JEEPS IN CHINA: STRATEGIES FOR ECONOMIC GROWTH

REMARKS OF

RICHARD C. BREEDEN, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

DETROIT ECONOMIC CLUB
DETROIT, MICHIGAN

OCTOBER 19, 1992

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Distinguished Guests, Ladies and Gentlemen:

It is my distinct pleasure to be here, though it is a challenging assignment to follow President Bush and so many other eminent speakers to this rostrum. As you may know, today is the fifth anniversary of "Black Monday", when the Dow Jones Industrial Average fell 508 points to close off a whopping 22.6% at 1,738. Indeed, from August 25, 1987 to October 20, 1987, the DJIA actually declined 37%, which erased about $1 trillion in market value of U.S. stocks.

On Black Monday and the following day, a total of more than 1.2 <u>billion</u> shares were traded on roughly a half million orders each day, straining the existing system nearly to its limits. To give you some idea of the magnitude of the volume, the average daily trading volume when John Kennedy became President was about 3 million shares per day. On Black Monday that volume transpired on average every 90 seconds.

As a result, systems for routing orders to the floor, executing trades, comparing trades (knowing what you ended up buying and selling the previous day) and ultimately settling transactions with final payment were all above the red line. Many individuals couldn't get their brokers to answer the telephone. Those that did were often unable to get prompt execution in a market that was falling rapidly. To top it all off, rumors swept the market that it might be closed, creating a further incentive for a rush to the exit.

In October of 1989, we had an "aftershock" that resulted in a 190 point drop (which was the second largest historic decline in terms of price, but only twelfth largest in percentage terms). Far worse was the situation in Japan, where a decline of roughly 60% in value -- three times worse than Black Monday -- took place in a sustained slide lasting over two years. Japan's losses amounted to more than $2 trillion.

Following Black Monday, numerous reports -- including that of the Brady Commission -- were prepared. These reports chronicled the impact of operational problems experienced at the exchanges, lack of timely price information, portfolio insurance, selling caused by liquidity pressures, inadequate market maker and specialist capital and performance, waves of program trading orders emanating from the futures markets, and other issues. Since that time, the securities exchanges, clearing

organizations, market makers and specialists, major firms and the regulators have all tried to shore up the defects that had become apparent.

During the intervening years numerous changes have been made. Portfolio insurance became discredited, systems for "cross-margining" intermarket portfolios of securities options and futures positions have been developed, and immense new capacity has been added to computer processing systems at the New York Stock Exchange, NASDAQ and other exchanges. Firms of all sizes have more capital today, and new procedures are in place to insure that individual customer orders are given priority for speedy execution -- though of course selling in the middle of a plunge in the market is a hazardous strategy individuals may have learned to avoid.

Congress even recently enacted authority fore the Federal Reserve Board to establish minimum levels of margin for the futures exchanges. Depending on how the Fed exercises that authority, it could curtail significantly one of the worst causes of risk in both 1987 and 1989.

One very important area of change was the institution of what we call "circuit breakers" into the trading mechanisms of the securities and futures exchanges. These are preplanned

intervals at which, in the case of the futures market, a price limit is temporarily placed in effect. In the case of the securities market, if the DJIA falls 250 points, trading would be halted for one hour in stocks, options and stock futures, and for two more hours if the DJIA falls 400 points.

Related to the circuit breakers are "speed bumps", which is a nice way of saying special regulatory provisions designed to slow the speed and force of a decline in various ways. For example, once the market rises or falls 50 points or more, "Rule 80A" of the NYSE operates to prohibit index arbitrage orders from being executed except on the "tick" away from the direction the market is moving. Thus, if the market has fallen by 50 points on the Dow, index arbitrage cannot be used like a hammer to pound the market on the head -- you can only hit the market when it tries to get up off the floor.

These arrangements are not designed to prevent the market from finding a new price level when the market decides, in its wisdom, that this is necessary. However, the circuit breakers provide certainty to the rules governing trading dynamics. This is far better than rumors and panic over whether the government "might" close the market.

In addition to avoiding surprises concerning trading halts, the circuit breakers are designed to give market participants a

few "time-outs" to assess their positions, review relevant news and, hopefully, to fill in the other side of an order imbalance. They do not guarantee that market participants will behave in a rational and orderly manner, but they do give people inclined in that direction a chance to do so.

Sometimes, for example, the market may fall steeply, but on very light volume. If there were 100 sell orders and only 2 buy orders, prices could fall sharply, even though most people were sitting on the sidelines or out getting a hot dog. By allowing the imbalances, and the lowered prices they produce, to be advertised a bit, circuit breakers and other delaying tools allow bargain hunters time to decide to jump in and cure the imbalance, leading to an offsetting price pressure. Of course if the sell orders are measured in large enough quantities, and people do not feel in a mood for bargains for whatever reason, watch out.

Given the nature of my position and the limitations of my own abilities, I leave the job of predicting market moves to investment analysts. Therefore, I cannot say whether or when we might see another event of the magnitude that we faced in 1987. However, whether or not we think that a repetition is likely, in my judgement we ought to be in a position to weather the worst storms we think the market could dish out at all times.

Viewed from this perspective, it is encouraging that today's market systems are so much stronger than they were in 1987. To be sure, there are still weaknesses, including a clearance and settlement system that is too slow, and a regulatory system that is too fragmented. On top of that, our technological systems remain vulnerable to errant backhoe operators. However, the progress and strengthening that has taken place since 1987 is undeniable, particularly in the improvements in systems by the exchanges and the greater capital reserves generally being maintained by the major market participants. By carrying through a major enhancement of the clearance and settlement system over the next 2-3 years, we can and should take very significant additional risks out of the system.

Ironically, in Europe the European Commission has just published a new directive on capital for banks and securities firms. It slashes capital requirements to levels that could well lead to multiple failures of even the largest institutions in the event of price moves of the severity experienced in October of 1987. At the same time, the world bank regulators have proposed a new "international" standard for banks that seems to provide that banks would not maintain any capital against their holdings of debt securities, which in the U.S. total hundreds of billions of dollars and exceed the volume of all loans.

The SEC has tried to be active participants in developing stronger capital rules worldwide. However, I do not think it is likely that the SEC will ever endorse capital standards that are not designed to provide sufficient buffer to allow major securities market participants to survive the inevitable market problems without government intervention, phony accounting or massive losses for their customers.

Indeed, one of the striking things about Black Monday was that all the major securities firms were able to ride through the storm with adequate capital. That is one of the things about the system that we do not intend to change.

In talking about what happened on Black Monday, it is interesting to note what did not happen. Though it may have been in part a harbinger of painful economic adjustment to come, it did not lead in the short term to a sharp contraction of the economy as a whole. While it drove many investors away from the market for several years, it didn't do so permanently. In fact, the NYSE estimates that the number of individual shareholders increased during the 1980s, despite Black Monday, from 30.2 million in 1980 to over 51 million in 1990. Judging from their participation, investors have recovered.

The market has also recovered, and in a significant way. The Dow is now about 1500 points higher than it was at the close

on October 19, 1987. With appreciation and dividends, an investment in the Dow stocks of $10,000 on the morning of October 20, 1987, would be worth more than $21,000 today.

Much more importantly than price levels, in the last two years the market has regained and far surpassed its previous levels of raising capital for the productive use of American businesses. In the years prior to Black Monday, the total annual volume of securities of all types, public and private, issued in a year was never above roughly $400 billion. In 1991, total financings in the U.S. securities market topped $700 billion. This year, public offerings registered with the SEC are running about 55% ahead of 1991's all-time historic pace. At this rate, we may exceed $1 trillion in issuances for the full year, and that number excludes more than $500 billion in commercial paper that is constantly being rolled over. Today it is not an exaggeration to note that the securities markets have become the principal tool for financing economic activity in the U.S., displacing the commercial banks who have apparently decided to become government bond mutual funds.

This past summer, I was invited to visit China to review their fledgling new securities markets in Shanghai and Shenzen. These markets have been open less than two years, and they are functioning without a particularly clear legal or regulatory framework. They also have the substantial handicap of developing

in a country with a recent history of disregard for human rights, not exactly the ideal framework for markets that absolutely and totally depend on the enforcement of private contracts in order to create or transfer value.

In addition to its recent history, China has numerous problems that it must overcome in order to facilitate the growth of a private securities market for domestic or foreign participants. They need training in all areas, but particularly for accountants, broker-dealers and lawyers. They have to replace two generations of central planning and its accounting systems with a new set of accounting principles and an entire new generation of accountants. They must prove that they can develop and enforce equally clear laws governing the offering and trading of securities, and the duties of companies, underwriters and others who offer or assist the offering of securities in the market. Corruption is also a major domestic problem that would prove highly toxic to the functioning of a securities market.

As most of you read, the Chinese attempted to distribute new stocks to buyers in Shenzen this summer. About one million citizens stood in line for two days and two nights to try to buy lottery applications that would give the buyer a 1 in 10 chance to actually purchase stock. However, in the past offerings have skyrocketed in value, leading many to believe that stocks were a one way ticket to economic heaven. This rather unusual sales

method was adopted by the Chinese because of a massive imbalance of the demand for stocks over their supply.

Shenzen is the capital of an "enterprize zone" in the south of China just north of Hong Kong. Ten years ago, it had a population of around 40,000 people. Today, well over a million people live there, with gdp growth in the past decade well into the double digits. The two McDonald's franchises appear to be thriving, though they accept at least four different currencies.

In addition to its bustling commercial side, Shenzen is very hot. While all the people were standing in line for two days and nights to buy stocks, it was over 100 degrees and with humidity that even Washingtonians would say was bad. When it was announced that the applications were exhausted, people suspected that corrupt officials had diverted the stock applications and a million people rioted. It is not hard to understand why the mayor of Shenzen has become very interested in securities regulation.

In light of this experience, one might assume that both the public and the officials would have been disenchanted with their experiment with stock markets. Instead, though prices have fallen considerably from their previous highs, individual brokerage volume remained high when I was there, and people line up outside banks and brokerages to place orders. Among

officials, there was not any indication that the new "experiment" with markets would be eliminated, though they were very interested to learn our techniques of regulating offerings and other aspects of the market. Indeed, in only two years more than a million Chinese have purchased shares in the two to three dozen firms that have issued stock.

With a population of over 1 billion people who have a savings rate estimated to exceed 30% per year, and real gdp growth estimated at around 10% annually over the past few years, China seems to be unleashing an enormous surge of entrepreneurial spirit in its people. Though China's people do not yet enjoy political freedom, they do seem to be gaining access to economic freedom at a rather rapid pace.

Obviously I leave the difficult issues of what the foreign policy of the United States should be toward China to others more expert than I in that arena. Nonetheless, as a first-time visitor, I was struck by the winds of economic change that seem to be blowing in China, and what that might mean for U.S. business. In Beijing, which fortunately is very flat, most of the population gets to and fro by bicycle. There are special lanes for bikes, and they pass by the thousands carrying people, animals and freight.

On the streets, you see an interesting collection of motor vehicles. There are 1940 - vintage Russian designed trucks, and an amazing vehicle that looks like my garden tiller with a large flywheel, conveyor belt and a trailer hooked behind. There are also many vehicles that look like some type of utility land rover, conveniently all of which are painted olive green. There were also a collection of buses, and Japanese minivans assembled in China.

In and among these unique vehicles were two vehicles that stood out quite differently. There were a large number of Audi 100s, and to my pleasant surprise there were quite a few Jeep Cherokees on the road. When I saw the first one I pointed it out to my Chinese interpreter and said something like, "Oh look, a Cherokee". He answered sternly, "Oh no, that is a Jee-pu." Having learned what they were called, I soon also learned that these are highly prized vehicles to the Chinese (though I didn't see any Explorers or Blazers, I am sure that they would be equally desirable). My Chinese friend estimated that several million people would like to own one, but with China's population and stage of development they need a couple million of everything.

In considering the challenges that face U.S. businesses, and particularly to the manufacturing sector that we cannot afford to surrender to foreign competitors, "exports" is a topic that is

certainly of concern to many. However, in thinking back to those Audi 100s, I thought of "capital" as a critical element for our future. Of course at the outset, you have to be able to make a Jee-Pu that people want to buy. Hopefully you can also make it efficiently, so that they can afford to buy it at a price that will still generate profits. Maintaining and expanding market share will create voracious demands for capital to support manufacturing, marketing, financing and many other requirements.

For two generations at least, the U.S. has been rather myopic on the question of savings and investment. The Japanese and Germans saved three times as much as Americans, piling up capital so that they can both make and export goods around the world. This accumulation of capital enabled these and other competitors to enjoy a lower cost of capital than U.S. firms, putting us at an enormous competitive disadvantage. In industry after industry, a high cost of capital has priced us out of incremental improvements to technology and hence productivity. It isn't that we don't know how to build things, and it isn't because we are too short term oriented. Rather, this comes about because we do not discipline ourselves to save and invest enough.

In the 1990s, I think that the world capital picture will change significantly. Germany's unification and Japan's securities and real estate disasters have made it very unlikely that those two nations will be capital exporters as they have

been. Look around the globe and you see scores of countries that have been added to the demand side of the world capital market.

In some cases that is because they used to be communist, and just weren't too interested in capital. In some cases it is because the countries used to be bankrupt and were unable to finance. In some countries it is because the companies used to be owned by the state, or local political pressures prevented "foreign" ownership.

Now, a series of changes has made these countries eager to finance in the world market, and most eager to finance in the world's largest stock and bond market in the United States. Indeed, in the three years that I have been Chairman of the SEC, more than 140 foreign companies have conducted public offerings in the U.S. for the first time, and another 120 or more have arranged their first U.S. private placements. Of course if the SEC did not require foreign companies to make the same disclosures to U.S. investors that U.S. issuers must do, there would probably be even more foreign financings than already are taking place.

With demand for capital skyrocketing in Russia, Eastern Europe, Latin America, India and elsewhere, there is a very different picture on the supply side. Deflation in residential real estate in the U.S. and Britain, and property and stock

deflation in Japan, have cut into the "net worth" of savers around the world. Voracious budget deficits in many countries, including the U.S., soak up vast pools of capital that would otherwise be available for private investment. Unfortunately, that debt has a compounding effect, making the situation worse.

Competitively, we may be better off. The days of largely free capital for Japanese firms appear behind us. German companies now have interest costs far above their American rivals. Strong markets have enabled U.S. firms to reduce their aggregate debt/equity ratio almost 20% in the last three years, leading to much lower debt service costs for the future. However, to realize market share gains in new markets around the world, as well as staying competitive here at home, it will require capital, and lots of it. To help put those Jee-Pus on the streets of China, that capital has to be in private hands.

To the degree that capital becomes much tighter in the future than we have come to expect, the U.S. needs to revisit fundamental policies. We have a tax code that penalizes equity investment in favor of debt, that taxes inflation and that taxes receipt of interest on a Treasury and long-term capital gains from an enormously risky investment in a startup business the same. Instead, the tax code should reward savings and promote investment in entrepreneurship. For example, if you can "roll-

over" your gain on a house, so long as you invest it in a more expensive house, why not the same thing for stocks?

We have a government that spends far, far too much, and often it spends its funds on the worst things. Among other things, we have more people writing regulations and deciding how to spend money than we need. For example, the SEC uses 2,500 people to oversee about the same number of regulated entities (with twice the assets) as the federal depository regulatory agencies, yet they employ about 43,000 people. By cutting back on deposit insurance and restoring market disciplines to the banking system, we could get the supervisory job done better, at a fraction of the cost.

Most importantly, though, we need to find ways to stimulate savings and then make sure that those investment dollars find their way into the hands of business -- and particularly small businesses. Three years ago the world banking regulators adopted a system of "risk-based" capital in place of a system that applied the same level of capital to a loan as it did to a government bond. The old system of equal capital rules wasn't complicated, but it also didn't allocate capital away from the business sector. Under the new rules a bank that makes a loan to business must have 8% capital, but putting the depositors money into Treasury securities has a capital charge of zero.

Not surprisingly, since these rules went into place, the loans to businesses have fallen every year. In only three years, commercial loans have fallen around 5% (despite asset growth of around 17%), but government securities holdings of banks have risen over 68%. By placing a heavy capital charge on a loan to business and no charge on a loan to the government, we have twisted the allocational neutrality of the banking system in a way that quite possibly will starve the small business sector for funding for an indefinite period. Larger firms have been able to turn to the public debt markets for financing, but very small companies cannot meet their working capital or expansion needs from securities in most cases. This is another example of a policy that could be altered to produce a flow of capital to the economy, not away from it.

Obviously, most of these tax and budget policies are well beyond the ability of the SEC to alter, and I am sure that most of you are saying "thank goodness" to yourself. I hope that you will forgive me these few specific examples of what is important as a general challenge, which is to find ways to increase the savings of Americans and to reduce the spending of government.

Whoever is the next President will face many challenges in many areas. From a business perspective, we have a chance to take advantage of the preoccupations of some of our major competitors to restore jobs and income to the United States. To

take advantage of our opportunities we will have to be smart, and we will have to work hard. Most importantly, however, we need to roll up our sleeves and get serious about capital formation, in any and every sensible way possible. That capital also needs to find its way into things that enhance productivity, like R&D or plant and equipment, not into legal bills and taxes.

As the country with the world's largest and by far most liquid, innovative and efficient securities market, the U.S. should have a major advantage in facing a period of tightening capital availability. Investors all over the world will be able to be more selective, and that means that the protections offered by U.S. markets and U.S. corporate disclosures may be an increasing advantage. However, we also need to realize that doing the things needed to put those Jee-Pus on streets around the world won't come cheap, and if we fumble the ball on capital formation those customers just might settle for the Audis, with financing of course.