning to White House Chief of Staff Howard Baker. "They said if you can do it (stay open), do it," he relates.

Despite the intensifying pressures to close, the market was still officially open at 12:30.

Tuesday, 12:38 p.m. With the closing of the Big Board seemingly imminent and the market in disarray, with virtually all options and futures trading halted, something happened that some later described as a miracle: In the space of about five or six minutes, the Major Market Index futures contract, the only viable surrogate for the Dow Jones Industrial Average and the only major index still trading, staged the most powerful rally in its history. The MMI rose on the Chicago Board of Trade from a discount of nearly 60 points to a premium of about 12 points. Because each point represents about five in the industrial average, the rally was the equivalent of a lightning-like 360-point rise in the Dow. Some believe that this extraordinary move set the stage for the salvation of the world's markets.

How it happened is a matter of much conjecture on Wall Street. Some attribute it to a mysterious burst of bullish sentiment that suddenly swept the markets. Some knowledgeable traders have a different interpretation: They think that the MMI futures contract was deliberately manipulated by a few major firms as part of a desperate attempt to boost the Dow and save the markets.

According to this theory, the rally in the MMI futures contract was caused by a relatively small amount of concerted buying by one or more major firms at a time when it was so thinly traded that the orders had an enormous and disproportionate upward thrust. By forcing the futures contract to a premium to the underlying cash value of the index, the buyers of the futures could trigger immediate buying of the stocks in the index and selling of the futures by index arbitragers. Because so many of the MMI stocks are in the Dow, this would enable the NYSE to reopen many of these stocks at higher prices, leading to an upturn in this psychologically important index. At the very least, the buyers could flash a powerful bullish signal to the markets.

Mr. Mahlmann says he doesn't know whether this is what happened, but he says it is possible. "The market was extremely thin at that point," he recalls.

Statistics supplied by the Board of Trade lend circumstantial support to the thesis that the index was driven upward by a small number of sophisticated buyers. During the half hour – 12:30 to 1 p.m. in the East, 11:30 to noon in Chicago – that encompassed the extraordinary rally, only 808 contracts traded, representing an underlying cash value of the index of about $60 million. The actual cost to someone buying those contracts can't be precisely determined, but it would have been a small fraction of the cash value.

Of the 808 contracts traded, about 70% were purchased at low commission rates. That indicates that the buying came from major Wall Street firms with their own traders on the floor. Only 30% of the buying came from so-called locals – smaller, independent traders who trade for their own and customers' accounts. The Board of Trade's statistician says this is an abnormally low percentage of local buying. Which firms were doing the buying couldn't be determined. Major firms contacted, including Morgan Stanley & Co., Kidder Peabody & Co., PaineWebber Inc., Goldman Sachs and Salomon Brothers, all either denied that they were responsible for the buying or declined to comment.

As news of the rally in MMI futures reached the New York Stock Exchange (major firms maintain open lines both to their traders in Chicago and to specialists in New York), the market got another important psychological boost: the announcement of stock buy-backs by big corporations. This, too, appears to have been encouraged by major investment banks, many of which spent Tuesday morning frantically calling chief executives of large clients urging them to buy back their stock. First Boston, for example, called about 200 clients.

"It looks like there's almost a get-together on the part of corporate America to prop up the market," Stanley Abel, a consultant specializing in buy-backs, observed that day. Among the companies announcing buy-backs were Shearson Lehman Brothers Holdings Inc., Merrill Lynch, Citicorp, Honeywell, ITT, Allegis, four regional Bell companies and USX.

The precise timing of those announcements and any accompanying purchases are difficult to pinpoint, but some occurred during the crucial hour between 12:30 and 1:30.

Floor traders at the Chicago Board of Trade say the major securities firms that maintain direct contact with specialists in New York were the first to learn of such buy orders, which in turn led to further buying by those firms of the MMI futures whenever the contract traded at a discount to the underlying cash index. (Indeed, the locals in Chicago long have complained that because the MMI consists of only 20 stocks, it can be manipulated by the major firms with access to Big Board specialists.)

A graph of Tuesday's movement in the MMI futures contract is consistent with such observations. At 12:45, the MMI contract had moved to a big premium to the underlying cash value of the index (so many of the stocks weren't trading that the underlying cash value was calculated using recent trades that probably overstated its true value at the time). The graph shows that the contract immediately turned downward, as traders presumably sold the futures and began to buy the underlying stocks, thereby locking in a profit.

If the goal of those buying the MMI futures beginning at 12:38 was to drive up the Dow, it succeeded brilliantly.

Tuesday, 1 p.m. Like water on parched earth, buy orders began flowing into securities firms and into the stock exchange.

Banks, including the recalcitrant Bankers Trust, had finally pledged their support after receiving reassurances from the Fed, giving specialists and other firms the financial confidence to execute orders. The Fed told the banks that they were free to increase their borrowings at the Fed's discount window. New York's Chemical Bank increased its loans to securities firms for that week by $400 million above normal, a bank official says.

All told, the 10 biggest New York banks nearly doubled their lending to securities firms that week to $12 billion, pumping in an extra $5.5 billion.

As the buy orders reappeared, large capitalization stocks – especially those in the MMI – began coming back to life. Merck reopened at 1:15, albeit 21 points lower, and IBM reopened at 1:26 at 112, unchanged from two hours earlier. By 2 p.m., when USX reopened, up 62½ cents, all the MMI stocks were trading.

Mr. Phelan told his counterparts at the other exchanges in New York and Chicago that the day's threat of closing had passed, that the immediate crisis was over. At the Amex, Mr. Shear got on the loudspeaker to announce that MMI options would resume trading in 15 minutes. Mr. Melamed ordered the resumption of futures trading on the Merc, and the Board of Trade's Mr. Mahlmann breathed a great sigh of relief. "We were immensely pleased that the market came back and that we were the ones who stayed open," he says.

Tuesday, 4 p.m. The stock market ended its tumultuous day with a record – and psychologically crucial – gain of 102.27 points in the Dow. Volume was also a record 608,120,000 shares, a little more than on Black Monday. On the Big Board overall, 1,398 stocks declined. Only 537 gained.

The Dow's rise partly reflected the strong peformance of the stocks that make up the MMI. Throughout the afternoon, the MMI futures traded several times at a premium to the cash index, apparently triggering buying of the underlying stocks. The performance of the MMI futures diverged significantly from that of the S&P 500, which remained at a deep discount to the index even after it reopened.

Because of the Fed's aggressive move to drive down interest rates by flooding the system with liquidity, the bond market, too, rallied strongly, providing crucial support for the broader financial system. "If the bond market had been going the same direction as the stock market – down – that would have been the straw that broke the camel's back," Mr. Phelan says.

* * *

On Wednesday, Americans woke to newspaper headlines proclaiming the largest rise in the Dow's history. A wave of optimism washed over the exchanges. The stock market that day was to have a real rally – 186.84 points on the Dow, with 1,749 stocks gaining.

In the end, the stock market and financial system didn't collapse on Tuesday. Although trading losses – mainly in takeover- related stocks – ran into hundreds of millions of dollars, no major securities firm defaulted on its obligations to customers or was rendered insolvent. A few specialist firms merged or were forced to find new infusions of capital; most survived. But privately, key participants say they were deeply shaken by how close to catastrophe the system came.

And the crisis in the financial system revealed glaring weaknesses that are being closely examined in Congress. The New York Stock Exchange specialist system – despite some heroic efforts – proved inadequate to meet the demands of huge international flows of capital, nearly triggering a shutdown of the exchange and a public crisis of confidence. Though there is little to suggest that program trading or portfolio insurance caused the crisis, both contributed to a degree of volatility that the system couldn't handle.

"The markets will be nothing but an open casino if you let this continue," Mr. Phelan says.

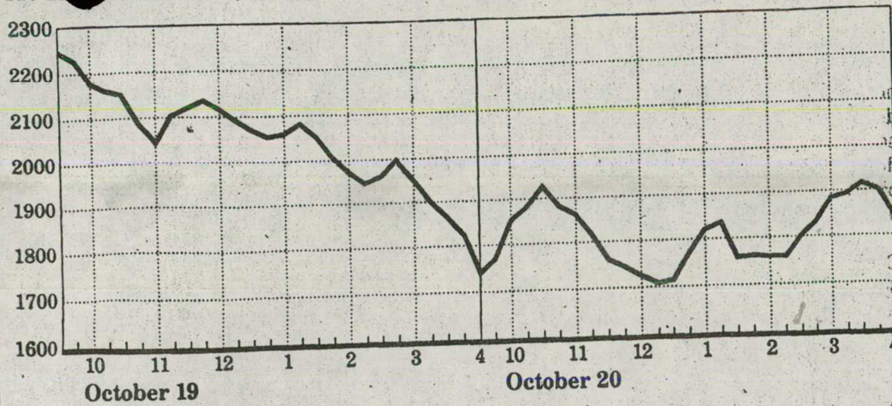
More worrisome, many officials note, is that the crisis occurred in the absence of any true calamity. What might happen to the markets in a major political or economic crisis? Could a real meltdown happen?

"I won't even get into that," the Merc's Mr. Melamed says.

After the Crash, the Real Crisis Begins

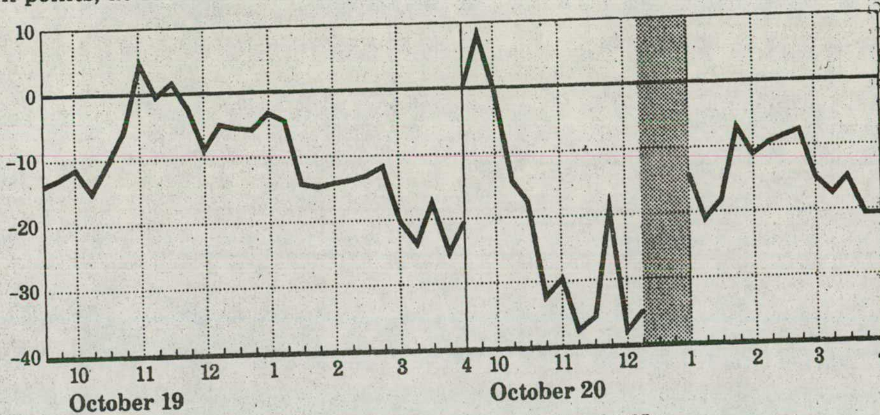
The Dow Jones Industrials

At 15 minute intervals



S&P 500 Cash-to-Futures Spread

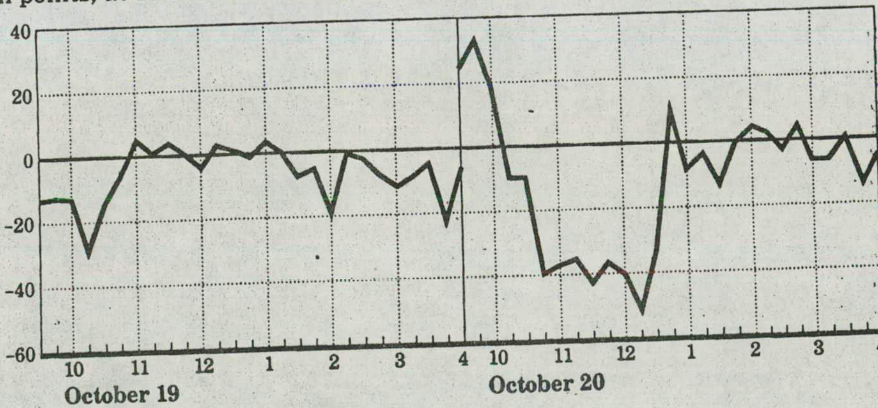
In points, at 15 minute intervals



NOTE: Trading in futures contracts halted between 12:15 and 1:05

Major Market Index Cash-to-Futures Spread

In points, at 15 minute intervals



Anatomy of Tuesday's Turmoil

Even though some stocks rebounded in early trading Tuesday—the Dow was up 200 points at 10:30—sell orders quickly swamped the exchange and many stocks stopped trading. By 12:15 the Dow was down 30 points (top chart). Trading in futures contracts on the S&P 500, the basis for most program trading and portfolio insurance, ceased because so many of the underlying stocks had been halted with the futures trading at a record discount from the index's cash value (middle chart).

Only the relatively thinly traded futures contract on the Major Market Index, a Chicago Board of Trade contract based on a basket of 20 blue-chip stocks, continued to trade (bottom chart). The sharp rebound at 12:45—which could have been sparked by relatively little buying—evidently was able to rally the stock market, which in turn allowed more stocks to open.

Source: Knight-Ridder Tradecenter

END

MG NOON REPORT

pmp

FINANCIAL MARKETS — Tuesday 24 November 1987

Opening	10 AM		NOON	Oil Price (10 AM)	
75.5	75.4	£ERI	75.5		
1.7815	1.7770	$/£	1.7780	Dec	$18.02
2.9822	2.9854	DM/£	2.9915	Jan	$18.17
1.6740	1.6800	DM/$	1.6825	Feb	$18.12
134.85	135.40	Yen/$	135.37		

UK interbank £			Eurodollars	
9	(+1/16)	7 day	6 3/4	(+1/16)
8 15/16	(-)	1 month	6 3/4	(-1/16)
8 15/16	(-)	3 month	7 5/16	(-1/8)
9 1/16	(-1/16)	12 month	7 7/8	(-)

Figures in brackets show change since previous market close

MARKET COMMENT: The dollar firmed slightly in New York on short covering ahead of Thanksgiving holiday. It continued to firm early this morning helped by Bundesbank cutting its repo rate from 3 1/2% to 3 1/4%. The dollar remained steady around DM 1.68, until the French cut their 7 day repo rate by 1/4% to 8 1/2% and their money market rates by 1/4% to 8%. The Dutch followed cutting their discount rate by 1/4% to 4%. This all helped to firm the dollar. Sterling is easier on the firmer dollar. UK Trade figures had little impact.
The US and Japanese equity markets closed up whilst the Hong Kong market closed down. Dow Jones 1923.1 (+9.4), Nikkei 22856(+105) and Hang Seng 2134.8(-6.9). The FTSE100 opened at 1659.0 +1.3 and is now 1682.1 +24.4.
The gilts market opened a little better and improved further on the trade figures in moderate 2-way trade. Index linked had met further sporadic demand.

R McRobbie

MARKET INTERVENTION ($m) — OTHER COUNTRIES INTERVENTION ($m)

+30 at 12.50

Overnight	-
Today so far	-
Total	-

GILTS

	Latest market movements	Price change since previous close
Shorts	Steady	+3/32
Mediums	Better	+11/32
Longs	Better	+13/32
Futures (Long Contracts)		+18/32 (Vol:1923)

Gilt Sales since market opening

+£8.2 million

All Index Linked

NAME. Miss R J McRobbie, MG1 Division

SECRET

MG NOON REPORT

FINANCIAL MARKETS — Wednesday 25 November 1987

Opening	10 AM		NOON	Oil Price (10 AM)	
75.8	75.7	£ERI	75.7		
1.7965	1.7915	$/£	1.7897	Dec	$17.90
2.9912	2.9927	DM/£	2.9927	Jan	$18.05
1.6650	1.6705	DM/$	1.6722	Feb	$18.05
134.40	134.75	Yen/$	134.92		

UK interbank £			Eurodollars	
9	(+1/16)	7 day	6 3/4	(+1/16)
8 15/16	(-)	1 month	6 7/8	(+1/16)
8 31/32	(+1/32)	3 month	7 7/16	(-)
9 1/16	(-)	12 month	7 7/8	(-)

Figures in brackets show change since previous market close

MARKET COMMENT: The dollar fell sharply in New York partly on profit taking ahead of Thanksgiving, but mainly on market view that Budget defecit package would not satisfy G7, fuelled by a comment from Wertz (Bundesbank Council) that the US not committed to Budget cuts promised at Louvre. It remained easier in the Far East on thin trading. It firmed here after an easy start triggered by a comment from Stoltenberg that the German Ministry and the Bundesbank would find a way to stimulate growth in Germany. Sterling opened firm but has eased on the firmer dollar.
The US, Japanese and Hong Kong equity markets closed up.Dow Jones 1963.5 +40.4, Nikkei 23220 +363 and the Hang Seng 2184.4 +49.5. The FTSE100 opened down -15.4 at 1673.7 it is now 1661.6 -27.5.
The gilts market is steady.

MARKET INTERVENTION ($m) — OTHER COUNTRIES INTERVENTION ($m)

Overnight	-
Today so far	-
Total	-

GILTS

	Latest market movements	Price change since previous close
Shorts	Better	+3/32
Mediums	Easier	-2/32
Longs	Easier	-2/32
Futures (Long Contracts)		-11/32 (Vol:13794)

Gilt Sales since market opening

-£12.6 million

All Index linked

NAME: Miss R J McRobbie, MG1 Division
TEL NOS: 270 5557/5560

SECRET

MG NOON REPORT

FINANCIAL MARKETS

Friday 27 November 1987

Opening	10 AM		NOON
76.0	75.9	£ERI	76
1.8065	1.8045	$/£	1.8045
2.9934	2.9919	DM/£	2.9931
1.6590	1.6590	DM/$	1.6587
133.80	133.87	Yen/$	133.87

Oil Price (10 AM)

Dec $17.80
Jan $17.95
Feb $17.97

UK interbank £			Eurodollars	
8 31/32	(+1/32)	7 day	6 3/4	(-)
8 15/16	(+1/32)	1 month	6 13/16	(-)
8 31/32	(-1/32)	3 month	7 5/8	(+1/16)
9 1/8	(+1/32)	12 month	7 15/16	(-)

Figures in brackets show change since previous market close

MARKET COMMENT In the foreign exchange markets sterling rose above $1.80 in the Far East on commercial demand which eventually spread into a further easing of the dollar.(Most of this was left over from last nights' London markets).On opening sterling continued to see demand but a modest dollar rally,which briefly took it over DM1.66, helped to stem the rise.Markets now generally quiet and very steady. The Japanese equity market closed down whilst the Hong Kong market closed up.Nikkei Dow 23269 (-13),Hang Seng 2194.2 (+14.6).The FTSE100 opened at 1653.7 (-7.0) and is now 1655.2 (-5.5). The Gilt market has seen a slight improvement.

ICPolin

MARKET INTERVENTION ($m)

Overnight -

Today so far -

Total -

OTHER COUNTRIES INTERVENTION ($m)

Canada +38$(yesterday)
Japan +98$

GILTS

	Latest market movements	Price change since previous close
Shorts	Steady	+3/32
Mediums	Steady	+7/32
Longs	Steady	+11/32
Futures (Long Contracts)		+13/32 (VOL:9291)

Gilt Sales since market opening

£0 million

NAME: I.C.Polin , MG1 Division
TEL NOS: 270 5557/5560

SECRET

SECRET

MG NOON REPORT

FINANCIAL MARKETS — Monday 30 November 1987

Opening	10 AM		NOON
76.2	76.2	£ERI	76.3
1.8245	1.8267	$/£	1.8315
2.9940	2.9921	DM/£	2.9949
1.6410	1.6380	DM/$	1.6353
132.50	132.25	Yen/$	132.17

Oil Price (10 AM)	
Dec	$17.82
Jan	$17.92
Feb	$17.92

UK interbank £			Eurodollars	
9 1/16	(+1/16)	7 day	6 3/4	(-)
8 15/16	(-)	1 month	7 15/16	(-)
8 15/16	(-1/32)	3 month	7 3/4	(+1/16)
9 1/16	(-1/16)	12 month	8	(-)

Figures in brackets show change since previous market close

MARKET COMMENT: The dollar fell in New York and Far East, despite comments by; Kohl that Germany would stimulate the economy and cut interest rates and Miyazawa that major nations will offer concerted intervention for currency stability. Market believes no point in G5/7 meeting at present. They also believe the US seems happy to let the $ fall to "force" the Germans and Japanese to reflate their economies. These views did not help the dollar and it has continued to drift down in bearish markets this morning. Sterling is firm but on the sidelines. The US, Japanese and Hong Kong equity markets all closed down. Dow Jones 1910.4 -36.5, Nikkei 22812 -240 and the Hang Seng 2138.4 -55.7. The FTSE100 opened down 45.2 at 1606.4 it is now 1590.1 -61.5 (its lowest point so far today).
The gilts market is stronger with sterling.

-75

MARKET INTERVENTION ($m)

Overnight	-
Today so far	-
Total	-

OTHER COUNTRIES INTERVENTION ($m)

Japan +48$
Germany +45$ (at the fix)
Canada +23$ (27.11.87)

GILTS

	Latest market movements	Price change since previous close
Shorts	Steady	+9/32
Mediums	Steady	+12/32
Longs	Steady	+17/32
Futures (Long Contracts)		+19/32 (Vol:11556)

Gilt Sales since market opening

+£17.1 million

Mostly Index Linked

SECRET

MG NOON REPORT

FINANCIAL MARKETS — Tuesday 1 December 1987

Opening	10 AM		NOON
76.1	75.9	£ERI	76.0
1.8150	1.8070	$/£	1.8110
2.9929	2.9906	DM/£	2.9945
1.6490	1.6550	DM/$	1.6535
132.70	133.30	Yen/$	133.40

Oil Price (10 AM)	
Dec	$17.65
Jan	$17.87
Feb	$17.90

UK interbank £			Eurodollars	
9	(-)	7 day	7	(+1/16)
9	(+1/16)	1 month	8 1/16	(-1/16)
8 15/16	(+1/32)	3 month	7 7/8	(-1/16)
9 1/16	(+1/32)	12 month	8 1/8	(-1/8)

Figures in brackets show change since previous market close

MARKET COMMENT: The dollar continued downwards on short covering in a quiet NY market despite Fed. intervention. It started to firm towards close in Far East. The Bank intervened to hold £/Mark cross-rate down. Concerted intervention initiated early this morning by the Bundesbank has helped the dollar to firm further though it is now steady. Sterling easier on the firmer dollar but still on the sidelines.
US and Hong Kong equity markets closed down whilst the Japanese market closed up. Dow Jones 1833 -77, Hang Seng 2109 -30, Nikkei 22833 +146. The FTSE100 opened 1589 +9 it is now at 1580.3 +0.4.
The gilts market opened easier as equities improved and has traded quietly. Index linked saw some good demand.

R J McRobbie

MARKET INTERVENTION ($m)

Overnight	+50$ (Far East)
Today so far	-
Total	+50$

OTHER COUNTRIES INTERVENTION ($m)

Germany +200$ Japan +20$
Belgium +12$ Holland +15$
France +30$ agst DM
Italy +12$ agst DM
US +50$ agst DM(30.11.87)
" +50$ agst Yen "
Swiss +30$

GILTS

	Latest market movements	Price change since previous close
Shorts	Steady	-1/32
Mediums	Steady	-4/32
Longs	Steady	-9/32
Futures (Long Contracts)		-11/32 (Vol:9404)

Gilt Sales since market opening

+£14.4 million

All Index Linked

NAME: Miss R J McRobbie, MG1 Division
TEL NOS: 270 5557/5560

3730/028

CONFIDENTIAL

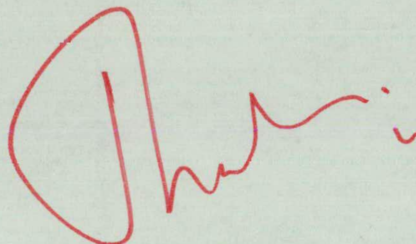
FROM: R N G BLOWER

DATE: 1 December 1987

1. MRS LOMAX Rl 1/12

2. CHANCELLOR

cc: CST
FST
PMG
EST
Sir P Middleton
Mr Cassell
Mr Peretz
Mrs Brown
Mr Ilett
Mr Neilson



EQUITY MARKET

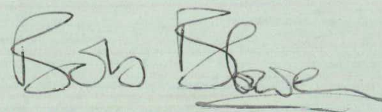
This note provides up-to-date information (11.00am today) on equity market developments, and on the BP share price, as background for your meeting this afternoon.

2. The FTSE100 fell 71.7 to 1579.9 yesterday in limited turnover. The weakness in the US dollar was widely attributed as the cause and Wall Street followed on with a fall of 76.93 overnight to 1833.5. News that the Japanese authorities had intervened to support the US dollar brought the Tokyo market off its lows to close up 146 at 22832.89.

3. London opened up around 11 points but slid back in continued low turnover (around half pre-fall levels) with brokers reporting a buyers strike. BP partly paid made up around 20 per cent of turnover up to 11.00am this morning with the price down 1p at 71-73 at 12.00am and the fully paid similarly down 1p at 242-245.

4. As of close last night a cumulative total of 45,874 BP partly paid shares had been bought at a cost of £32,111.80. Yesterday's total was 5,500 for £3,850. At the quarterly revaluation the Bank's holding of 40,374 shares had gained £3,028.05 in value.

5. I attach graphs illustrating the relative performance in the BP fully and partly-paid shares and when compared to Shell and the FTSE100.



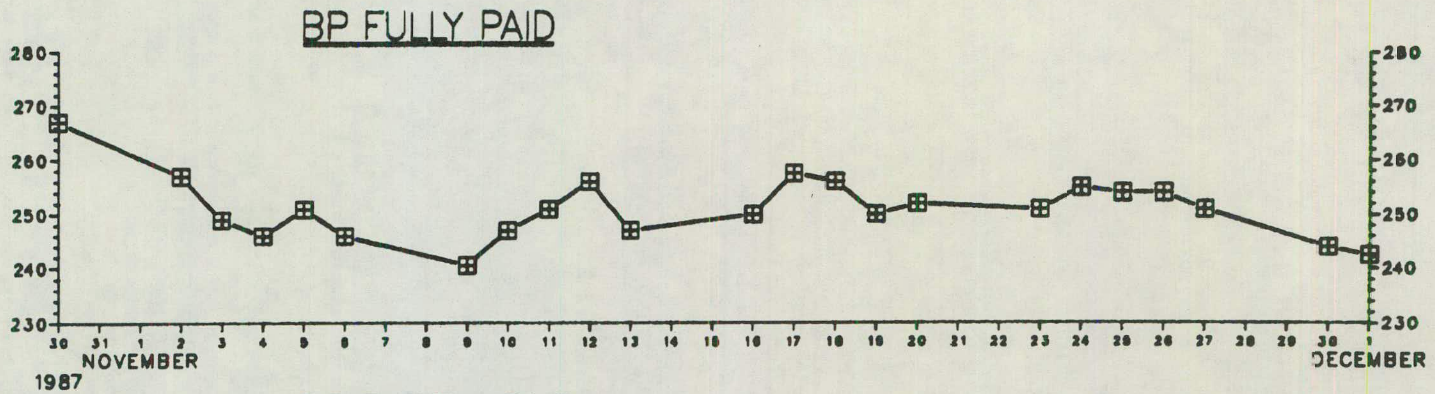
R N G BLOWER

1135/21

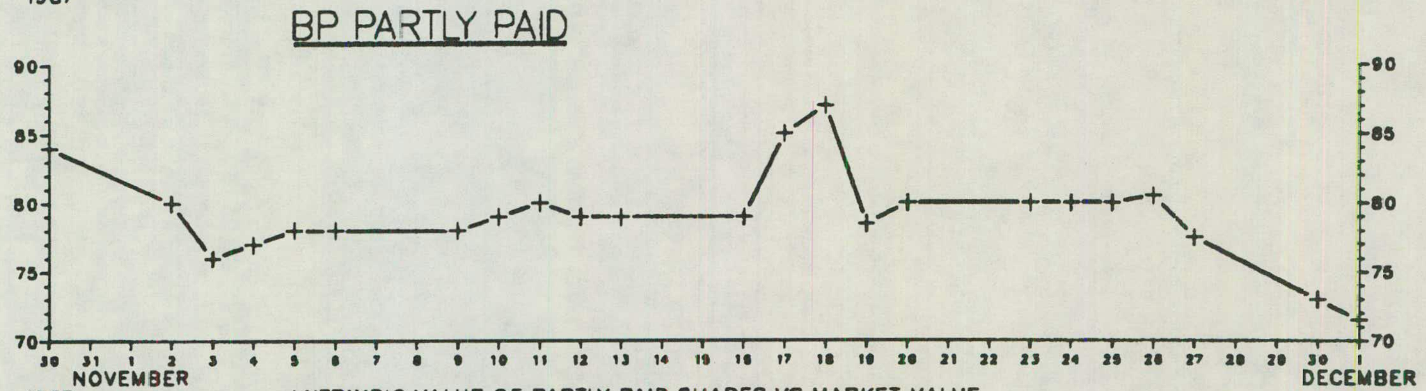
Date	Fully paid Price	Partly paid Price(2)	value of buy back option(3)	Intrinsic value(1)	FT-SE 100
Opening 2.30 30/10/87	272	87	4½	82½	
close 30/10/87	267	84	6½	77½	1750
close 2/11/87	257	80½	13	67½	1724
close 3/11/87	249	76	16½	74½	1654
close 4/11/87	245	77	23	54	1608
close 5/11/87	251	79½	19½	60	1639
close 6/11/87	245	78½	24½	54	1621
close 9/11/87	240½	78	28½	49½	1565
close 10/11/87	247	79	23	56	1573
close 11/11/87	251	80	20	60	1639
close 12/11/87	256	79	14	65	1702
close 13/11/87	247	79	23	56	1678
close 16/11/87	250	79	20	59	1685
close 17/11/87	257½	85	18½	66½	1660
close 18/11/87	256	87	22	65	1664
close 19/11/87	250	78½	19½	59	1639
close 20/11/87	252	80	19	61	1633
close 23/11/87	251	80	20	60	1658
close 24/11/87	255	80	16	64	1689
close 25/11/87	254	80	17	63	1664
close 26/11/87	254	80½	17½	63	1661
close 27/11/87	251	77½	17½	60	1652
close 30/11/87	246	73½	18½	55	1580
11.00 am 1/12/87	242½	71½	20	51½	1579

(1) Intrinsic value = price at which partly paid shares would be trading in absence of Bank's share purchase arrangement (ie partly paid price (Col 2) - value of buy back option (Col 3)).

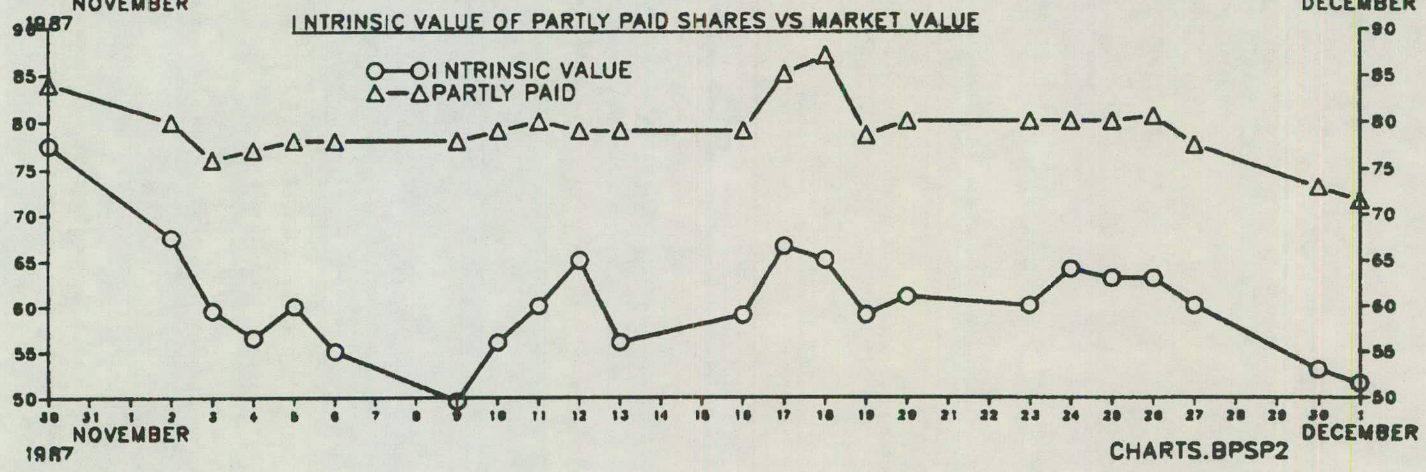
BP FULLY PAID



BP PARTLY PAID



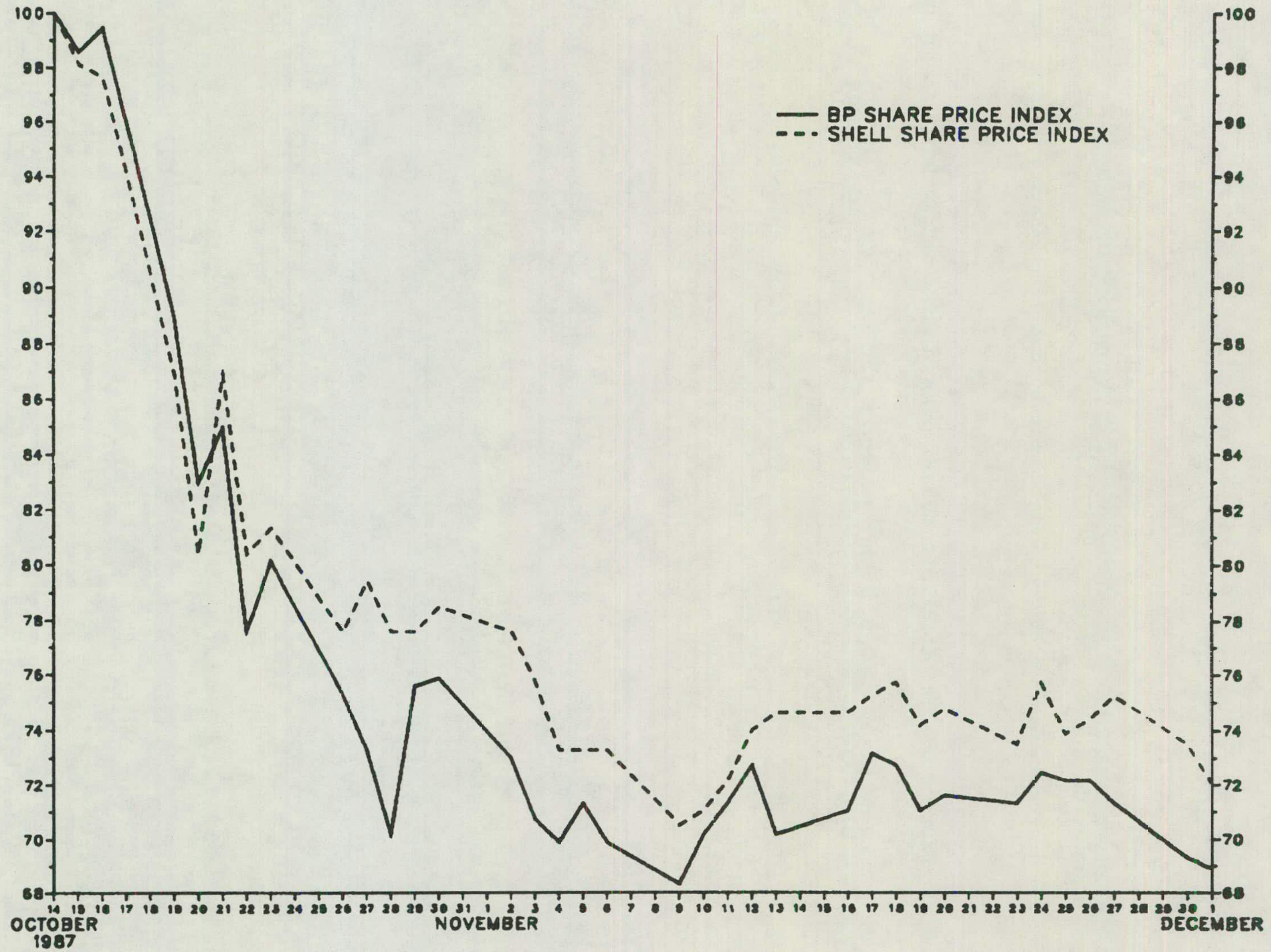
INTRINSIC VALUE OF PARTLY PAID SHARES VS MARKET VALUE



CHARTS.BPSP2

SHELL SHARE PRICE VS BP SHARE PRICE

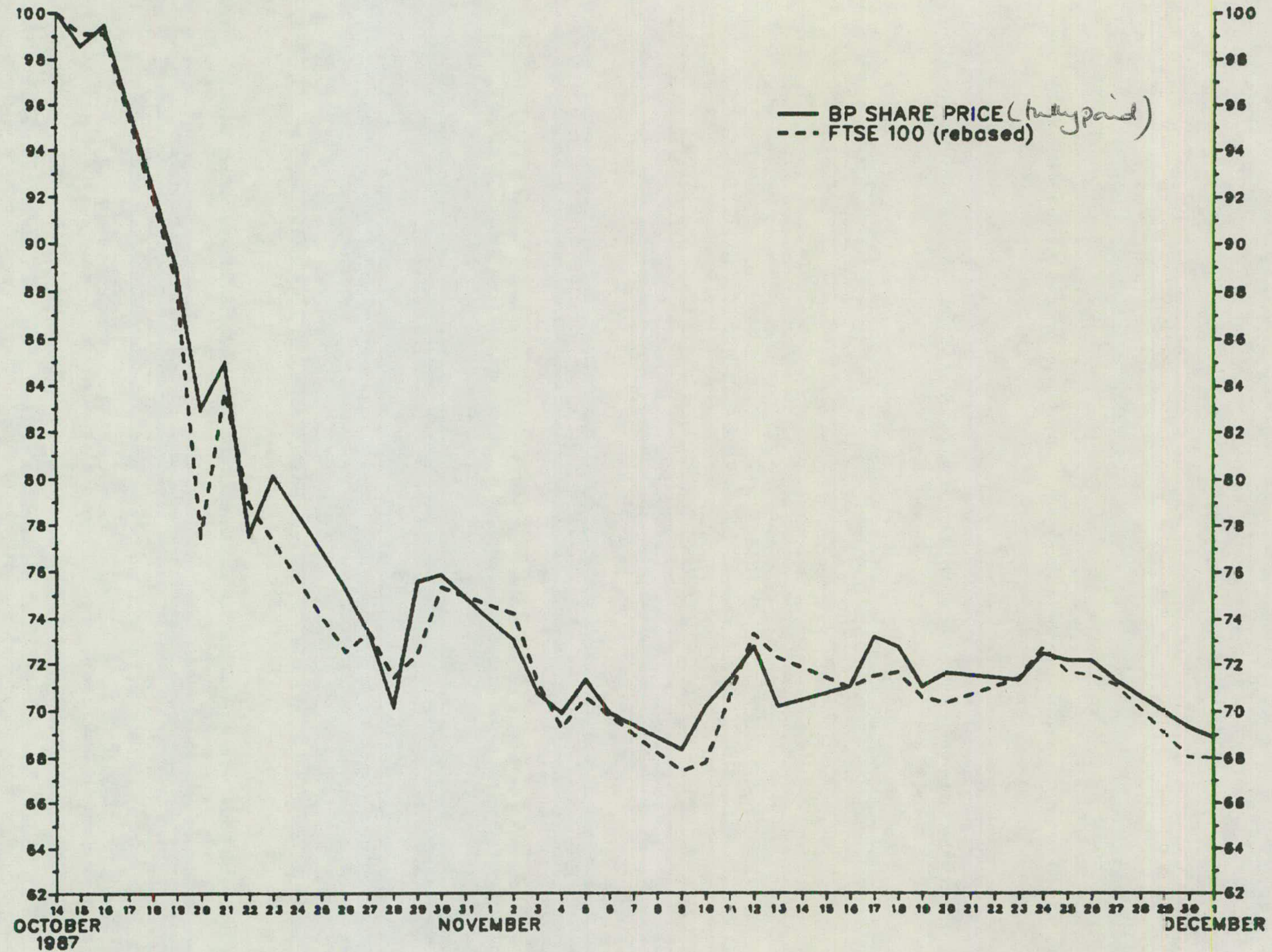
OCT 14 = 100



CHARTS.BPFT4

FTSE 100 VS BP SHARE PRICE INDEX

OCT 14 = 100



CHARTS.BPFT2

C2/24

UNCLASSIFID

PWP

~~bf 10.12~~

FROM: A P HUDSON

DATE: 1 December 1987

MRS LOMAX

cc PS/Economic Secretary
Sir P Middleton
Sir T Burns
Sir G Littler
Mr Cassell
Mr Scholar
Mr Peretz
Mr R I G Allan
Mr Pickford
Mr Cropper
Mr Tyrie
Mr Call
Mr N Forman MP

STOCK EXCHANGE CHRISTMAS LUNCH, 16 DECEMBER

1. One more sign of the imminence of the festive season: the Chancellor would be grateful for suggestions for his speech at the Stock Exchange Christmas lunch.

2. As usual, much of the speech will be light-hearted. Any ideas for jokes gratefully received.

3. The Chancellor also wants to include a short serious section. This will include the following points:

   a. the fact that this is the first year of a new regime under the International Stock Exchange, and the significance of this;

   b. the globalisation of the markets, and hence of the collapse;

   c. something on the collapse itself;

   d. a very short piece on regulation.

The Chancellor would be grateful for any further suggestions. He would then be grateful if you could work up all the points into about five minutes' worth of text.

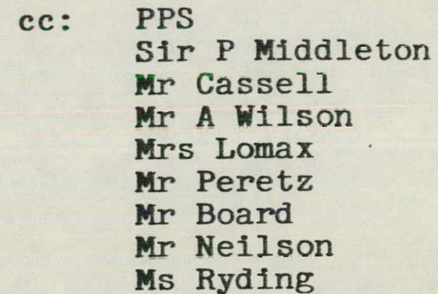
APH

A P HUDSON

FROM: N J ILETT

DATE: 2 December 1987

ECONOMIC SECRETARY



cc: PPS
Sir P Middleton
Mr Cassell
Mr A Wilson
Mrs Lomax
Mr Peretz
Mr Board
Mr Neilson
Ms Ryding

Mr Jenkins T.Sol.

FINANCIAL MARKETS BILL

Introduction

My submission of 19 November discussed Mr Francis Maude's proposed statement on this Bill. The present submission considers the "DTI" part of the Bill itself, ie the proposals to restrict the application of insolvency law to financial markets. The DTI have to get the Instructions to Counsel next Monday, 7 December. The "Treasury" part of the Bill, which deals with the security of floating charges within the Central Gilts Office system, will be the subject of another submission shortly. (Parliamentary Counsel is allowing us a little extra time.)

Background

2. The justification for the Bill was set out in a little detail in Annex A to my earlier submission. I attach this for ease of reference.

3. One point merits further expansion. There is a key difference in the Bill between markets which work on <u>margin</u>, and markets which do not. The whole purpose of margin is to give the people handling the business in the market, which can mean the central market authorities, cash with which to transfer the market positions of a defaulter to somebody else, so that the market as whole can have confidence that deals which have already been set up will be completed. This is essential in the derivative markets, because the failure of bargains which market members think they have struck

can mean that their position is the opposite of what they thought. There is no point in running a market on the basis of margins if the margin has to be returned to an insolvency administrator precisely when it is actually needed for the purpose for which it was designed.

4. The Bill will also apply to non-margined markets, notably the Stock Exchange. The justification for this has always been less evident than for the margined markets, because the effect of the Bill is not simply to protect the concept of "margin" but to privilege unsettled transactions within the Exchange over creditors outside the Exchange. This is justified in the Instructions largely on the grounds of the potential domino effect of the collapse of one member firm on other member firms. Imagine that a significant market-maker had gone down after the recent price collapse; and that the insolvency administrator enforced all sales by that market-maker but refused to honour any purchases. Other members of the market who thought they had sold out when prices were higher would now find they still had their stock but it would be worth less.

5. The Bill will therefore validate new Stock Exchange rules which require the totality of a failed member's bargains to be netted out a "hammer" price. (It is disconcerting to learn that the Stock Exchange have lived with the problem the Bill is designed to solve since a House of Lords judgement in 1877. The argument is that the new-style market would find it harder to cope than the old-style market.)

6. One final piece of background. My last submission reported that Treasury Counsel had advised the DTI and the SIB that the SIB should not recognise "Recognised Investment Exchanges" (RIEs) under the Financial Services Act if their rules were in conflict with insolvency legislation. This meant that this Bill must reach the statute book before "A" day in April 1988. The effect is further to hazard an already dodgy timetable. The Stock Exchange now has a contradictory Opinion from an eminent QC.

Structure of the Bill

7. The DTI's approach has been to bolt this Bill on to the Financial Services Act. This is a ponderous and arguably unnecessary procedure, involving a range of technical provisions whose description takes up most of the 130 pages of Instructions to Counsel. The effect is to allow RIEs to make rules which, once vetted by the SIB, cannot be overridden by insolvency law.

8. I attach the latest draft of the Instructions. DTI are committed to getting these to Parliamentary Counsel next Monday. **This is all optional reading and most is even more optional than the key passages on pages 2-10 (marked in yellow).** If you want to get some of the flavour of some of the detail, the yellow highlighting of occasional bits of the rest of the text is a guide. (Copy recipients who want to see the Instructions should ask me.)

Assessment

9. As I have mentioned before, I think this Bill is more complicated than it needs to be, that it would better not to have linked it to the Financial Services Act, and that it would have been wiser to get the markets to do more to reduce their own exposure to these risks by adapting settlement practices, altering contractual relationships etc before embarking on legislation which risks being interpreted as a panic measure. The timing of the Bill - introduction in February or March - will probably leave something to be desired, assuming that the equity markets are still fragile.

10. That said, we have no reason to suppose that the Bill will not actually work, DTI Ministers have been closely involved in its preparation and are responsible for insolvency law, Treasury Ministers supported the concept of the Bill back in the Summer and it is not really worth your arguing with Mr Maude about points of detail even if time allowed. Also, we are "demandeurs" on the gilts market part of the Bill, which weakens our negotiating position on the "DTI" part.

11. There are two main Treasury interests to watch:

(i) Whether the balance of interest to the economy

justifies special arrangements for insolvency in these markets. This includes looking at the Revenue's position as a potential creditor;

(ii) Whether the Bill interferes with banking payment systems.

12. On (i), the Revenue is happy to leave decisions to the Treasury. Our support for the concept of the Bill back in the Summer would make it very difficult to argue now that the DTI's judgement on the balance of interest to the economy is wrong. But there is one specific point on which DTI have almost certainly gone too far. This is that the Bill will allow exchanges to make rules about the insolvency of people who are not members of the exchanges, but simply large customers of members.

13. The thought is that some of these customers, if they defaulted, could hit the exchange as hard as the failure of the firms through which the customer was dealing. However, it would be both difficult and controversial to attempt to decide whether or not a particular failure by a large customer merited special treatment even if the principle of giving special treatment to anybody outside the exchange "family" could be defended. I have already expressed some surprise at this proposal to DTI officials, but Mr Maude is said to be wedded to it. (The relevant bits of the Instructions are paragraphs 3.26 and 3.27 which attempt to limit an RIE's ability to make rules applying to non-members to people whose default would affect the "continued viability of the market". But, as paragraph 3.28 says, "It is difficult to express the concept".)

14. On (ii), as things stand we are reasonably happy that there is a clear line between the markets the Bill will cover and banking payment systems. Financial markets systems are concerned with the transfer of assets in exchange for cash, which is quite different from the settling of purely cash payments. But we shall have to watch the drafting of the Bill very carefully.

Conclusion

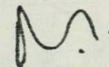
15. Taking this Bill forward is going to be a pretty thankless task; a seed of doubt sown by an American lawyer's analysis of

long-standing City procedures has grown into a rather unwieldy instrument intended to solve a problem whose existence is not generally known and, to the extent that it was suspected, was largely ignored.

16. You will become involved to some extent because of the "Treasury" bit of the Bill. But there is no need at this stage for you to get involved actively in the DTI provisions; rather the contrary. It would be safer to hold your fire for later, in case the draft of the Bill highlights something on the DTI side on which you need to intervene or the DTI get difficult about our bit of the Bill.

17. So I suggest that I write to my opposite number at the DTI to put it on the record that, as I have already told him, the Treasury has reservations about the way in which the Bill applies to non-margined markets, specifically the Stock Exchange, and in particular about the proposal to extend it to defaults by some non-members of the markets. I would add that we shall need to look at the Bill itself very carefully once it has been drafted, and to be ready to review aspects of the policy which further work and Parliamentary discussion show to be controversial or doubtful. But given that there is no time left for discussion now we agree these Instructions must go to Counsel now.

18. Would you be content for me to write in these terms and for the Bill to be drafted on the lines the DTI wish?



N J ILETT

(From submission of 19 November).

ANNEX A

THE PROBLEM WITH INSOLVENCY LAW

For simplicity, the following paragraphs refer to the Stock Exchange. Problems of the same order are thought to arise in other financial markets, but they may show up in a number of different ways, depending on technicalities.

2. The Bill is intended to cope with the following point. A Stock Exchange member firm will have a number of positions in the market. By the time the Account ends, some transactions undertaken during the Account will prove profitable; others may not. Other members of the market will be the counterparties to each of these transactions, and will rely on the first member firm to come up with the securities or the money on the due day.

3. If the first member firm becomes insolvent, the Exchange rules would require these bargains to be completed, so that any net surplus of funds could be handed over to the receiver or administrator, and any net shortfall could be presented as a claim of the Exchange on the assets of its insolvent member. The risk which the DTI perceives, however, is that the administrator of the insolvent firm could make other member firms with whom the insolvent firm had profitable bargains pay up, while at the same time refuse to honour bargains in which the insolvent firm came off worse (ie "to pick the cherries out of the pie".) It is not certain that the courts would maitain an Administrator's attempt to operate in this way if that conflicted with the Exchange's rules; DTI legal advice is that there is a substantial risk, which DTI Ministers judge they must remove.

4. This argument has been simplified even in relation to the Stock Exchange. But it applies to a number of other markets, and in particular to futures and options markets which work on margin and where a central organisation, such as the International Commodities Clearing House (ICCH), takes over as counter-party to each of the sides in the original deal. In practice, problems on how to close out deals when insolvency strikes are more likely to arise in these markets than in the Stock Exchange.

5. The consequence the DTI fear is that other market users who thought they had a given position in a particular stock, commodity, future or whatever would suddenly find that they did not have that position, or did not know their position because there was uncertainty about which bargains the administrator handling their insolvent counterparty's affairs would honour. The thought is that it would be at the least unhelpful if market authorities hesitated to apply their rules because they were not sure whether the Courts would find that those rules were in conflict with insolvency procedures (though the Stock Exchange rules are actually inadequate anyway post-Big Bang). Worse, an Administrator might attempt actively to interfere with the market authorities' crisis control operations.

6. At best, the argument goes, if this weakness in the UK legal framework underpinning financial markets became known, people would be more reluctant to do business here - especially North Americans who are used to more protection from insolvency procedures. (It was a US lawyer who drew the DTI's attention to the problem in UK law.)

7. At worst, the loss of profitable bargains or of hedged positions and uncertainty as to members' actual positions could trigger a progressive collapse in a particular market. If a firm which aims to be fully hedged does not know what contracts will be honoured it cannot take action to restore its fully hedged position and is thus exposed to an unknown client.

8. The justification for the Bill is therefore the need to remove the uncertainty about the present legal position which has emerged since the insolvency Administrator procedures came into force in the last couple of years. As yet, the suspected need for legislation is not widely known, though the DTI have been consulting the market authorities in confidence and some lawyers with special interest in this area of the law also know that the DTI thinks there is a problem.

The Central Gilts Office part of the Bill

9. The Bill will also deal (at Treasury behest) with the following possible problem in the gilts market.

10. The Central Gilts Office operates by ensuring that the package of gilts one way and the money in payment for them travelling [illegible] other way arrive at their respective destinations at the same time. The banks which operate the CGO guarantee these transactions. So if the customers of one of these banks defaults that bank has to make good any loss to counter-parties in the market from transactions which are going through the CGO system. The banks protect their position by a floating charge over the gilts they hold on behalf of their customers, but there is some doubt as to whether this charge would work in all circumstances, which makes the banks reluctant to admit further members to the CGO whose ability to meet any commitment which may arise is perhaps less certain.

The structure of the Bill

11. The approach the DTI is adopting is to graft the legislation onto the Financial Services Act and to use the Act's administrative machinery. The Bill would enable markets ("recognised investment exchanges") which have appropriate insolvency rules, duly vetted by the SIB under principles laid down in the Bill, to carry out those rules notwithstanding any provisions of insolvency legislation.

12. The advantage of this approach is that it limits the damage done to the principles of the Insolvency Act (all creditors to be treated alike), by restricting the special treatment to markets which have proper rules on this subject. The disadvantage is that it is more complex than generic amendment of the Insolvency Act, it adds to the SIB's duties when the SIB has quite enough to do already, and it risks something of a rerun of the themes of the Financial Services Act in Parliament.

13. The approach we intend to recommend on the CGO provisions is to protect assets in assured payment systems listed by the Treasury under subordinate legislation on the recommendation of the Bank - we will of course let Treasury Ministers see detailed proposals when the work has gone a little further.

MG NOON REPORT

FINANCIAL MARKETS — Wednesday 2 December 1987

Opening	10 AM		NOON	2.30	4.00
75.9	75.9	£ERI	76.0	76.0	
1.8015	1.8030	$/£	1.8080	1.8110	1.8150
2.9950	2.9969	DM/£	2.9968	2.9945	2.9970
1.6625	1.6622	DM/$	1.6575		
133.50	133.45	Yen/$	133.70		

Oil Price (10 AM)

Dec	$17.60
Jan	$17.85
Feb	$17.80

FT88: 2.30 +18.7; 4.00 +14

UK interbank £			Eurodollars	
9 1/8	(+1/8)	7 day	6 29/32	(-3/32)
8 31/32	(+1/32)	1 month	7 15/16	(-1/8)
8 13/16	(-1/16)	3 month	7 3/4	(-1/8)
8 31/32	(-1/8)	12 month	8 1/16	(-1/16)

Figures in brackets show change since previous market close

MARKET COMMENT: The dollar continued to firm in New York on rumours that Germany may cut discount rate on Thursday which brought about some short covering. It remained firm in the Far East as a result of central bank intervention and opened on a firm footing this morning. The market remained steady and quiet until 11.30 when the reserves were published. There was little reaction to this but the German Industrial production figures out at the same time caused some buying of DM and sterling firmed with it.
The US and Japanese equity markets closed up with the Hong Kong market closing down. Dow Jones 1842 +9, Nikkei 22915 +83 and the Hang Seng 2100 -8. The FTSE100 opened at 1599 +21 and at 12.14 it was 1601 +22.5.
The gilts market is steady.

R McRobbie

MARKET INTERVENTION ($m)

Overnight	+496$	New York
	+45$	Far East
Today so far	-	
Total	+541$	

OTHER COUNTRIES INTERVENTION ($m)

Japan +7$
US +30$ agst DM (1.12.87)
" +20$ agst Yen (1.12.87)

GILTS

	Latest market movements	Price change since previous close
Shorts	Steady	+2/32
Mediums	Easier	-3/32
Longs	Steady	-1/32
Futures (Long Contracts)		+4/32 (Vol:7766)

Gilt Sales since market opening

- £1.1 million

NAME: Miss R J McRobbie, MG1 Division
TEL NOS: 270 5557/5560

pmp

papers pse

DEPARTMENT OF TRADE AND INDUSTRY
1-19 VICTORIA STREET
LONDON SW1H 0ET
TELEPHONE DIRECT LINE 01-215 5422
SWITCHBOARD 01-215 7877

Secretary of State for Trade and Industry

CONFIDENTIAL

3 December 1987

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A J Langdon Esq
Cabinet Office
70 Whitehall
LONDON SW1

Dear Anthony,

FINANCIAL MARKETS BILL

Thank you for your letter of 12 November.

The Statement has been drafted on a contingency basis because Ministers have not decided whether to make a Statement if a serious default were to occur before Introduction.

However, it remains the intention to legislate in the current Session whether or not a particular default occurs beforehand. The Bill is needed to safeguard the financial markets against future defaults and the sooner it is on the statute book the better.

A second reason for early legislation has now emerged. It will not be possible to implement the Financial Services Act on the planned basis without the new Bill. The Government have announced their intention to implement that Act by April 1988, and we must therefore announce before Easter next year our intention to legislate. By that time we would hope that calm will have returned to the markets.

Between that announcement and Royal Assent, the Securities and Investments Board and the exchanges and clearing houses concerned will have to rely on the Government's intention to legislate and it is essential to keep this period of uncertainty to a minimum so as to avoid an adverse effect on confidence in the markets.

JG7AFF

The Bill should therefore retain its place in the current Programme. We have told First Parliamentary Counsel that we shall be able to deliver Instructions to Counsel by 7 December, and I understand that he is content. We do not expect this technical Bill to require much Parliamentary time.

Our Ministers may wish to add another aspect of market settlement systems to the Bill. We have been discussing an electronic share transfer system with The Stock Exchange which would reduce dealing costs and avoid settlement backlogs, thereby reducing the risk of a default. The Stock Exchange aims to be ready to introduce the system in the Spring of 1989. The topic would add up to 10 clauses but would not, we believe, pose any difficulty in getting the Bill through Parliament. Final discussions are now being set up with The Stock Exchange in order to agree on the legislative approach and we expect to know early in the week beginning 7 December whether we will be in a position to seek clearance. I thought you should be aware of this development; if we go ahead, we will have Instructions ready by 14 December. I should emphasise that if this topic cannot be accommodated our Ministers would still wish to press ahead with the Bill in this Session.

I am copying this letter to Alex Allen (Treasury) and John Footman (Bank of England) as well as to Mike Eland (Lord President's Office).

Yours sincerely

Stephen Ratcliffe

STEPHEN RATCLIFFE
Private Secretary

JG7AFF

999-49

CONFIDENTIAL

Pmp. b/f 4/1/88 PPS
→ m.

NOTE OF A MEETING HELD IN MR CASSELL'S OFFICE, HM TREASURY, ON 3 DECEMBER 1987

Present

see attached list

MEETING WITH INSTITUTIONAL INVESTORS

Subjects discussed at the meeting were :

i) how well the new market structure had coped during the stock market fall, including the use of hedging devices.

ii) how institutions had acted, and what they felt about the liquidity of the market.

iii) why equity prices had fallen so sharply in London.

iv) how institutions might restructure their portfolios in the light of the recent experience, including views about their current liquidity position.

v) the effect of the BP sale.

vi) takeover activity.

vii) the outlook.

Market Performance

2. Mr Cassell opened the discussion by inviting views on how the new market structure had coped during the stock market fall and the subsequent period.

3. The general view was that market liquidity in the UK had been relatively good, particularly on the first day of heavy falls (ie "black Monday"), and had remained good in alpha stocks. There had, however, been difficulties in transacting large sized deals at reasonable prices, or at least at prices thought to be reasonable at the time. Liquidity of beta and gamma stocks had declined, and it had become clear that there were problems in trading in gamma stocks in difficult markets.

4. As to whether the screen-based market system had itself contributed to the fall, the general view was that the same fall would have occurred under the old system, though perhaps not quite so quickly.

5. There was general support for the view that London had been particularly hard hit at least in part because it was a less arthritic market than overseas, so that international funds had found it easier to sell stocks in volume in the UK. It had been almost impossible to trade in the US during the sharpest part of the fall. One participant, however, said that it had in fact been easier to sell large volumes of stock, in the first two days of the collapse, in the continental markets - though they dried up thereafter. It was also possible to trade actively in Japan throughout.

6. Mr Cassell asked whether institutions had made much use of new hedging devices, for example in the futures market, and whether they thought that such devices had tended to increase or decrease market instability. Responses varied from institutions which made no use at all of these devices, to those who used them a great deal - and found them a valuable method for reducing risk and improving returns.

7. The US futures market had broken down during the stock market fall, with quoted prices a long way adrift from the cash market : so it had not in the event proved very useful. In the UK, LIFFE had avoided the same problems by acting swiftly to bring about a sharp increase in margin requirements : but this too had the effect of cutting down on volume. Even so one participant

thought that in the UK market-makers had used the futures markets significantly to hedge their market risk, and that this had had a stabilising influence. For the longer term, it was thought that a lot of houses would now be examining their internal controls for exposure to the futures markets : many naked option writers had not hitherto fully appreciated the counterparty risk they were incurring.

8. On whether the events on black Monday would have been any different if the UK market had been functioning normally on Friday 16 October, the general feeling was that there would have been a "black Friday" if the markets had been properly open.

Institutional behaviour during the market fall

9. Most participants said they had not dealt significantly at all during the first two days of the fall, and that they believed that institutional turnover had been low. One, however, said he had experienced some difficulty in selling.

10. Mrs Lomax pointed out that Stock Exchange figures showed higher average bargain sizes as well as substantial customer business and record turnover. She wondered who had been selling. Several participants suggested that much of the selling had been done by market-makers, who had been running positions as principals to boost profits. It was also thought that there had been selling by foreigners, particularly Americans, who had been prepared to sell at the time at almost any price.

11. It appeared that many UK institutions had reacted by selling overseas equities as a way of rebuilding liquidity, on the ground that UK equities were judged a better investment. Several of the institutions represented at the meeting had been sellers of Japanese equities, although they had also been doing this earlier in the year.

12. Mr Grice asked why in these circumstances the institutions had not <u>bought</u> UK equities. In reply it was argued that once prices cracked it became plain that the market had become overvalued following the big rise in the first half of 1987.

Another view, however, was that the market had not been particularly overvalued before the fall : but that there had simply been a lack of further money available to invest in equities. Since pension funds had reached a point with over 80% of their portfolios in equities, it was not surprising that they did not in the circumstances feel able to add further to their equity portfolios. Cash holdings represented no more than minimum working balances.

13. Mr Cassell asked whether the institutions' move into equities before the market fall had been entirely voluntary - or whether the massive dose of rights issues had reduced their cash balances below the desired level. Opinion was unanimous that the move had been voluntary. The rights issues were a response to a strong demand for equities by the institutions. Holdings of 5% or more in cash would constitute an active policy of holding cash, which did not look very attractive in the bull market conditions of the time. Only one institution at the meeting had been holding more than 5% cash at the time of the market collapse.

14. Institutional investors had come to regard equities as their natural asset. Past statistics showed that they had out performed fixed interest bonds over any 20 year period.

15. Mr Peretz asked why UK institutions held a higher proportion of equities than American and other overseas institutions. It was suggested that legislation and administrative restrictions in Japan and the US were responsible - particularly the rules affecting Japanese pension funds.

Reasons for the market fall

16. There were varying opinions on the reasons for the fall and why prices had fallen more in the UK. One view was that there was simply a shortage of funds to invest in equities after the unprecedented rights issues over the summer. Just as "weight of money" had pushed up stock markets worldwide, lack of money had prompted a slide. Another view was that prices of fixed interest assets had reached such an extremely low level worldwide that investors had begun to switch back to them.

17. It was also mentioned that the surprising liquidity of the market in gamma stocks after Big Bang had been a special factor pushing up the UK market. One participant felt that the liquidity of beta and gamma stocks might now suffer permanently, as inexperienced market-makers reacted to losses suffered during the market fall. Others felt that this would only be a temporary effect. As the weaker players dropped out their business would be taken up by stronger institutions, including Japanese institutions. There was also some doubt as to how great the market makers' losses had actually been, since few figures had been published. Perhaps losses simply served to offset profits made earlier in the year.

18. Mrs Lomax asked whether the authorities ought to draw any policy conclusions on capital requirements for market-markers. One participant thought it demonstrated that past volatility figures were not necessarily a good guide to future volatility, and that the Bank of England and SIB risk ratios should therefore be increased. The dramatic fall in the market had in any event had a great psychological impact, making market-markers considerably more risk averse.

Portfolio adjustment and liquidity

19. Mr Cassell asked whether institutions would now be restructuring their portfolios, and how they felt about their current liquidity position.

20. According to one participant, fears of recession immediately after the market collapse had shifted investment preference in favour of gilts; but since then inflationary worries had resurfaced, and demand had shifted towards index-linked stocks and gold. In general, it was thought it would be unattractive to sell equities at current prices; and more likely that institutions would simply allow inflows to accumulate in cash for a while, until liquidity reached a comfortable level. Several

institutions, however, felt this point had already been reached, and were now investing new inflows in either bonds or equities.

21. In choosing between equities and bonds, institutions looked mainly at prospective dividend yields, although they considered earnings as a guide to future dividends. Dividend yields were now about half the yield on gilts - 4½-5% against 9-10%. One participant saw nothing radically changed in the fundamentals over the last 5 years, and therefore considered equities now to be undervalued. Another, who would have been unwilling to buy equities before the market fall, said he would probably now do so. Another participant thought that institutions would from now on seek to hold a higher proportion in future in fixed interest assets. It was acknowledged that the authorities might have little need to sell large amounts of new gilts. In that case the institutions might buy gilts from overseas holders; companies had not hitherto shown any great interest in issuing fixed interest bonds. Most participants agreed that cash itself - ie short-term liquid instruments - was not now an attractive investment option. There was a general (though not unanimous) feeling that trustees' attitudes to asset allocation will have been changed markedly by the equity collapse, and that this would be a factor in prompting restructuring of portfolios. Several felt that an important factor underlying recent portfolio adjustments had been an attempt by institutions to reduce the weight of equities, and increase the weight of property and fixed interest assets, before 31 December : which was an important balance sheet date for many funds, and the date of accounts submitted to trustees.

22. Mr Cassell said he was interested to hear that institutions now felt their liquidity positions to be comfortable. He remarked that the authorities had avoided sterilising recent intervention in the short-run by immediate gilt sales, partly to avoid policy becoming more restrictive by preventing an increase in liquidity that was desired by the institutions.

23. Mr Cassell asked how institutions' inflows had been affected. Life assurance and pension fund inflows had been largely

unaffected. On a rather longer view, pension fund contribution holidays had probably reduced inflows this year - some participants thought considerably, others only moderately.

24. Unit trusts had been more affected. Outflows had in fact been low since mid-October with few redemptions by individuals. But inflows had fallen off, and managers had increased liquidity in anticipation of outflows.

The BP sale and safety net

25. Mr Cassell asked if the BP sale had been a significant factor in the London markets' fall. The reply was that it had not greatly affected the outcome. Although it had forced institutions to use liquidity, and had left them without much cash, UK institutions, at least, had been happy to fulfil their commitments. Most of the effects had now worked through. With some large calls on past privatisations coming through in 1988, however, a new privatisation in early 1988 would not be welcomed.

26. Mr Cassell asked if participants were holding new BP shares, and if they were likely to sell them to the Bank of England. One participant commented that for the present many were regarding the new BP shares as a form of cash - which made them particularly attractive to hold over the December end-year accounting date. Even though they would no longer have that characteristic in the New Year, they would not necessarily be sold to the Bank of England.

Takeover activity and Bank lending

27. It was thought that takeover activity had had a significant impact on the money and bank lending figures. Moreover, it was expected that such activity would continue. Many companies had taken the opportunity of the fall in equities to build up strategic stakes in other companies. We could expect to see many second tier companies taking over third tier companies.

Purchases by companies of their own shares, in the UK, had however been small.

Outlook

28. Sentiment was divided on the future balance of risks (the discussion having taken place before the ½% cut in base rates was signalled at 12.(30?) pm). Some felt that any concern with overheating before the market collapsed had now changed to a fear of recession. One fund manager, however, expressed some re-emerging worry about inflation, with the large amount of liquidity that had been injected by the authorities worldwide; and the seeming US willingness to see the dollar fall further. Most felt that if anything UK equities were now undervalued; and that once confidence recovered any desire to build up liquidity would disappear quickly.

Distribution :

Those present

\+ PPS
PS/EST
Sir P Middleton
Sir G Littler
Mr Scholar
Miss O'Mara

ANNEX

LIST OF PARTICIPANTS

Tom Heyes
Imperial Chemical Industries plc
Insurance Investments Group

Peter John Manser
Chief Executive
Save & Prosper Group Ltd

Michael G Newmarch
Prudential Assurance Co Ltd

David W J Price
Mercury Assets Management

David Rough
Royal Life Holdings Limited

Andrew Threadgold
PosTel Investment Management Limited

Roger G Ward
Legal & General Investment Management

John Webster
Sun Life Assurance Society Group plc

HM TREASURY

Frank Cassell, Grade 2, Public Finance

Rachel Lomax, Grade 3, Financial Institutions & Markets Group

David Peretz, Grade 3, Monetary Group

Nick Ilett, Grade 5, Financial Institutions & Markets Group

Joe Grice, Grade 5, Monetary Group

Vyvian Bronk, Senior Economic Assistant, Monetary Group

CH/EXCHEQUER
REC. 07 DEC 1987 7/12
ACTION FST
COPIES TO

PRIVY COUNCIL OFFICE
WHITEHALL, LONDON SW1A 2AT

4 December 1987

Dear Stephen,

FINANCIAL MARKETS BILL

I have shown the Lord President a copy of your letter of 3 December to Antony Langdon in the Cabinet Office.

The Lord President recognises that this Bill was given a place in the legislative programme by Cabinet on 7 July, although with the proviso that it should only be prepared as drafting resources became available. He believes, however, that the agreement to include Steel Privatisation in the programme and to achieve Royal Assent by the summer recess has now transformed the position. It is clear that drafting the Steel Bill in order to secure the earliest possible introduction must now take top priority. Although the three main 'flagship' Bills on Rates, Housing and Education have now been introduced, they are in a far from perfect state and will require major amendment by the Government before they reach the statute book. This fact, plus the abnormally heavy programme this Session and the addition of the Firearms Bill and your own Regional Development Grant Bill, mean that the normal seasonal slacking off in the work of Counsel will not now take place.

But the Lord President's main concern, as he made clear at Cabinet yesterday, is that the available legislative time for the remainder of the Session is now fully committed. In particular, the fact that the Steel Bill must receive Royal Assent by July means that it will pre-empt a large slice of prime legislative time in the crucial months of the summer. This will already have major consequences for some of the other politically important Bills in the programme. The Lord President simply does not think it feasible to compound these problems by deliberately planning for a further Bill to proceed, on which drafting could not start for some time.

Stephen Ratcliffe Esq
Private Secretary to the Secretary of State
Department of Trade and Industry

On the other hand, the Lord President fully recognises that the need for the Financial Markets Bill could arise at short notice and that the Government needs to be in a position to deal with that situation. Since the Lord President believes that the introduction of the Bill would now have to be at the cost of dropping some other measure, he believes that for the remainder of this Session it should be regarded as a contingency Bill rather than being in the main programme. This would mean that you should proceed to instruct Parliamentary Counsel as you propose and that drafting should begin as soon as work on this Session's Bill permits, but that no further action should be taken to introduce the Bill unless the situation demanded it. The Lord President understands that the Lord Chancellor and the Law Officers have already agreed that, in that event, it would be appropriate for your Minister to announce the effect of the Bill and for the measure to have retrospective effect to the time of the announcement.

A Bill that had been drafted in this way would clearly be an obvious candidate for introduction as a programme Bill right at the beginning of next Session.

The Lord President would now like to confirm all this with his QL colleagues and would be very grateful to know early next week if your Secretary of State sees any difficulty.

I am sending a copy of this letter to Alex Allan (HM Treasury) and Antony Langdon (Cabinet Office).

Yours sincerely,

Mike Eland.

M J ELAND
Private Secretary

SECRET

MG NOON REPORT

FIN[illegible]CIAL MARKETS

Friday 4 December 1987

Opening	10 AM		NOON	Oil Price (10 AM)	
76.0	76.0	£ERI	76.0		
1.8085	1.8117	$/£	1.8130	Dec	$17.95
2.9976	2.9975	DM/£	2.9978	Jan	$18.17
1.6575	1.6545	DM/$	1.6535	Feb	$18.00
132.45	131.95	Yen/$	131.97		

UK interbank £			Eurodollars	
8 3/8	(-1/4)	7 day	6 15/16	(+1/32)
8 1/2	(+1/8)	1 month	7 15/16	(-)
8 1/2	(+1/16)	3 month	7 3/4	(-1/16)
8 3/4	(-1/8)	12 month	8 1/16	(-)

Figures in brackets show change since previous market close

MARKET COMMENT: The dollar continued firm in New York as a result of the interest rates cuts yesterday. Sterling firmed with the dollar and intervention was done to stop the DM cross rate from breaking the 3DM level. In the Far East the dollar eased a little on the firm Yen, and on the comment by Miyazawa that a G7 meeting was contingent on progress on US budget. The dollar has continued easier here this morning with sterling remaining firm. Bank intervention has again been required during the course of the morning to stop the cross rate reaching 3DM. Market is generally steady and quiet.
The US, Japanese and Hong Kong equity markets all closed down. Dow Jones 1776.5 -72.5, Nikkei 22603 -205 and Hang Seng 1994.2 -63. The FTSE100 opened at 1567.2 -21.2 it is now at 1574.5 -13.9.
The gilts market is easier particularly in longs.

R McRobbie

MARKET INTERVENTION ($m)

Overnight	+551$ New York
	+40$ Far East
Today so far	+160$
Total	+751$

OTHER COUNTRIES INTERVENTION ($m)

Japan +55[illegible]

GILTS

	Latest market movements	Price change since previous close
Shorts	Easier	-4/32
Mediums	easier	-10/32
Longs	Easier	-34/32
Futures (Long Contracts)		-35/32 (Vol:14992)

Gilt Sales since market opening

-£12.1 million

All Index Linked

NAME: Miss R J McRobbie, MG1 Division
TEL NOS: 270 5557/5560

SECRET

hpe22/30.11

FROM: HUW EVANS
DATE: 4 DECEMBER 1987

SIR GEOFFREY LITTLER

cc Sir T Burns
Mr Odling-Smee
Mr Peretz
Mr Sedgwick
Mr Matthews
Mr Dolphin
Mr Savage

WP3: ECONOMIC POLICY ISSUES IN THE WAKE OF THE STOCK MARKET CRASH

I attach some notes I have prepared for my use at WP3 on 8 and 9 December.

2. I am impressed by the buoyancy of demand and output in the latest figures for a number of countries: Japan (October industrial production 8 per cent up on a year earlier); US, UK, Canada, Italy. This buoyancy, plus the absence of deflationary looking symptoms in the forward looking indicators (such as commodity prices), plus the size of the monetary policy response in the US and Europe, suggests that we may all be too cautious on prospects for 1988. And little case now pushing for more expansionary policies in G7 as a whole - though Germany could ease up and the US tighten.

HPE

H P EVANS

bpe8/30.11

NOTES FOR WP3

Recent developments

Increasing evidence of strengthening domestic demand and output into Q3 and Autumn 1987 in most major countries. Features:

(i) Strong rise in industrial production in recent months: 5½ per cent in the US (export growth): Japan 8 per cent up in October on a year earlier (domestic demand); UK and Canada (domestic demand and exports).

(ii) Growth of real GNP, which had been around or a little under 2½ per cent for G7 in total in first half of 1987, probably faster in second half year: outturn for year as a whole could well be a little above the widely forecast 2½ per cent.

(iii) Inflation continuing at about 3 per cent on average, having picked up as long expected from the 1½ per cent or so in 1986 and early 1987, when the impact of low oil and commodity prices was greatest.

(iv) Continued fall in unemployment, mainly outside Continental Europe.

2. Compared with the prospects seen by the Secretariat in July, and discussed at WP3 then, growth is proving stronger, as a number of us had anticipated. Worries about inflation still at a low level before stock market crash, though the rise in long term interest rates a matter of some concern: did not accept that the rise mainly reflected inflation worries. In fact, inflation in 1987 (and forecast for 1988) turning out very close to that expected some time ago: inflation prospect has barely changed.

The economic outlook

3. Many stock markets have fallen by 20-30 per cent since mid-October. Given the substantial rise earlier in 1987, and the lags in nearly all of our countries between movements in financial wealth and spending, much more useful to look at changes over a longer period e.g since the average of 1986.

	To December 2
Wall Street	+ 2
Tokyo	+ 40
London	+ 3
Frankfurt	- 33
Paris	- 20

4. Downward adjustments are needed to spending forecasts on account of lower stock markets. But crucial that forecasts also take full account of the effects of earlier stock market rises, the buoyancy of demand and output this Autumn, and the successive cuts in interest rates.

5. In addition to stock market falls, evidence from recent weeks on the changes in economic prospects for the main industrialised countries:

(i) Short term interest rates have fallen since mid-October by about 1 per cent. Long term rates are little changed.

(ii) Continued strength of commodity prices: after some rise up to mid-October, prices initially fell back in response to stock market falls. But by late November, prices were at their 1987 peak in SDR terms, 11 per cent above the 1986 average and slightly above the 1985 average, according to the Economist index. The recovery in commodity prices obviously owes much to the strength of industrial production.

(iii) Gold prices have changed little in recent weeks. The recent rise in $ terms has been largely but not wholly a result of dollar weakness. On November 30 the dollar gold price was 26 per cent above the 1986 levels: 10 per cent higher in SDR terms.

(iv) Oil prices, on the other hand, are weakening - but this looks much more like OPEC over supply than perceptions of weak demand.

(v) Business surveys: the latest CBI survey in the UK, was very buoyant and showed little impact from the stock market falls. The same is true of business surveys in the United States and Germany. On the other hand, a survey of US consumer sentiment showed a fall back in November. The overall index of leading indicators in the US, which gives a weight to the level of the stock market, has not fallen back.

6. It will take time for the reduced value of financial wealth to show up in slower growth of consumer demand, and for orders to be affected. It may also take time before the adverse effects of exchange rate volatility come through. Nevertheless, **the combination of more buoyant economies pre-crash, generally robust evidence post crash, and a significant easing of monetary policy in recent weeks suggest that we are overdoing the caution in our forecasts of demand and output** - unless of course we foresee further major upheavals in financial markets.

External deficits

7. Recent evidence also suggests a substantial degree of adjustment is in train on external deficits. The stock market crash should help to bring about a larger gap between domestic demand growth in the US and that in the surplus countries.

8. A sustained reduction in the trade imbalances requires a period of several years in which domestic demand grows faster than potential output in Japan and Germany, more slowly than potential in the United States. All three countries have external deficits of at least 3 per cent of GNP. To bring those down by half, to 1½ per cent, by 1990 - not all that ambitious - requires something like 4½-5 per cent growth of domestic demand in Japan, 3½ per cent in Germany, 1½ per cent in the United States. These growth rates of domestic demand would be broadly consistent with potential growth rates of 2¼-2½ per cent in Germany and in the US, and 3½ per cent in Japan.

9. None of these illustrative figures must be regarded as in any way targets. And the way in which they come about, if they do, is crucial for policy: in particular the levels of exchange rates and interest rates. But they provide a benchmark against which to judge prospects and policies:

(i) In the case of the US, domestic demand growth has been running over, rather than under, the 1½ per cent benchmark.

(ii) In the case of Japan, domestic demand growth is running close to the figure of 4½-5 per cent.

(iii) In the case of Germany, domestic demand growth is running well below the 3½ per cent figure.

Dollar depreciation

10. The dangers of promoting a sizeable exchange rate fall were brought home in the Secretariat study of historical episodes. Now, there is a danger that because the short term effects of dollar depreciation on US inflation are so limited, the adverse consequences will be underestimated:

(1) Exchange rate falls do not raise the US price level nearly as much as in most of other countries. Allowing for some continuing - but reduced - absorption by importers, a steady dollar depreciation of 20 per cent over the next 12 months might add not much more than one per cent to the US price level by this time next year. But the risks on inflation are much greater than this, especially in subsequent years.

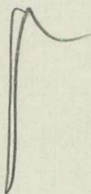
(2) Even if inflation is slow to respond, inflation expectations will be affected more quickly, raising bond yields.

(3) Disruption in markets may bring about a larger or quicker dollar depreciation producing a need for measures, especially interest rate increases, to stabilise the dollar.

(4) Longer term, more restrictive measures will be needed to reduce inflationary pressures.

(5) There is likely to be some undershooting of the dollar, which would in time be unwound, at some cost to the US and its partners.

11. With the currently competitive state of the US dollar, and full employment in the US, it is likely that further substantial falls in the dollar would not achieve the looked for improvements in the trade balance. Resources need to be available for the turn round in the trade balance - from tighter fiscal or monetary policies, or a fall in financial wealth. At the same time, the measures necessary to stabilise the dollar - including a willingness to use interest rates - are more likely to be consistent with growth than a policy of allowing the dollar to fall.



Ch,

Market report at 2.00 (Brussels time)

Index : 75.8

£/$: 1.7965

£/DM : 2.9984

$/DM : 1.67–

FTSE : +19

No intervention (and no knowledge that others have intervened)

JT

53/2/LPD/3743/041

CONFIDENTIAL

FROM: P D P BARNES
DATE: 4 December 1987

MR ILETT

cc PPS
Sir P Middleton
Mr Cassell
Mr A Wilson
Mrs Lomax
Mr Peretz
Mr Board
Mr Neilson
Mrs Ryding

Mr Jenkins - Tsy Sol

FINANCIAL MARKETS BILL

The Economic Secretary was grateful to you Mr Neilson and Mrs Ryding for coming to see him this morning to discuss your submission of 2 December.

2. As he said at the meeting, the Economic Secretary would be content for you to write to the DTI along the lines suggested in your submission.

PB

P D P BARNES
Private Secretary

CONFIDENTIAL

SECRET

MG NOON REPORT

FINANCIAL MARKETS

Tuesday 5 December 1987

Previous Close	Opening	10 AM		NOON
75.7	75.7	75.7	£ERI	75.7
1.7952	1.7965	1.7960	$/£	1.7967
2.9971	2.9957	2.9957	DM/£	2.9955
1.6695	1.6675	1.6680	DM/$	1.6672
132.77	132.80	132.75	Yen/$	132.72

Oil Price (10 AM)

Dec	$17.72
Jan	$17.90
Feb	$17.70

UK interbank £

8 3/8	(-1/8)	7 day
8 1/2	(-1/16)	1 month
8 39/64	(-1/64)	3 month
8 15/16	(+1/16)	12 month

Eurodollars

6 15/16	(+1/16)
8 3/16	(+3/16)
7 15/16	(+1/8)
8 3/16	(+1/8)

Figures in brackets show change since previous market close

MARKET COMMENT In the foreign exchange markets the dollar firmed in New York on short-covering ahead of US trade data out this Thursday, and on the lack of supply of liquidity by the Fed. indicating the US may accede to higher interest rates to support the dollar. The Banks' score was done as we were pulled higher against the Mark on a firmer dollar. In the Far East the dollar eased on a leaked BOJ report showing very strong growth in Japan(4 1/4%). Markets here have been very quiet. The US, Japanese and Hong Kong equity markets all closed up. Dow Jones 1812.2 (+45.4), Nikkei 22948 (+361) and the Hang Seng 1986.1 (+91.1). The gilts market opened lower but has shown some recovery during the morning.

I Colvin

MARKET INTERVENTION ($m)

OTHER COUNTRIES INTERVENTION ($m)

Overnight	+5$ Late London
	+982$ (of which +5DM, +977$) New York
Today so far	-
Total	+987$

GILTS

	Latest market movements	Price change since previous close
Shorts	Better	-2/32
Mediums	Better	-6/32
Longs	Easier	-9/32
Futures (Long Contracts)		+3/32 (Vol:8256)

Gilt Sales since market opening

-£23.3 million

All Index Linked

NAME: Miss R J McRobbie, MG1 Division

Restricted Until Release

7/12/87

PRELIMINARY REPORT

ON THE QUALITY OF ISE MARKETS

OCTOBER 19 - NOVEMBER 13, 1987

A Study of ISE Markets During A Very Volatile Period

1. Introduction

Forming part of a much wider examination of the performance of the London securities market in the period from 19th October to 13th November, this preliminary report outlines major findings to date. Together with quantitative analyses and an examination of the statistics available, this report also highlights views and comments of market participants and observers during the turbulent weeks immediately following the crash on 19th October.

The wider analysis will include a fuller examination of the effect of market structure, trading patterns, liquidity and the impact of derivative product markets (options and futures) on past weeks' activity and performance. Special attention will be given to the examinations of intra-day movements and interactions of prices and transactions in an attempt to understand the dynamics which resulted in the extent of market falls.

A final report is planned to be available by mid December.

2. Summary of Findings

Key results from the preliminary analysis of available statistics and data indicate the following:

1. Despite the sharp falls in prices, volumes reached unprecedented levels in the week of the 19th October, peaking at over 100,000 bargains on two days. Much of the higher turnover of recent weeks has been in alphas. Alphas have been running at an average of 63% of turnover value in the last three weeks compared to 50% earlier. The levels of trading in betas, gammas and deltas (despite being a lower proportion of total turnover) rose in the week of 19th October but have since declined.

2i. There has been a reduction in liquidity as measured by the touch. For all SEAQ categories, touches have increased significantly while quotation sizes have reduced over recent weeks. This is an expected response to a time of great uncertainty and represents the increased cost of running a market making operation under very volatile conditions.

While such an increase in transaction costs is undesirable - it represents a reduction of market quality - it is unavoidable. The alternative, which other exchanges have adopted, is to close or restrict trading. While higher costs to users are unfortunate, the costs to users of a closure would be much greater; London remained open throughout the turbulent period.

ii. Alpha touches have increased almost three fold - from an average of 0.76% to currently 2.17%; maximum size of quotations for alphas averages £120,000, a 50% reduction on more normal times.

iii. Beta and gamma touches have also increased significantly but by less than alphas. Beta and gamma touches have doubled to 3.45% and 5.37% respectively, while maximum quotation size in both categories has been reduced by about two-thirds.

3. More surprising is the fact that some 80% of these customer transactions were buy orders, predominantly from private clients.

4. Intra-market trading accounted for a much lower proportion of overall activity. Normally half of the total turnover value is intra-market activity. Since October 19th, the intra-market share of total turnover value has reduced to about one third.

5. The "crash" and the level of activity arising from it have accentuated the strength of London's electronic competing market maker system. UK equity market makers were able to hold substantial long positions - over £250 million on October 19th - a reflection of their valuable stabilising role in being able to absorb the weight of selling pressure.

3. Market Price Movement

In the period 19th October to 11th November, FTSE fell by 29%. Sydney, Hong Kong and Frankfurt were among the major markets registering larger falls than London. The FT World Index, which has a heavy weighting of American and Japanese stocks, fell by only 18% in US dollar terms. Given the depreciation of the US dollar, in sterling terms, the fall in the World Index was much larger at 24%.

London fell more rapidly than other exchanges e.g. Tokyo. It is argued that an efficient exchange is one which rapidly absorbs new information. The quicker these changed expectations are absorbed into prices, then the more efficient (and fairer) is the market.

It is worth mentioning that different methods of trading can contribute to differential rates of market price movements. For example, equity trading in London operates on a 'quote-driven' system. The ISE's market makers input price quotations on SEAQ and SEAQ International; these quotations form the basis on which transactions are executed. In essence then, market makers need to judge the size and flow of orders in light of new information.

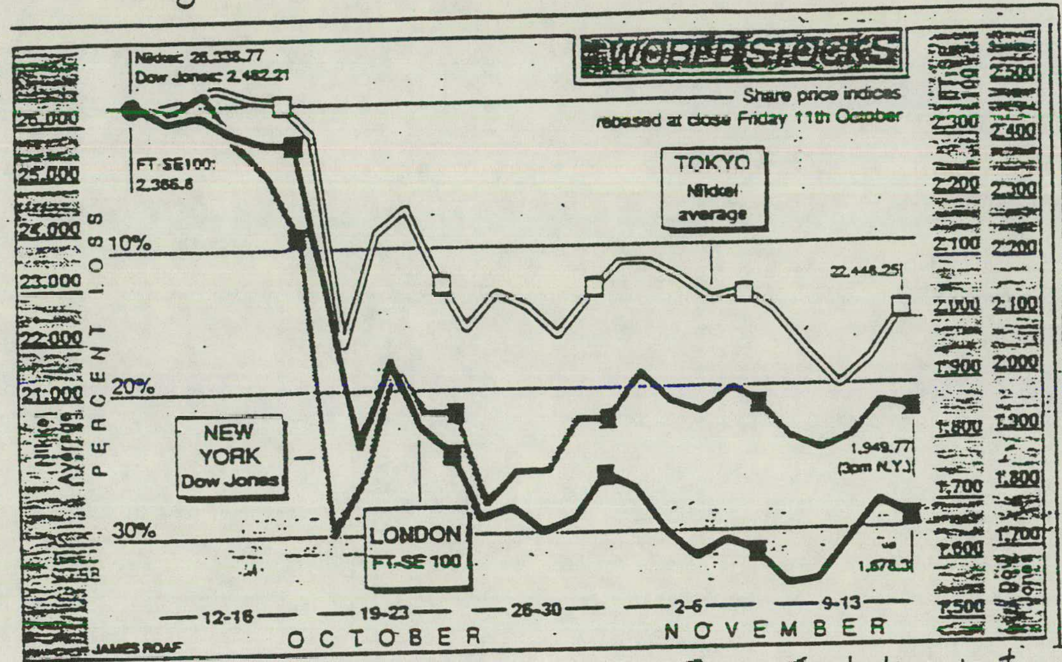
In an 'order-driven' system, eg. on the NYSE or Tokyo, where the specialist executes deals by matching buy and sell orders, new information may take longer to filter through to prices.

Whether or not London's rapid fall was a direct response to fundamental changes in investor expectations or perceptions, and hence serves as an indication of the responsiveness and quality of the ISE, will be carefully assessed as part of our wider analysis. We will be examining in very much more detail the movement and interaction between prices, quotations and transactions during the day, with particular attention being paid to October 19th and 20th when FTSE fell by some 250 points successively.

The ISE was effectively closed on Friday 16th October because of the disruptions caused by the severe weather conditions in London and most of Southern England. This meant that the significant 109 point (4.6%) fall in the Dow Jones Index on 16th October did not register on the London market until the ISE's opening on Monday 19th October, thus magnifying the extent of the fall for that day.

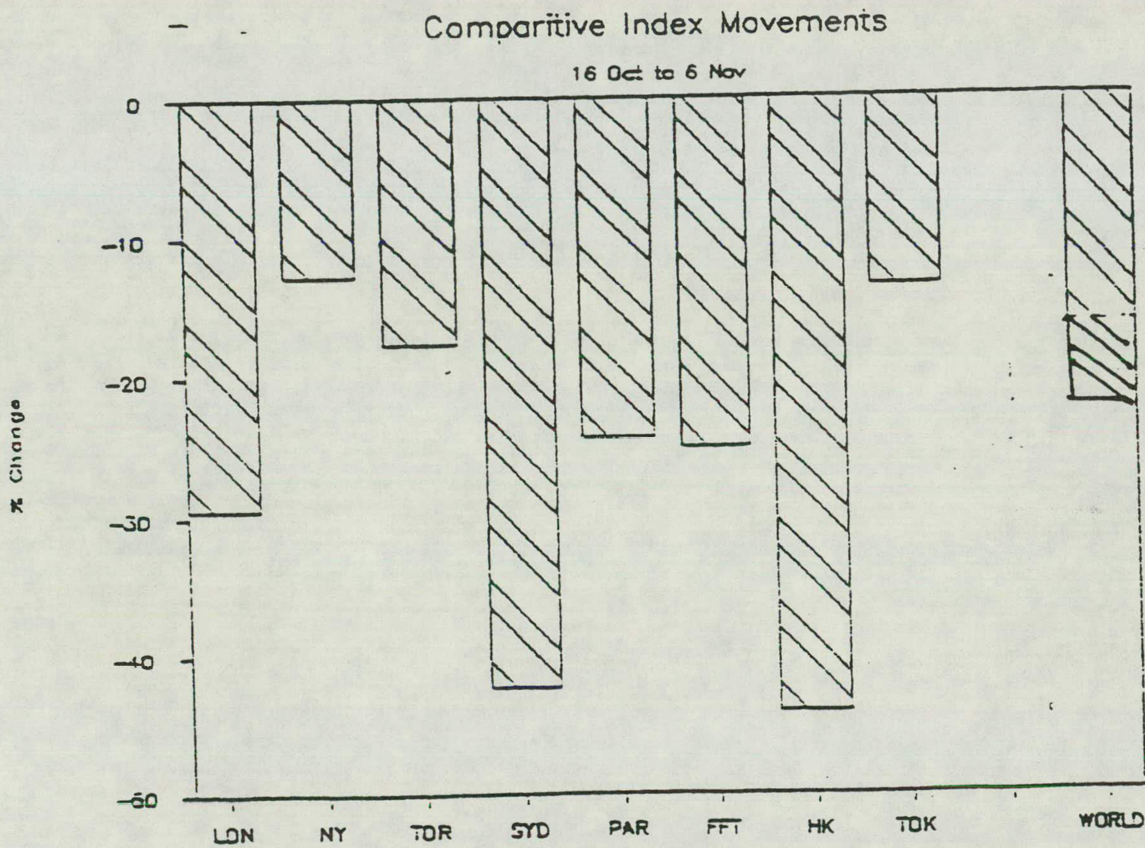
It is also worth noting that while some markets were either closed completely or partially after 19th October, e.g. Hong Kong and NYSE, press reports indicate that financial intervention by Japanese securities houses led to an artifical dampening of the full extent of the market fall.

Figure 1.



Source: The Independent.

Figure 2.



Specific characteristics of markets can also explain differential price movements on different exchanges. For example, UK institutions hold a higher proportion of equity in their portfolio than US or Japanese funds. Over the past year, while the market has increased substantially, they have invested particularly heavily in equities. This, together with cash being absorbed in recent underwritings (and sub-underwriting e.g. the BP privatisation issue), may have left UK institutions short of cash.

Therefore, even when stocks had fallen dramatically since the crash, and were now considered in valuation terms as "good buys", lack of funds would have meant they were unable to do so.

On the other hand, reports from the US suggest that listed companies in the US have taken the opportunity to reduce their takeover vulnerability by buying back stock when the price had fallen sufficiently. As this practise is not widely used in the UK, this type of support was not apparent in the London securities market.

Further investigation and analysis of the flow of funds will need to be undertaken to assess the impact of these issues on the performance on the London securities market during this period.

Concern has also been expressed about whether there was any discernible consistency in the pricing of alpha stocks. Prices of some stocks have moved a lot, while others only "moderately".

Figure 3 shows the results of an analysis of the differences in price movements of each alpha security relative to the movement in the market as measured by the FT All Share Index, and with respect to each stock's US dollar exposure. The graph shows that stocks (such as RTZ, Wellcome, BOC, Jaguar) with high dollar exposure, have performed much worse than stocks with little dollar exposure e.g. Marks and Spencer, BT, ASDA, etc.

Measures of dollar exposure are not entirely reliable since apparent exposures may be more or less hedged. However, it is apparent from the results that there is a clear relationship: stocks which were most vulnerable in terms of dollar exposure have fared worse. Obviously other factors influence individual stocks differently but there is nothing here to suggest that prices have moved substantially differently from expectations.

Figure 3.

12th October 1987 to
30th October 1987

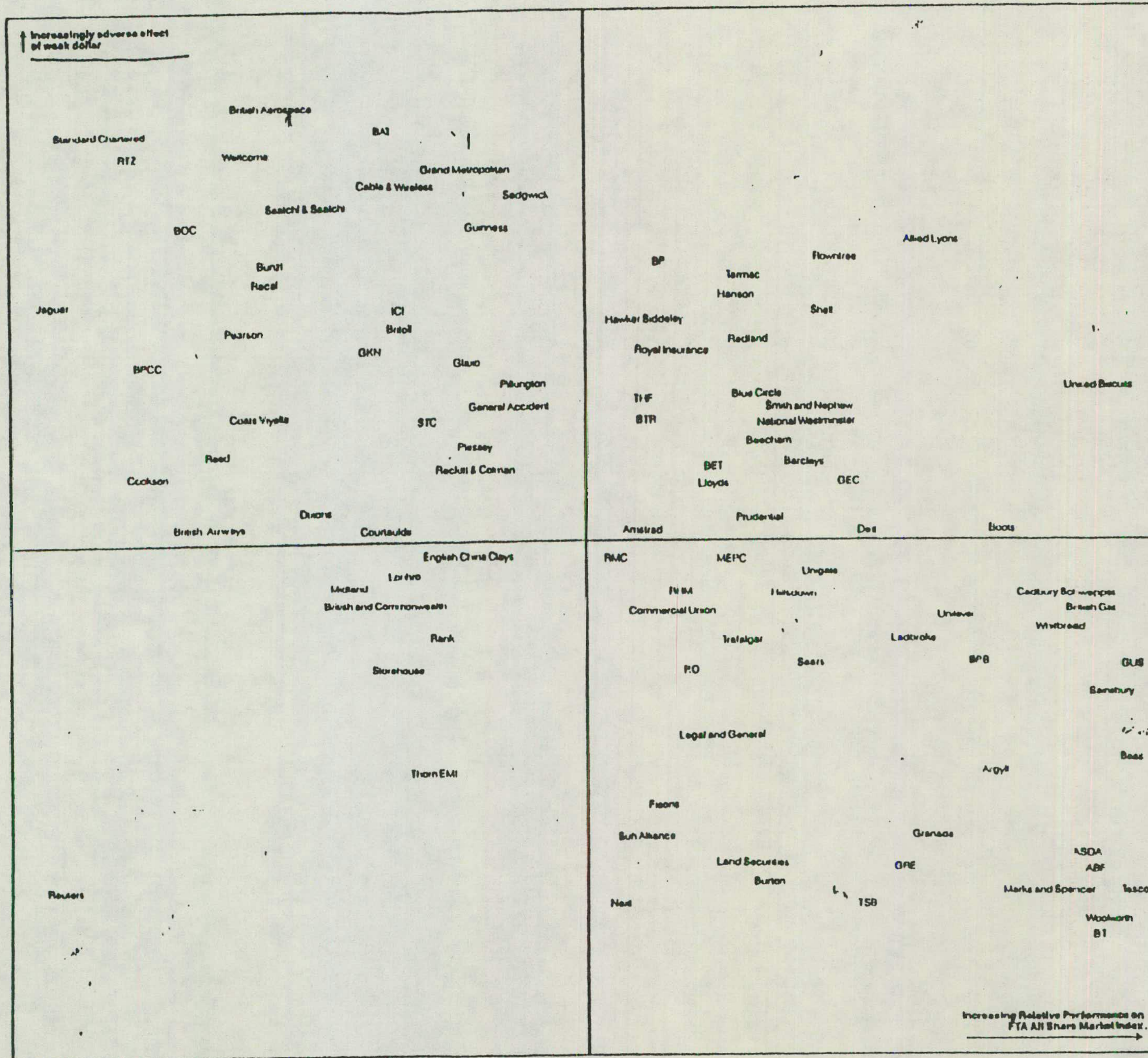
Exposure to the Dollar

Although at first sight this might be considered a non-subjective measure, this is not the case. Assessing currency exposure for most companies from segmental information has always involved a good deal of guess work. Dollar input cost effects are even more difficult to fathom but it is the increasing use of hedging instruments which makes the short term position impossible to predict without a good steer from the companies concerned. Such hedging activity may boost one year's figures but if there are dollar profits earned they will, on sustained devaluation, be worth less in sterling terms over a period of time.

Analysts responsible for covering each of the stocks have therefore made a "normalised" guess at net dollar exposure to locate companies on the vertical axis, but taking some account of any longer term hedging measures.

Relative Performance

Relative performance is measured against the FTA all-share Index for the three week period 12th October to 30th October, 1987.



Source: Hoare Govett.

It is important to note that computer trading techniques are not a major feature on the London market and therefore did not contribute to the dramatic price falls. However, techniques such as program trading and portfolio insurance were very prominent features of major American exchanges and authorities in the US, such as the SEC, are currently investigating the extent to which these techniques have been destabilising factors.

Given today's inter-linkages between international exchanges globally, it is important to recognise that events on one exchange have much wider ramifications than within its national borders (especially if that nation is the USA - "when it sneezes, Europe catches a cold").

4. Effect of Internationalisation

It has been argued that the high level of visibility of SEAQ causes jumpiness among market makers which, in a volatile phase, generates "excessive" (and possibly spurious) price movements. It can also be claimed that London, with a higher representation of international stocks, overseas securities houses and overseas client base, is more exposed to changes in global sentiments.

London is a major centre for trading foreign stocks but, more importantly for this study, many UK equities have major foreign holdings. In light of non-UK related developments, overseas shareholdings are likely to be more volatile than holdings by domestic institutions.

London, since it has remained open and with a high level of liquidity, would have been the best market for foreign funds wanting to liquidate portfolios. If investors wanted to reduce their equity share in their portfolio, they may have been more inclined to dump their UK stocks more readily than, say, their Hong Kong stocks since the UK market was open and liquid throughout the turbulent period.

The actual impact of overseas investors selling into the London market is another issue which will require further analysis. However, we should note that foreign equity volumes increased by over 60% during the week of the crash - from £510 million per day to over £800 million, with almost all the increase coming from the trading of European and Japasese stocks.

but this effect should soon be damped by arbitrage

UK ADRs were also very heavily traded during the week of the crash (over 2.5 million ADRs per day compared to about one million per day on average), suggesting a high degree of trading by Ameriacan investors into the London market.

While further work is required before conclusive reasons can be drawn on the effect of internationalisation on London's performance, the key point is that the ISE remained the most liquid and assessible securities market, not only for UK equities but also for foreign stocks.

5. Visibility of UK Market

It can be argued that stocks with higher visibility, i.e. first line stocks such as alphas, are more susceptible to greater volatility than less visible stocks such as betas, gammas and deltas. However, given that alphas make up a significant share of trading, visibility of the alpha market may exert some influence on the, perhaps perceived, visibility of the market as a whole. If this was the case, then one would expect similar levels of volatility across all sectors of the market, and not more so just for alphas.

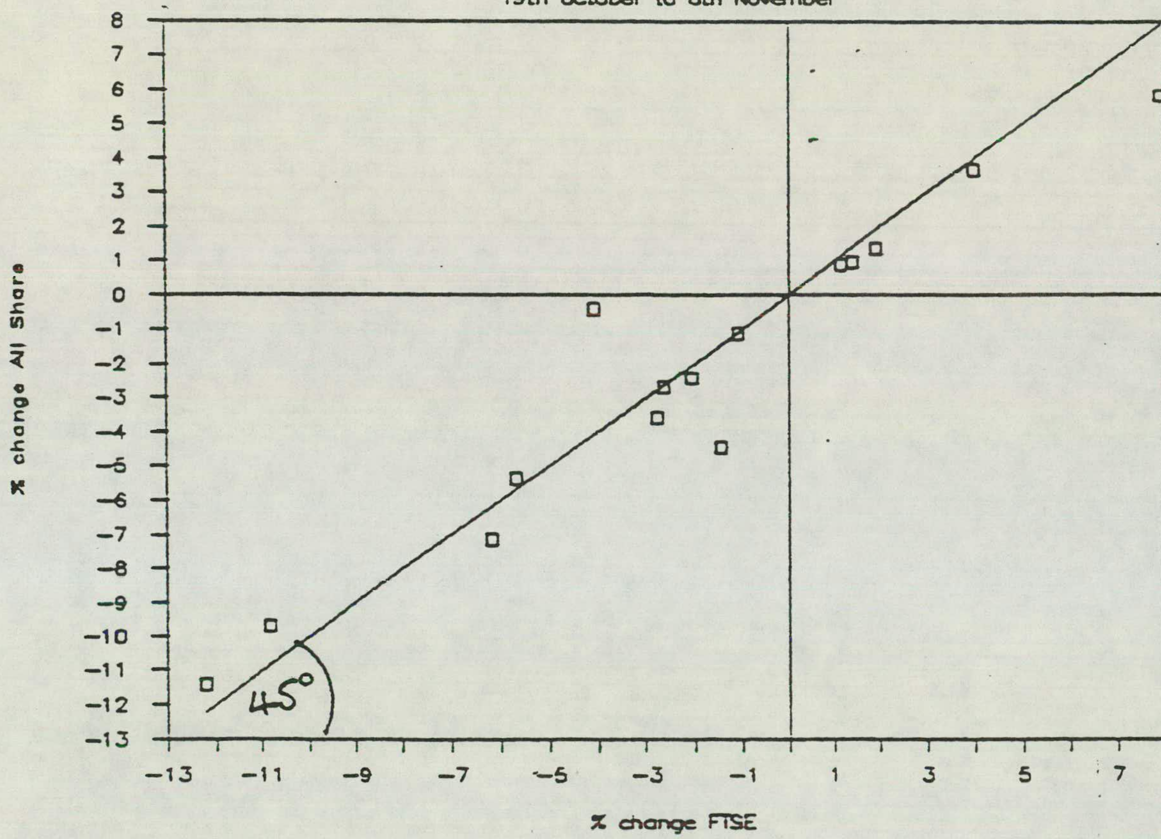
While conclusive results on volatility will require more study, a preliminary study of a sample of stocks from each of the four groups (internationals, main ADR stocks, other alphas, betas and gammas) has been conducted.

Obviously volatility increased for all types of stock during the past weeks. We compared price volatility in the 15 business days before October 19th and the 15 business days after. The measure of volatility was the standard deviation of closing price changes. Changes in volatility are illustrated in Table 1.

Table 1: Volatility in Four Groups of Stocks

Stock Group	Standard Deviation of Daily % Price Movements:		Relative Volatility
	(a) before	(b) after	(b/a)*100 %
International	.050	.220	437.5
Alphas	.063	.218	345.2
Betas	.070	.239	340.6
Gammas	.062	.272	415.9
All Stocks	.062	.237	383.1

Figure 4



There are minor differences - volatility of international stocks and gammas has increased slightly more than that of alphas and betas. This result suggests that in fact, less visible stocks were more volatile than alphas and betas. However, given the roughly 400% increase in overall volatility, minor (and difficult to explain) differences between stock types are probably no more than statistical quirks.

An alternative method of examining whether visibility was a factor causing increased volatility is to look at the differential price movements between first line stocks and second line stocks. While FTSE measures the market price movements in the top line stocks, the FT All Share Index covers 750 stocks and hence can be used as a proxy measure of price movements for the greater number of second line stocks.

Figure 4 shows the percentage change in movements in the FT All Share Index against changes in the FTSE Index. The results indicate that apart from November 2 and 3, both indices moved closely in step implying that, in general, first and second line stocks have moved together. On November 2nd, FTSE fell more heavily; the next day, the FT All Share fell most, thus resulting in the two indices moving similar amounts over the two days.

Thus far, our results indicate that there is no significant evidence that volatility has been stimulated by visibility. In effect, our results suggests that the enhanced visibility of ISE markets has meant that price sensitive information and changes in market sentiment can be and are much more quickly reflected in prices. The more quickly information is relayed to the market and absorbed into prices then the more efficient (and fairer) is the market - "the stock exchange is the messenger, not the message".

6. Trading Volumes and Liquidity

Despite the sharp falls in prices, volumes reached unprecedented levels in the week of the 19th October, peaking at over 100,000 bargains on two days. Figure 5 shows the daily change in FTSE between October 12th and November 11th, while figures 6 and 7 show daily customer and intra-market turnover in terms of bargains and value traded over the same period.

Much of the higher turnover of recent weeks has been in alphas. Alphas have been running at an average of 63% of turnover value in the last three weeks compared to 50% earlier. The levels of trading in betas, gammas and deltas (despite being a lower proportion of total turnover) rose in the week of 19th October but have since declined.

Figure 5

CHANGE IN FTSE PER DAY

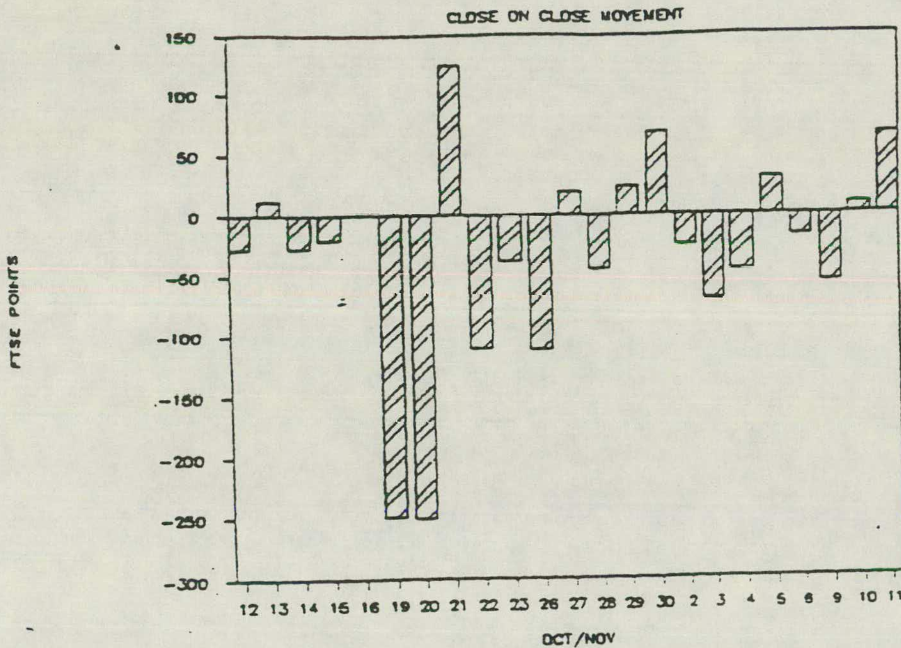


Figure 6

BARGAINS TRADED PER DAY

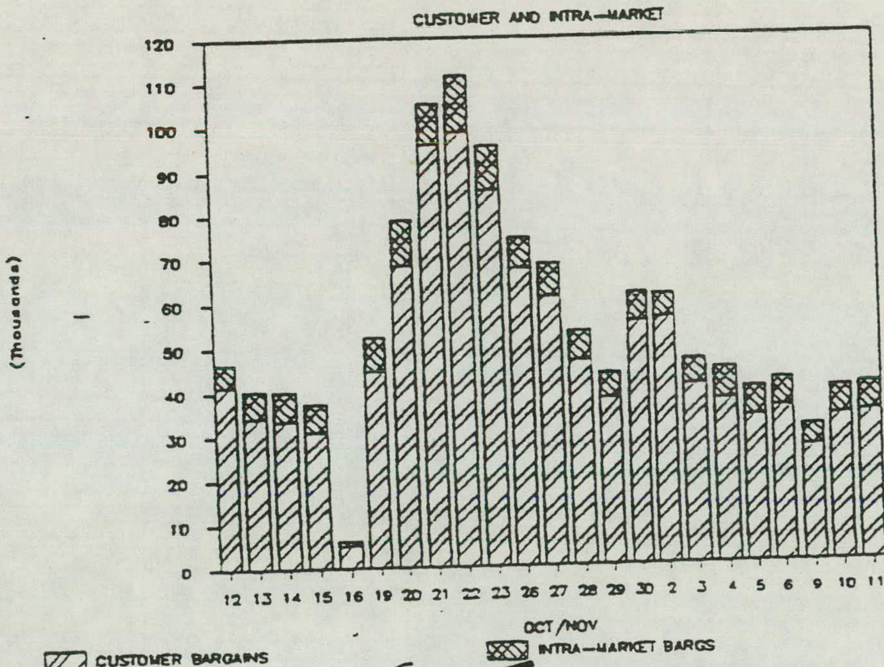
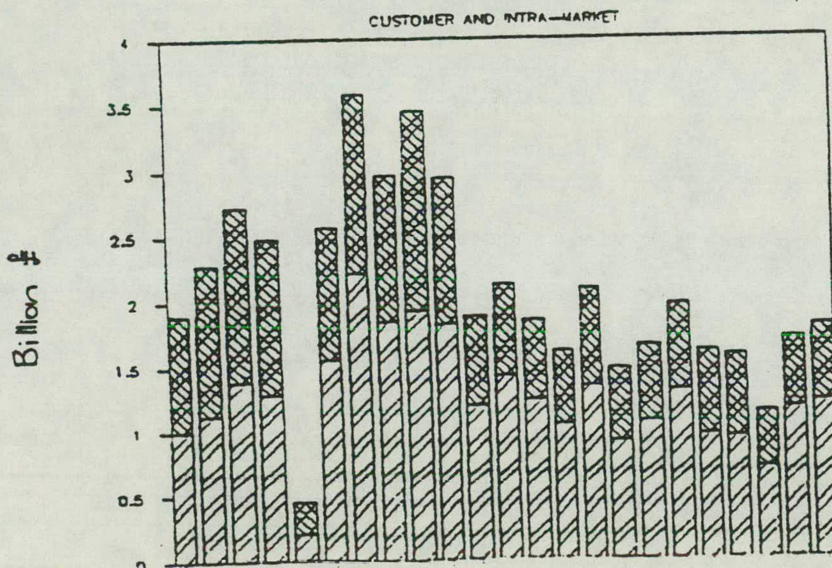


Figure 7

TURNOVER VALUE PER DAY



We shall be undertaking a detailed analysis, particularly for gammas as most quotes are indicative only, to see how screen quotations compare with actual dealing prices. Significant deviations of quotes from actual dealing prices would imply inefficient pricing which would adversely effect liquidity; on the other hand, the closer quotes match dealing prices, then the more efficient is the market.

Preliminary analyses show a reduction in liquidity as measured by the touch. For all SEAQ categories, touches have increased significantly while quotation sizes have reduced over recent weeks.

This is an expected response to a time of great uncertainty and represents the increased cost of running a market making operation under very volatile conditions. Clearly such an increase in transaction costs is undesirable - it represents a reduction of market quality - yet is unavoidable. The alternative, which other exchanges have adopted, is to close or restrict trading. While higher costs to users are unfortunate, the costs to users of a closure would be much greater.

As Table 2 shows, alpha touches have increased almost three fold - from an average of 0.76% to currently 2.17%; maximum size of quotations for alphas now average £120,000, a 50% reduction on more normal times.

Beta and gamma touches have also increased significantly but by less than alphas. Beta and gamma touches have doubled to 3.45% and 5.37% respectively, while maximum quotation size in both categories has been reduced by about two-thirds.

Table 2: SEAQ Touches and Maximum Quote Sizes (MQS)

	Alphas		Betas		Gammas	
	Touch %	MQS £000	Touch %	MQS £000	Touch %	MQS £000
Average Sept	0.84	289	1.58	48	2.68	9
October 14	0.79	304	1.35	54	2.57	11
October 21	1.37	145	2.04	22	3.65	3
October 28	2.10	117	3.00	14	5.05	3
Nov 4	2.17	122	3.45	16	5.37	3

7. Structure of Trading Activity

During the weeks following the 19th October, significant changes in trading patterns have occurred. Two features stand out: the significant increase in the proportion of customer purchase orders to customer sales orders (normally 50:50), and the amount of intra-market trading via equity IDBs.

i) Intra market business

On average, intra-market turnover usually accounts for half of total turnover (customer plus intra market) by value. Since October 19th, it has been running at about 40%, much lower than usual (see figure 8).

More interesting is the fact that equity IDB business has been running at much higher levels than usual. The number of intra-market bargains being dealt via IDBs have increased three fold since October 20th.

As a corollary to our results of much wider price spreads and touches, it is worth noting that wider quotes makes it easier to transact IDB business. This is because IDB deals are conducted using one price to match the buyer with the seller. Wider touches means there is more room to "negotiate" a price which is acceptable.

While we shall be investigating reasons why there has been more IDB activity, it has been said that the very high level of uncertainty has discouraged firms from trading amongst themselves for their own account. In particular, during "fast market" periods, when all price quotations are indicative only, market makers have been able to avoid being "hit" by other market makers if their price moved out of line.

While this may be true, it is also felt that the decision to announce "fast market" periods enabled customer business to be executed in more orderly conditions than would otherwise have been the case.

The "fast market" indicator is used when the volume of market activity is such that market makers are unable to keep their quotes up to date. When the fast market status flash appears on the screens, all prices shown on SEAQ are regarded as indicative only and must be confirmed prior to dealing with market makers.

Figure 8

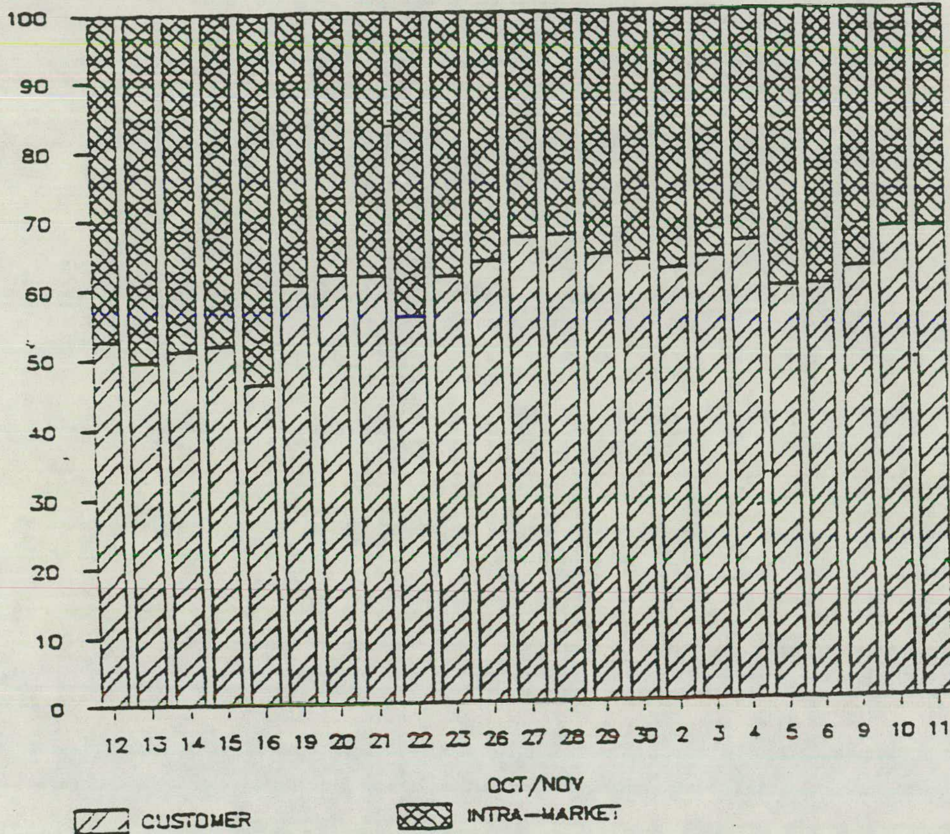
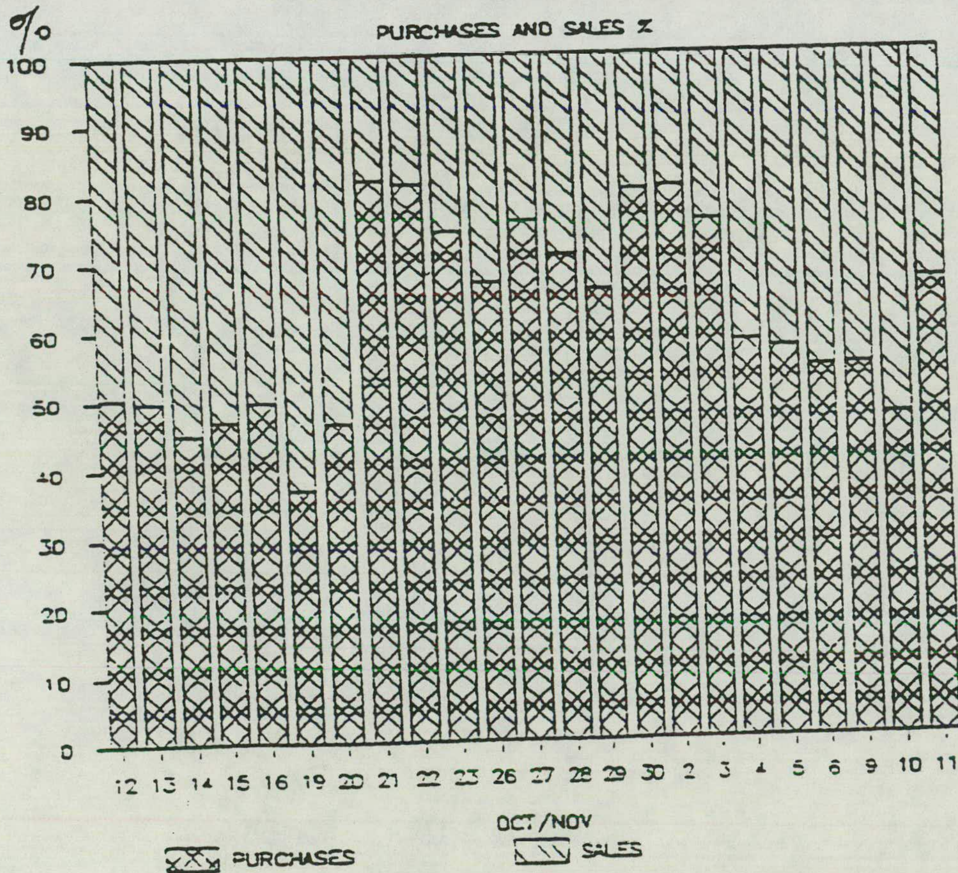


Figure 9



Fast markets were declared during the following times during the week of 19th October:

	Fast Markets Declared
Monday 19 October	09.10 - 09.23 11.00 - 12.00
Tuesday 20 October	09.00 - 11.00 14.32 - 16.00
Wednesday 21 October	09.00 - 09.30
Thursday 22 October	09.08 - 10.00 11.47 - 12.40

ii) Sellers and buyers

Usually there is a fairly even balance of small and large bargains among buyers and sellers so that buy orders and sell orders are roughly equal in number. Since October 19th, the pattern has changed significantly. There has been a consistent and marked pattern of many more small buy orders to a much lower number of larger sell orders.

While the split of customer turnover by money value between purchase and sale orders is roughly 50:50 as expected, in terms of the number of orders transacted, between October 21st and November 3rd, purchases accounted for up to 80% of all customer bargains. Subsequently, the split has become more balanced. Figure 9 shows the daily split of buy and sell transactions.

The clear implication is that individuals have been net buyers since the fall. This is borne out both by comments from member firms and by independent surveys of investor attitudes. Rightly or wrongly, individuals have seen the crash as an opportunity to buy.

Figure 10

NET CUSTOMER PURCHASES – UK EQUITY

Daily: 12th October – 11th November

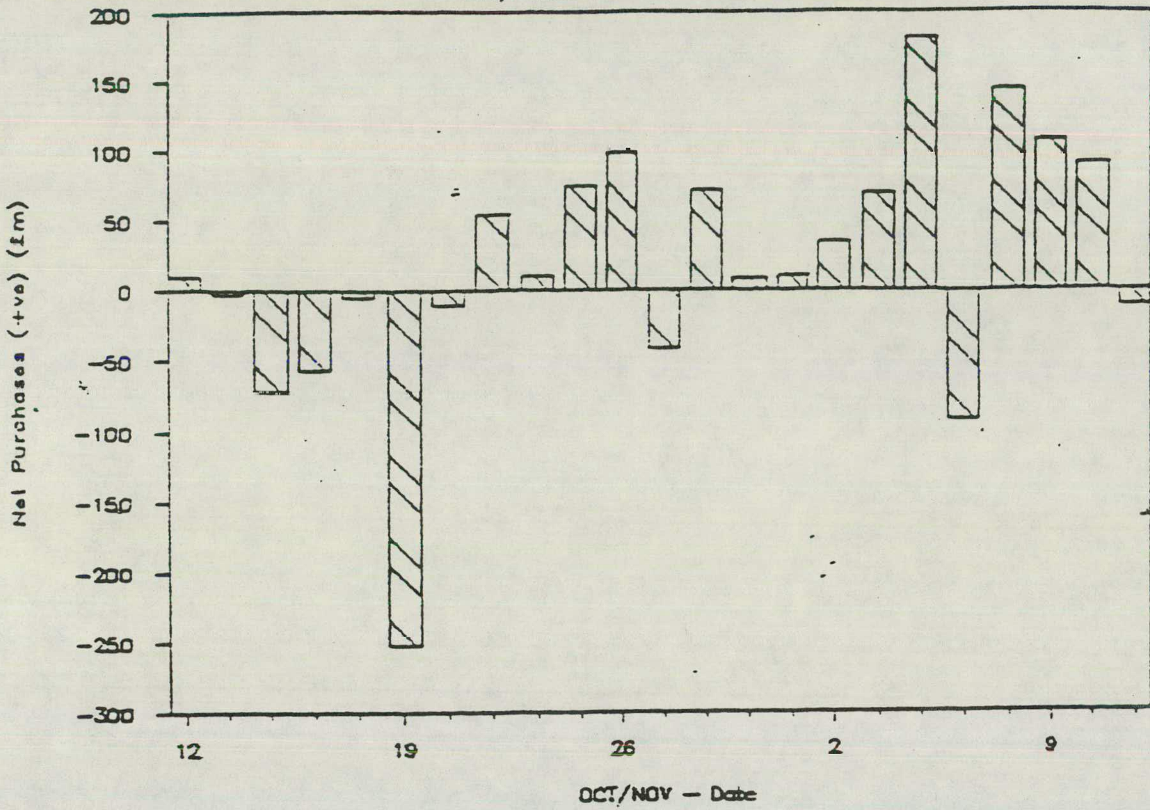
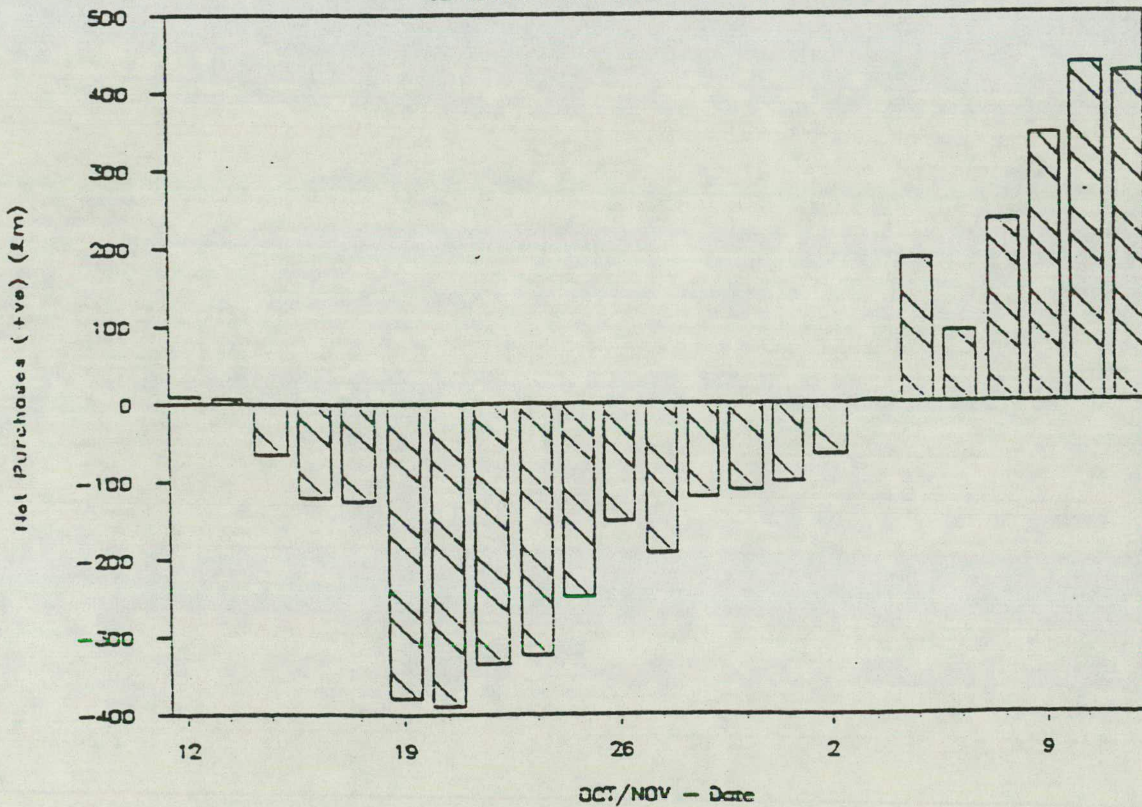


Figure 11

NET CUSTOMER PURCHASES – UK EQUITY

Cumulative 12th October – 11th November



8. Resilience of Market Maker System

Net customer sales were very substantial on October 19th, amounting to over £250 million. On subsequent days, the net positions were much smaller until the latter part of last week when substantial customer buying re-emerged.

Figure 10 shows the daily net customer purchases since October 12. The daily balance of customer net sales and purchases can be seen as an indication of the success of market makers in judging the market equilibrium.

Figure 11 shows the cumulative net purchases over the same period. One can conclude that in the period from October 19th to November 3rd, market makers were managing their price quotations with a reasonable degree of success. They managed to modify selling pressure, thus allowing them to unwind their position.

It is important to note that the ISE's Account trading system, where deals can be closed within the 10 working days of the Account period without any transfer of funds, would tend to exascerbate selling pressures because of investors' ability to sell short. The extent to which the Account system contributed to London's dramatic fall will be examined in our wider study.

There is little doubt from results of our preliminary study that the ability of market makers to hold substantial long positions is a reflection of their valuable stabilising role in absorbing the weight of selling pressure. Commentators have argued that without the increased capital inflow resulting from the Big Bang restructuring of firms, market makers may not have been able to "weather the storm" as well as they did.

9. Further Areas for Research

This study forms part of a much wider analysis of the performance of the London securities market during a very volatile period. By outlining and highlighting the effect various pressures had on the pattern and level of trading, this preliminary report has aimed at providing insights into the forces acting on the market during this turbulent period.

It has also raised a number of issues which will need to be examined in more detail over the coming weeks such that, if necessary and where possible, we can develop effective policies either to reduce the impact of adverse conditions on market quality in the future, or at least recognise and understand more fully the processes at play which produced such dramatic market and price volatility.

The wider analysis will include a very detailed look at the effect of intra-day price movements and trading activity, especially on October 19th and 20th when FTSE fell most dramatically. It will also consider such questions as "did intra-market business drive the market?, what happened to the flow of funds?, did pricing anomalies between futures and cash markets emerge?, were derivative markets destabilising?, etc."

A final report is planned to be available by mid December.

Quality of Markets Unit
November 19, 1987.

CONFIDENTIAL

Mrs Lomax cc Mr Ilett
Miss Noble
Mr Roberts/File All

RF 11/12

cc. Mr Hewell
T.A. Clark
D. Green
L. Price
J. Kirby
J. Anderson
J.S. Beverly
Douglas Board; H.M.T.

(Received unclassified from the Bank). D Board 11/12

Basle Supervisors' Committee

I enclose a copy of a report to Governors on the impact on banks of the collapse in stock markets. You will remember that, following the tour de table on this matter at the Committee's November meeting, the Chairman said he would propose to send a short summary of the discussion to Governors for their information.

Our standard practice is always to clear drafts of reports to Governors with members before they are sent to Governors. Exceptionally in this case, however, the Chairman took the view that, given the factual, non-controversial, nature of the summary and the importance of providing timely information, Governors would be better served by receiving the report as soon as possible, rather than delaying it for a further ten days to obtain clearance from members.

I am therefore also sending a copy of the report directly to Governors.

C.J. Thompson

9th December 1987

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RHF 11/12 20

BS/87/91

Committee on Banking Regulations
and
Supervisory Practices

Report to Governors

Impact on banks of recent developments in stock markets

1. At their November meeting, the members of the Supervisors' Committee had an opportunity to share some early views on the consequences for banks of the turbulence in world stock markets following 19th October. This note presents a brief summary of the Committee's discussion as an initial comment on these events for the information of Governors.

2. Although authorities in most member countries have been in close contact with their banks and in some cases special surveys have been conducted, it should be stressed that the conclusions drawn in this note are provisional and tentative and for the most part relate to the direct effects on banks and banking groups through their own holdings of securities or dealings in share option markets. Any secondary effects, for example a potential increase in customer bad debts as a result of the fall in share collateral values, are not assessed.

3. Not surprisingly, the significance of problems experienced by banks in different countries has been varied in accordance with the degree to which regulation and practice permits direct involvement by banks in equity markets and investment business. In banking systems or in specific institutions where such activity is not permitted, the losses registered so far as a direct result of market disturbances appear negligible. In some cases banks have experienced a positive side-effect; profits have been boosted by the rally in bond prices which followed the stock-market crash and liquidity has strengthened through the action of central banks and from a "flight to quality". For example, a survey of 215 banks in the United States carried out by the Federal Deposit Insurance Corporation found out

but, in the longer run, what about banks' losses via lending to securities firms.
D Board 14/12

that the overwhelming majority did not expect any change in earnings or loan losses as a result of the stock-market decline; and some 31 per cent. said deposits were coming in at a noticeably higher level than before the crash.

4. On the other hand, institutions conducting substantial equity and equity-related operations on their own account, or through subsidiaries, recorded significant and in some cases substantial losses, depending on how their books were positioned at the time of the fall. However, notwithstanding the size of the share-price collapse and the speed at which the markets moved, all the banks affected appear to have been able to manage these losses without raising serious doubts about their solvency.

5. The fact that individual banks undertaking equity business have not been more seriously affected is in large part due to the existence, for the majority of the institutions active in this market, of substantial cushions of profits built up in the first nine months of the year which have allowed losses to be absorbed. Only a few institutions - bank subsidiaries specialising in equity markets - have been obliged to look for additional injections of capital to compensate for the effect of the drop in equity prices on their capital. There appears to have been not great difficulty in securing such support from the parent banks. There is little evidence that these institutions have suffered any significant erosion of liquidity requiring special funding efforts.

6. Such problems as have surfaced so far relate not only to losses on share holdings generally but also to underwriting and share options and futures contracts. The losses in underwriting, as is already well known, largely arise because of the coincidence of the market disturbances with the public flotation of the UK Government's shareholding in the British Petroleum Company. The losses in options markets, suffered by brokerage houses and also by banks in several countries, have been particularly severe: in the case of an options-clearing subsidiary of a major US bank losses are estimated at $90 million, and in the case of some of the largest banks in Sweden losses are estimated in total at around the equivalent of $130 million.

7. The losses suffered by the US company appear largely to reflect the failure of counterparties selling put options on shares or share

indices to honour margin or collateral obligations on contracts which, with the collapse of the market, had incurred a substantial liability. This was also the case for Swedish banks but, additionally, the banks themselves appear to have sold uncovered put options and some dealers had exceeded internal limits on such positions.

8. Several members mentioned the collapse of the futures market in Hong Kong but the incidence of losses on G-10 banks from this source was not quantified.

Implications for the supervision of banks

9. Where banks are permitted to undertake equity business on their own account or through separately capitalised companies within a banking group, several members noted that the events confirmed the difficulty of insulating the bank from losses on securities business.

10. As regards banks' involvement in new instruments - stock-index options and futures - the losses which had occurred pointed up inadequacies in management and internal control systems. It was also noted that nominally hedged positions could also lead to losses where counterparties defaulted on margining requirements. (This credit risk aspect of off-balance-sheet innovations is addressed in the Committee's capital convergence proposals.)

11. Most member countries' systems of capital adequacy measurement are still constructed to capture credit risks rather than the position risk on securities. In the light of the increased importance of securities, notably equities, in the balance sheets of some banking groups, the Committee is conscious that more attention needs to be devoted to devising an appropriate means of measuring the risk of loss arising from the volatility of the prices of such securities and other trading risks. This, in turn, raises a number of important questions regarding collaboration between banking supervisors and the supervisors of major institutions dealing in securities which are not themselves banks. The Committee will be giving attention to these issues in the period ahead.

7th December 1987

SECRET

MG NOON REPORT

FINANCIAL MARKETS

MONDAY 7 DECEMBER 1987

Opening	10 AM		NOON	Oil Price (10 AM)	
75.6	75.7	£ERI	75.7		
1.7930	1.7925	$/£	1.7935	Dec	$17.80
2.9952	2.9974	DM/£	2.9964	Jan	$18.05
1.6705	1.6722	DM/$	1.6707	Feb	$17.85
132.50	132.85	Yen/$	132.77		

UK interbank £			Eurodollars	
8 1/2	(+1/16)	7 day	6 3/4	(-1/32)
8 1/2	(-)	1 month	7 15/16	(-)
8 5/8	(+1/8)	3 month	7 3/4	(-1/16)
8 7/8	(-)	12 month	8	(-1/16)

Figures in brackets show change since previous market close

MARKET COMMENT: The dollar continued firm in New York due to a variety of rumours (UK joining the EMS, realignment of EMS likely, and that a G7 meeting was imminent), and also as a result of Central Bank Intervention. It remained firm in a quiet Far East market and opened here firmer than Friday's close. Sterling opened easier against the dollar but has firmed slightly this morning. Market generally steady and quiet awaiting the US trade figures due out on Thursday, and progress on US budget package. The US, Japanese and Hong Kong equity markets closed down. Dow Jones 1766.7 -9.8, Nikkei 22587 -86 and the Hang Seng 1894.9 -99.2. The FTSE100 opened at 1587.5 +4.7 it is now 1601.9 +19.1.
The gilts market is quietly easier.

R J McRobbie

MARKET INTERVENTION ($m)

Overnight	+145$ New York
	+43$ Far East
Today so far	-
Total	+188$

OTHER COUNTRIES INTERVENTION ($m)

Canada +13$ agst Yen (4.12.87)

GILTS

	Latest market movements	Price change since previous close
Shorts	Steady	0
Mediums	Steady	-8/32
Longs	Steady	-15/32
Futures (Long Contracts)		-25/32 (Vol:13313)

Gilt Sales since market opening

-£7.5 million

NAME: Miss R J McRobbie, MG1 Division
TEL NOS: 270 5557/5560

SECRET

COVERING CONFIDENTIAL

V. useful
discussion
for G7. ✓

PWP
7/12/87.

Chief Economic Adviser to the Treasury

cc SIR G LITTLER
MR EVANS
MR ODLING-SMEE
MR SEDGWICK
MR S DAVIES
MR S MATTHEWS

STOCK MARKET FALL

I attach a draft of a note I have been putting together, both as possible background to our discussions in advance of a G7 meeting; and to draw on at EPC next week. I would be grateful for any comments by this evening if possible.

VH

pp. T BURNS

Alex

Maybe the Chancellor would like to glance at this draft tomorrow on his travels. I ~~was~~ am planning to do some more work on it tomorrow but any comments welcome at this stage if possible.

[illegible]

STOCK MARKET FALL THE NEXT STEPS

CONFIDENTIAL

POST-STOCK MARKET FALL: THE NEXT STEPS

1. After events of past month, worth standing back and trying to assess implications of what has happened.

Discuss under a number of headings:

Summary of position we took in Washington at the end of September.

Chronology of events in October.

Change to environment post-crash.

Risks and dangers.

A possible agenda for a G7 meeting.

Situation pre-crash

2. At the meetings in Washington there was increased optimism about economic activity in the major industrial countries. Growth rates had picked up - particularly in US and Japan. As with UK, domestic demand growth possibly helped by rising prices of securities and property/land. Some worry about poor growth in Germany.

3. Inflation rate had picked up - but largely once for all effects of oil prices. One puzzling and worrying feature was movement of long-term interest rates. Also seen some strengthening of commodity prices but patchy. In general little in way of inflationary threat. The nagging worry was the persistence of trade imbalances of the US, Germany and Japan.

4. The US trade deficit had been slow to improve. Figures for August very bad - a merchandise trade deficit of $15.7 billion.

US trade deficit had deteriorated sharply between 1980 and 1986. There were a number of influences: poor underlying performance; the strength of domestic demand, partly due to fiscal policy; and the direct effects of the huge dollar appreciation between 1980 and 1985.

Over past two years fiscal stance has improved; and the dollar has fallen sharply. But little improvement in trade deficit; partly J-curve; partly because domestic demand has continued to grow relative to elsewhere. One possible factor keeping down savings ratios has been buoyant financial markets. Also length of lags. As result imports growing rapidly; and exporters taking opportunity to increase profit margins.

5. Following the Louvre agreement an effort had been made to stabilise the dollar and support it with policy changes. There were several reasons for a period of exchange rate stability:

- to give an opportunity for the lags to work through so that we could observe the underlying situation a little more clearly following the large dollar depreciation;

- to slow speed of depreciation that could lead to an undershoot of the dollar;

- to give the appreciating countries an opportunity to adjust their economies from emphasis on growth of external trade to growth of domestic demand;

- to avoid inflationary expectations in the US getting too firm a hold.

6. At the time of the Washington meetings it was possible to be optimistic about the exchange rate aspect of the agreement. A combination of intervention, adjustment of monetary policies and an unwillingness of the market to take on the authorities had all contributed to the period of stability. You set out your reasons for continuing the approach with some suggestions for building upon the experience since Louvre.

7. But some other aspects of the Louvre agreement were not working out as planned. Although the US budget deficit had fallen sharply in the current financial year, projections showed only modest improvement - if any - over the medium term. Japan had introduced a fiscal package but doubts about speed of opening up domestic markets to imports. And promised German fiscal action remained on a long fuse despite sluggish growth.

8. Some commentators argued that a dollar depreciation was necessary:

- the large projected trade deficits;
- the absence of private sector financing during 1987;
- the risk that slow growth of money supply in the US, and rising interest rates caused by action to defend the dollar, would lead to recession;
- the comparable risk that rapid monetary growth in Japan and Germany would lead to higher inflation

9. We took the line that the case for further depreciation had not been demonstrated:

- the effects of the previous depreciation had not worked through;

- it was not possible to have a rapid adjustment of the US current account deficit; patience was needed;

- the US appeared to be close to full capacity and further depreciation without bigger cuts in the budget deficit risked feeding through rapidly into faster inflation. Growth of imports and profit margins of exports further evidence;

- (privately) that a longer period of stability would advance the cause and credibility of managed floating;

- there was little risk of US recession; slow monetary growth had to be balanced against earlier exchange rate depreciation and buoyant financial markets that had both served to ease monetary conditions. Inflation was a bigger risk than recession;

- similarly there was little risk of burgeoning Japanese and German inflation; the delayed effects of exchange rate appreciation had tightened monetary conditions and this had to be offset against the faster growth of domestic monetary aggregates.

The ambition was not to keep the dollar fixed indefinitely but to lay the groundwork so that when a change was needed it would be "managed".

10. At the G7 Meeting in Washington the Louvre agreement was confirmed. Worries about tightening of monetary policy in Japan and Germany were raised but assurances given that this was not happening.

The Events of October

11. The chronology of the events of October/November are worth setting out as they are often mis-stated by those wishing to blame the Louvre accord for the stock market crash:

- despite assurances German monetary policy appeared to tighten - albeit marginally;

- Baker said he would rather see the dollar fall than be pushed into interest rate war and called on Germany to relax policy;

- stock market collapse; some strengthening of bond markets but initially exchange rates stable;

- attempts begin by US administration to speed up budget discussions;

- the US (and UK) moved to reduce interest rates as response to tightening of liquidity;

- the dollar began to fall;

- some interest rate response from Germany

- statement from Baker that US not going to risk recession to help dollar;

- further dollar weakness; equity markets drifting lower.

Change to Economic Environment Post-Crash

12. The sharp fall in equity prices combined with some easing of interest rates and a lower dollar will have significant effects on the economic outlook.

13. Domestic demand is likely to be adversely affected. Those countries with the biggest stock markets should be most affected. Furthermore the biggest negative effects are likely to be in countries who have been benefiting from previous strength of financial markets. Given the time lags it is difficult to be precise about effects but we could see

some increase in private sector savings ratios. Housing/land markets are likely to be adversely affected. Despite lower interest rates incomes in the financial community will be damaged. In most cases it was in the financial centres that property prices were particularly strong. This will also tend to work to dampen domestic demand.

14. The big unknown is the extent of the shock to business investment. There were signs of strengthening investment intentions. Some will now be put on ice until the dust is allowed to settle.

15. Commodity prices and long-term interest rates have fallen. This points to some easing of any inflationary threat. Projections of inflation rates are likely to be reduced.

16. The weaker dollar will cause problems for the export industries of the appreciating countries with knock-on effects to investment. Before the recent dollar fall there were increasing signs of gradual adjustment to the earlier dollar depreciation. A further round of adjustment will now begin. On past evidence the net effect in the G7 countries could be adverse; how adverse will depend on the extent to which the NICs stick to the dollar or adjust their parities.

17. The combined effects on US domestic demand are likely to be beneficial as far as the trade accounts are concerned. In addition the reduction of pressure on resources could mean that the effects of previous dollar depreciation become more evident.

Risks

18. The biggest risk we now face is of uncontrolled dollar depreciation. This would:

- further disrupt financial markets;
- cause major problems for appreciating countries;

- lead to worrying inflation rates in the US;

- eventually push up US interest rates and force authorities to act quickly on the budget deficit;

- risk further bout of protectionism.

19. This would all be extremely damaging as far as business confidence is concerned. The dangers of a major recession would become very real.

A Possible Package

20. You have argued that a credible package might be as follows:

- a lower US budget deficit with convincing adjustment in later year;

- measures to strengthen domestic demand in Germany/ Japan;

- agreement to stabilise the dollar at a lower rate and a commitment to action that would bring that about.

21. A lower US budget deficit is crucial to stabilisation of financial markets:

- the US are incapable of financing their deficit from internal savings; higher net domestic savings could emerge for a variety of reasons - none of them comfortable: higher inflation, higher interest rates, or a lower rate of investment;

- until earlier this year private sector capital flows made a significant contribution. They have now dried up. They will only re-emerge when the expected rate of return is high enough. The greater the expectation that the dollar will decline the more that will require higher interest rates.

That is why recent comments have been so damaging - it is a serious mistake to imagine that a lower dollar can avoid higher interest rates if no action is taken on the deficit:

- it is a mistake to think that a lower budget deficit will bring an unnecessary recession. That may happen anyway. But action to correct the deficit could boost confidence, restore the flow of overseas finance and avoid further financial markets disruption. If UK experience is anything to go by the net effect could be positive;

- it is difficult to see how an improvement in the current account will emerge without a correction of the budget deficit. A lower dollar will only exercise significant trade effects if there are the resources available for it to "work". A lower budget deficit (or higher interest rates) are the only mechanisms available to create that room apart from a recession caused by a blow to confidence.

22. Measures to strengthen domestic demand in Germany/Japan are necessary to smooth the path of adjustment to lower external demand resulting from lower US domestic demand and exchange rate appreciation:

- domestic demand will be strengthened automatically from lower inflation but on its own that may not be enough;

- it is up to each country whether this should be brought about by fiscal or monetary policy. Some of the burden is likely to fall on monetary policy if the third objective - a stabilisation of the dollar - is to be achieved;

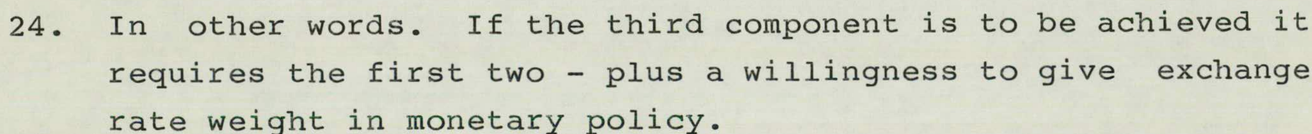
- there is little in the way of inflation threat to either country. The weakness of commodity prices, coupled with the strength of their own currency, will both be exercising a powerful disinflationary force;

- given the progress on budget consolidation in recent years there can be little danger of bringing forward tax reductions that are planned for later years.

23. A reaffirmation of the objective of dollar stability would be very helpful. But difficult to make credible. Helpful because serious risk of dollar undershoot and world recession. Difficult because so many recent comments have seemed directed to undermining principles of co-operation. Some important principles:

- If dollar stability is wanted it requires a commitment to provide the means. Intervention can play a part. But most crucially it requires monetary action. There is no escape from the principle that exchange rate variations have to be given a large weight in the conduct of monetary policy. Already set out reasons for this. If cannot do this then no point in making commitment.

- And it must be supported by policy action to bring about necessary adjustment of trade imbalances, which has clear implications for growth of domestic demand.



24. In other words. If the third component is to be achieved it requires the first two - plus a willingness to give exchange rate weight in monetary policy.

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From the Parliamentary Under Secretary of State for Corporate and Consumer Affairs

The Hon Francis Maude MP

ECONOMIC SECRETARY
REC'D -9 DEC 1987
ACTION Mr ILETT.
COPIES TO PS/CHANCELLOR, Sir P. MIDDLETON, Mr CASSELL, Mrs LOMAX, MISS NOBLE, Mr NEILSON

Peter Lilley Esq MP
Economic Secretary to the Treasury
Treasury Chamber
Parliament Street
LONDON
SW1

7 December 1987

Dear Peter,

FINANCIAL MARKETS BILL

Thank you for your letter of 20 November. I entirely agree that we should keep our options open on the question whether to make a statement before the Bill is introduced. We are, I hope, also agreed on the need for a Bill, and one option which I am seriously considering would be to make the Bill retrospective from the date of its introduction. That would probably avoid the need for a statement beforehand, and would attract less adverse attention than a special statement made either before or after introduction.

If we were to introduce the Bill without the retrospective adaptation of Insolvency Law, investors might begin to worry about the ability of the market authorities to handle a default while the Bill was going through Parliament. There is a separate problem over the implementation of the Financial Services Act which may also require a retrospective provision.

There is however no need to make a final decision on the question of retrospection until nearer the time of introduction.

I am copying this letter to Lord MacKay, Patrick Mayhew, the Governor and Sir Robert Armstrong.

FRANCIS MAUDE

J04CSI