

Safer than it looks

Most of the recent proposals to curb volatility in America's financial markets are unnecessary and misguided

EVER since the stockmarket crash of October 1987, the regulators of America's stock and futures markets respectively have squabbled over ways to control volatility in the nation's financial markets. Many pundits like to blame stockmarket volatility on the differing margin requirements (that is, the collateral that investors must put up in exchange for securities) between America's stockmarkets and the futures exchanges that trade stock-index contracts.

In particular, the Securities and Exchange Commission (SEC), which regulates stockmarkets, takes exception to the fact that margin requirements on Chicago's futures exchanges are so much lower than on the New York Stock Exchange (NYSE). The SEC believes that the S&P 500 stock-index contract traded on the Chicago Mercantile Exchange is a tail that wags the stockmarket dog.

Largely for that reason, the SEC has campaigned to be the single regulator of both stocks and stock-index futures, which are currently overseen by the Commodity Futures Trading Commission (CFTC). Now a regulatory compromise appears in sight, giving the Federal Reserve Board oversight of margin requirements for both stock-index futures and (as has been the case since 1934) shares.

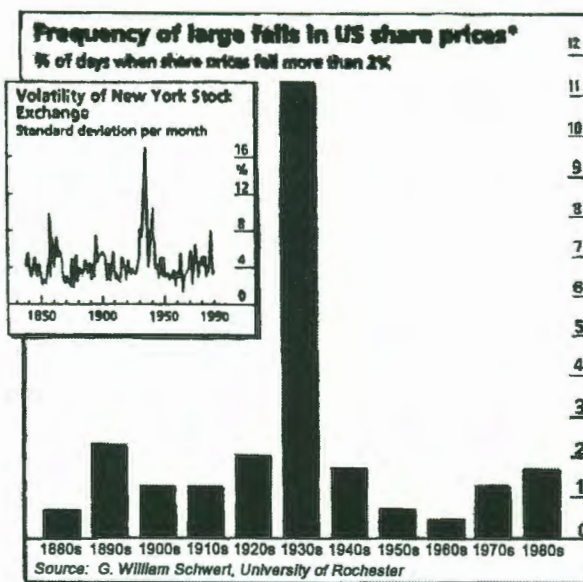
Other attempts are being made to curb stockmarket volatility, by curbing trading when markets move violently. Already, so-called circuit-breakers are in place in stock and futures markets. If the Dow Jones industrial average falls or rises by 250 points, then trading is temporarily suspended. If the S&P 500 futures contract moves by 12 points (roughly equivalent to 100 points on the Dow), then trading in the futures market is suspended (this is what happened on July 23rd, when the Dow fell by 108 points in the first hour of business). Now an NYSE panel is proposing to curb trading after as little as a 100-point fall. The SEC has also approved a proposal by the exchange to restrict program trades (ie, the buying or selling of baskets of shares) after the Dow has moved by more than 50 points.

Such restrictive measures are approved of by those who think there is something bad about volatility. Certainly, extreme volatility of the type that en-

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gulfed markets during the October 1987 crash can threaten the integrity of financial markets. That day-to-day volatility drives away investors from the stockmarket, so raising the cost of capital for America's industry is less certain.

There is no evidence that markets are now any more volatile than in some distant, nostalgic past. In the June issue of the *Financial Analysts Journal*, Mr G. William Schwert, of the University of Rochester, looks at NYSE volatility since the 1840s. As the chart shows, in terms of



the number of daily stockmarket falls of more than 2%, the 1980s were less volatile than the 1920s, 1940s and 1890s, much less volatile than the 1930s, and not much more volatile than the 1970s. During the 1980s the standard deviation (a statistical measure of the variation of returns) of monthly returns was in line with the historical average of 4%—that is, roughly two-thirds of monthly returns were up or down by 4%.

Even if existing levels of volatility are worrying, raising margin requirements will do little to cut them. Currently, the NYSE margin requirement is 50%; at the CME it hovers between 10% and 14%, and is now at 12%. Since the two markets are linked, many argue that low margins in Chicago create excess volatility in New York. But there is a good reason (as the

SEC recognises) for the margins on the futures contracts to be different from those of the underlying stocks. Futures contracts are settled daily, whereas the settlement period for shares is five days. Stock-index futures also cover a basket of stocks benefiting from a diversification that individual stocks cannot offer.

There have been many empirical studies that look at the effects of margin requirements on stockmarket volatility. The latest study, in the March issue of the *Journal of Finance*, by Mr Merton Miller of the University of Chicago and Mr David Hsieh of Duke University, looked at changes in NYSE margin requirements since 1934. It concluded that a 1% increase in margin requirement was associated with a negligible 0.04% increase in volatility.

Evidence of the effect of circuit-breakers on volatility is inconclusive. A study by the SEC of the mini-crash of October 1989 (when trading on the S&P 500 futures contract was suspended) concluded rather feebly that the "division's findings do not indicate any harm to the markets attributable to the imposition of the circuit-breaker mechanism."

On the other hand the CFTC's report into the mini-crash concluded that "prices constrained by shock absorbers in one market were associated with increased volatility in other unconstrained markets." On the morning of July 23rd this year, some blamed the floor on the futures contract for accelerating the fall, as traders tried to place their sell orders before the halt was called.

Nor is there evidence that the NYSE is particularly volatile on the days when more program trades (and hence, usually, more index arbitrage) are done. The effect of separating equities from their respective derivatives is hard to measure. But Mr Sanford Grossman of the University of Pennsylvania notes that the bid-ask spread in America's Treasury-bond market widens after 3.00pm, when the market for bond futures closes.

The proliferation of computerised trading, derivative markets and competition from other countries' exchanges in the past 15 years has inevitably put pressure on America's financial watchdogs to update their regulation of stock and future exchanges. Many of the proposals made since the stockmarket crash of 1987 aim to curb financial innovations, in the belief that they are responsible for excessive volatility. Putting the clock back and reversing financial innovation is unlikely to have the desired effect.