# THE STOCK EXCHANGES OF THE WORLD: THEIR ROLE AND THEIR RELATIONS IN THE FUTURE

Notes for a speech by
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to the

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Ladies and Gentlemen,

I would first like to thank you sincerely for your invitation to participate in this first international conference organized by the National Security Traders Association. I must admit that it was with great satisfaction that I accepted to join the prestigious speakers during these three days. For the institution which I direct, the Montreal Stock Exchange, my presence here today is an additional sign of encouragement and recognition of which I am particularly proud.

Although I have been invited to speak of the future and particularly the future of our stock exchanges and their relations, I feel that we cannot ignore the profound changes which have taken place within our industry during the last few years. Indeed, we cannot seriously look at the years ahead without taking the time to analyse the present situation and to study the major trends which have affected our exchanges since the beginning of the decade.

THE PRINCIPAL CHANGES OF THE EIGHTIES

The first of these major trends I feel, is the discovery of the stock market as a tool for investment and economic growth by an ever increasing portion of individuals and companies alike.

One need only consider the recent abundance of periodicals dedicated to economic and financial questions in order to be convinced that our thinking has evolved rapidly, and that the stock portfolio has, for many of us, replaced more traditional investments. In Québec, the result has been the quadrupling in one decade of the percentage of Quebecers holding stocks, to a level of 17% of the population. The increase in the volume of transactions on the floor of the Montreal Exchange, has been even more remarkable; in barely five years, trading has increased tenfold, to more than $22 billion at the end of 1987. This makes the Montreal stock exchange the tenth largest in the world.

Of course businesses have profited handsomely from our citizens' new interest. The clear lesson of the 1982 recession and its accompanying exorbitant interest rates was the grave consequences of business under-capitalization. Since then, methods of financing have changed radically. We must also remember that personal enrichment has risen considerably since the beginning of the decade. It was essentially through equity and not debt, therefore, that companies financed their impressive growth during the last five years. Today, with an improved capital structure, these companies are much better prepared to face the hazards of variations in the economy. They can now look ahead with confidence in this new era of dynamic entrepreneurship which is now deeply rooted in Canada and in Québec.

Many governments have also benefitted handsomely from this opening of stock markets. Indeed, it has enabled them to proceed with ambitious programs of privatisation of state-owned corporations. In turn, these privatisation policies have directly contributed to the rise of our exchanges by allowing a number of small savers to discover the secrets of stock investment.

This brings me to the second major trend we have witnessed in the past few years; I am referring to the globalization of economies. This was first manifested by a veritable explosion of international trade. Since 1950, international trade of manufactured products increased fifteenfold, or four times the increase of global income during the same period.

For their part, financial markets not only followed this globalization movement, but accentuated it as well. Indeed, for every $1 of merchandise traded in the world, there are $40 circulating in financial markets. I need not explain therefore, that if money were originally created to facilitate trade, it has now gone far beyond that role. Since stock exchanges, as intersections, play an increasingly important role in financial markets, it is not surprising that the internationalization movement has somewhat modified their habits already.

At the Montreal stock exchange we have determinedly taken this international turn. Since limiting ourselves to a role as a regional stock exchange was out of the question, we had to widen our horizons to the entire planet. It is for this reason that we have established, in collaboration with the stock exchanges of Amsterdam, Sydney and Vancouver, an international options market operating nearly twenty four hours a day. In this respect, we have been at the forefront of the internationalization movement, because it was in 1982 that the embryo of this network was created, beginning with a link between Montreal and Amsterdam.

We have also reinforced our relations with other North American exchanges. Indeed, we have put in place a novel electronic link with the Boston stock exchange, which allows Montreal brokers to trade American stocks directly from Montreal. And we are working right now on a reciprocal Boston-Montreal link, through which investors in your country can directly trade the stocks listed on our exchange.

In Montreal, internationalization is expressed in other ways as well. I can mention the many foreign brokerage firms, especially American, who are now full members of our exchange. There is also our international division whose mandate is to facilitate the listing of foreign stocks in Montreal by reducing the bureaucracy to a strict minimum for large multinationals already listed on exchanges in countries like France, Switzerland, Great Britain or the U.S.. In short, I can assure you that no effort has been spared at the Montreal Stock Exchange to get on the internationalization train which ran right outside of our door.

Technological innovations represent the third major trend to have transformed our recent past. The increasingly massive introduction of computers on exchange floors is perhaps what has most deeply modified the daily work of professional negotiators. Essentially, I think that we can group stock exchanges into two categories, depending on the applications they have made, or are in the process of making, with these new technologies:

- In the first category, there are those which began replacing traditional floor trading by a system of electronic links between brokerage houses. The best-known example of such a scheme is surely the London Stock Exchange. This is true because as you know, the Big Bang in October 1986 did not only signify the opening of British financial markets to foreign institutions. It also consisted of a considerable modernization of the London trading floor, which has essentially been replaced by a huge computer.

- The second group consists of exchanges which have chosen to limit computing to a role of support for professional negotiators. And since we definitely attach a priority of man over machine, you will understand that we, at the Montreal Stock Exchange, find ourselves resolutely in this second category. The system we installed five years ago and which we have continued to perfect ever since, gives our specialists greater availability to complete their duties. Since the beginning of this year, orders of fewer than 2000 shares are conveyed and processed automatically, bypassing the trading floor, which considerably reduces the administrative work of our specialists. In addition, the system continues to be perfected, and by years’ end, our specialists will have at their disposal a sophisticated decision-support system which will greatly facilitate the opening process of the market, notably by suggesting opening prices and allowing for sensitivity analysis.

Finally, the fourth trend I wish to underline, are the winds of deregulation which have blown on a large number of financial arenas in the world. After London and its Big Bang of October 1986 which was undoubtedly the most resounding of all, countries like France, West Germany or Canada followed the trend with more or less intensity. In your country, although Glass-Steagall still exists, deregulation is around the corner since, to my knowledge, it is now being discussed in the Senate. In Canada deregulation means two things:

- firstly, that all Canadian financial institutions can acquire control and ownership of a brokerage firm;

- secondly, that foreign institutions can also proceed with such acquisitions.

In reality, I won't deny that after one year, it is mostly the first avenue which has been chosen. With the exception of one major transaction involving an American financial institution - Security Pacific of Los Angeles and Burns Fry - the model most often followed is that of acquiring brokerage houses by large Canadian banks. In fact, our large banks have become important players in the area of stock trading. They are now members of our exchanges, either through their discount brokerage subsidiaries, or through recently acquired firms. The consequence of this important strategic shift will be felt only several years from now. The inherent culture in banking characterised by prudence and long-term vision, will progressively make a mark on our habits, which will not be without effect on practices in our industry.

In summary, this is the environment in which our stock exchanges are evolving today. If you will, I would now like to move on to the heart of my subject today by turning to the future. At first, we must reflect a few moments on our short-term future, the one in which we will be operating as we approach the 1990s.

## THE NEAR-TERM FUTURE: THE PASSAGE TO THE 1990's

For the next few years, I personally feel that we should not expect many great surprises. The major upheavals which I have just mentioned will of course continue to progressively change the international financial setting. I don't see any major shocks in the short-term, essentially for three reasons:

- Firstly, because of the intense activity which we have witnessed for several years now. I certainly would not have spent the last few minutes reminding you of the upheavals of the eighties if they had not effectively constituted a veritable revolution for stock exchanges around the world. But, as you know, revolutions have a common characteristic: they are generally of short duration and are followed by long "digestive" periods which enable all to settle in the new situation.

- The second reason I do not expect any major shocks in the near term is because of a new political trend that we find in almost all continents, and which I could qualify as the "death of ideologies". I assure you, I have no intention of elaborating on Soviet "perestroïka" which the media around the world have praised for several months now. Without going quite so far, however, we need only notice that political issues prevail today in most European or North American countries have lost a large part of their ideological content. After an extremely favorable period for State intervention which lasted through the seventies, the eighties have been characterised more by massive privatisation and deregulation. Today, after several painful experiences during one or the other of these periods, we all realize that the road to success lies instead in the middle lane, where tumultuous surprises can be avoided while ensuring the necessary cohabitation of the private and public sectors.

- The third reason explaining this temporary pause I feel, is of course the drastic stock market correction of last October. What we lived through during the months following the crash of October 19th, was a long period of uncertainty which for all practical purposes froze the new stock trading habits of individual investors. In the context of extreme caution in which we find ourselves today, there is certainly no room for new upheavals. Instead, a long and progressive phase of reconstruction awaits us in the near future. I must add that observers of all sorts have not really helped us in bringing calm and serenity back to the markets. While drawing a somewhat shaky parallel between 1987 and 1929, they were able to scare everyone and convince investors to flee the stock market as quickly as possible.

I would like to expand briefly on this last point. Although I am aware that the first role of journalists is to inform the public, I feel that with respect to the stock market's evolution these past few months, there was a net tendency for many toward sensationalism rather than objectivity. In their defense, I will admit that there were effectively several economic indicators which seemed to fit a pessimistic outlook:

- First, the period of economic expansion which began in 1982 was already in its sixth year. Because we know that economic cycles consist on average of a fifty month expansion followed by an eleven month recession, there were genuine grounds for concern;

- Secondly, because the size of Black Monday's decline was comparable to Black Friday's in 1929, ardent pessimists interpreted this as the usual prelude to an economic recession. In fact, by tracing a parallel with 1929, we could not really speak of a recession but instead of a descent into hell.

- Thirdly, there were large grey clouds above Western economies. I am referring especially to the budget and trade deficits of the American economy, which seemed to compromise the chances for future growth in that country.

- Finally, for all these issues, I must add the non-negligible role of those observers who publicly displayed the greatest pessimism. Unfortunately, by yelling openly that a crisis was coming, there was a risk of modifying the conduct of economic agents and of increasing the probabilities of a recession by creating a self-fulfilling prophecy. But what do you expect, I feel sometimes that economic analysis is like the movies; it is much easier to make people cry than it is to make them laugh…

Despite all these factors, I am pleased to see that more than nine months after the October crash, the pessimists were wrong. Not only did the great recession they promised not take place, but we are now predicting a continuation of global economic growth. They had indeed forgotten that in economic matters, history never repeats itself exactly the same way. They had also neglected the impact of automatic stabilizers, those compensatory mechanisms which, when the dollar had depreciated enough with respect to other currencies, allowed for the American trade balance to recover.

My point having been made, let us now look at what the role of the stock market community should be during the next few months or years. I think we first have the duty to reestablish confidence among our investing clients. And you all know that this task will be long and hard. After having falsely imagined the stock market as a miraculous lottery where one wins with every try, investors today have lost their profound faith in the market. The lengthy task we must therefore undertake or continue is one of informing investors. We must capitalize on all audiences offered to us to downplay the dramatization of the present situation and to explain the reasons for hope.

By simply observing the current economic climate, most should be convinced of the health of the global economic system. Low inflation, vigorous trade, sustained economic growth- are these not grounds for frank optimism? As for the value of stocks, today's price/earnings ratios are extremely reasonable. In Canada, for example, stocks are presently being traded at multiples in the range of twelve times earnings, which is certainly indicative of more than just one bargain on the market. It is also surprising to note that, despite such multiples, investors are unhappy with stocks today, while less than a year ago, they were feverishly buying up stocks typically trading at twenty-two times earnings.

To illustrate the informative work we must undertake, I wish to describe the strategy which was devised at the Montreal Stock Exchange in order to defend the Quebec Stock Savings Plan. This is a program which provides fiscal advantages to investors who purchase certain categories of stock in Quebec companies, mostly developing companies. The plan has been in existence for ten years, and it has greatly contributed to improving the capital structure of our companies; it has also introduced many citizens to the stock market. Despite this success, the Quebec Stock Savings Plan was criticized on many fronts following the October crash. All sorts of faults were attributed to it, and investors were advised to avoid at all costs the stocks listed through the plan, allegedly synonymous with poor investments and lost capital.

In this context the Montreal Stock Exchange sponsored a study by an independent firm, which thoroughly documented the characteristics and performance of the Quebec Stock Savings Plan stocks. The study concluded that because of their weak capitalization, these stocks were more volatile than the market, increasing more during expansionary periods but also falling more during market corrections. Although such movement is perfectly understandable for stocks with low capitalization, there was unfortunately nobody before us to point that out. The results of the study were widely publicized, and I can assure you that people adopted a more objective attitude toward the plan. Our objective of