POLICY BRIEF
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THIS TIME IS NOT DIFFERENT: BLAMING SHORT SELLERS

KEY POINTS

- Short-selling bans invariably fail to accomplish their stated objectives to prevent price declines and distort equity market pricing.
- Policy makers need to be clear and transparent about the economic arguments behind any desire to impose a ban on short selling.
- Short-selling bans may be effective under certain circumstances, but only if policy makers around the world cooperate through fora such as the G20 and the Financial Stability Board.

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Reinhart and Rogoff's timely volume, *This Time Is Different: Eight Centuries of Financial Folly* (2009), makes it abundantly clear that financial crises are protracted affairs. The title of this policy brief highlights the irony of lessons never learned. History, in the form of recurring economic crises, does indeed repeat itself. Nevertheless, a closer look at Reinhart and Rogoff's often-publicized conclusion reveals that there are remarkable variations across individual countries' experiences, as well as across time. For example, the actual severity of crises can be exacerbated when a banking crisis is accompanied by a currency crisis. Most importantly, the severity of the recession that typically accompanies all types of financial crises is often determined by the response of policy makers.

Interestingly, Reinhart and Rogoff do not cite the work of Hyman Minsky (1986a),[1] the late author who promoted the idea that financial systems are

1 Reinhart and Rogoff also ignore the contribution of exchange rate regimes in creating conditions favourable to economic crises. Indeed, the mantra among policy makers in Canada has always been that a floating exchange rate regime does a good job of insulating the domestic economy against foreign shocks. This view is supported by empirical evidence — see, for example, Choudhri and Kochin (1980) and Murray, Schembri and St. Amant (2003) — though some reservations have begun to surface at the Bank of Canada (Murray, 2011).

GLOBAL ECONOMY PROGRAM OVERVIEW

Addressing the need for sustainable and balanced economic growth, the Global Economy program is a central area of CIGI expertise. Its importance was heightened by the global financial crisis at the end of the last decade, which gave impetus to the formation of the G20 leaders' summits — a development for which CIGI experts had advocated.

The Global Economy area includes macroeconomic regulation (such as fiscal, monetary and exchange rate policies), financial regulation (such as requirements on capitalization of banks) and trade policy. We live in an increasingly interdependent world, where rapid change in one nation's economic system may affect many nations. CIGI believes improved governance of the global economy can increase prosperity for all humankind.

PROGRAM LEADER

James A. Haley, Director, Global Economy

inherently unstable, with episodes of stability encouraging excessive risk taking that presage the next bout of unstable economic outcomes. Because Minsky's work has only recently been re-discovered, policy makers do not seem to "...recognize that intervention and regulation are needed to generate a reasonable path of development of our inherently unstable world economy" (Minsky, 1986b: 15).

There appears, however, to be a remarkable exception to this rule. Time and time again, financial crises prompt policy makers to impose restrictions on the ability of stock market participants to short sell equities. Since what happens in equity markets is often a trigger for financial crises, or accompanies them, it is worth considering why policy makers consistently react the same way when these crises occur and whether their response is the correct one. Remarkably, the repeated imposition of such restrictions seems to fly in the face of considerable academic evidence, which suggests that these restrictions range from ineffectual to downright damaging, as hampering the inability of investors to act according to their own judgment distorts the operations of equity markets. Why then, if the evidence appears so conclusive, do policy makers keep repeating the same mistake? Is there some deep-seated fear that failure to act when a financial crisis looms will lead to an even larger collapse in stock prices?

This brief draws attention to the role that fear of a stampede plays in precipitating the next stock market crash, prompting policy makers to impose short-selling restrictions despite evidence to the contrary — namely, that such fears are misplaced because the evidence in their favour is weak to non-existent. Indeed, the dominant position that institutional investors play in today's equity markets actually reinforces the case against short-selling restrictions. This is, in part, because

the fear of performing worse than their peers leads to the overpricing of stocks. Rather than supporting the notion that there exists wisdom in crowds, the resulting herd-like mentality effectively points to a bias towards avoiding the next stock market rally instead of pricing stocks according to their fundamentals.[2] Whether there is evidence of herding, particularly in the throes of a financial crisis, is an open question this brief returns to below. Regardless, policies should be geared to ensuring that adequate price discovery takes place, and that the misaligned incentives of professional investors are rooted out.

SHORT SELLING AND ITS CRITICS: A BRIEF HISTORY

Short selling is the gamble taken by investors who profit from an anticipated decrease in the price of a stock. Put differently, short sellers exploit the over-optimism and, in some cases, the exuberance of investors who drive equity prices far in excess of their fundamental value. Typically, this is accomplished by simultaneously repurchasing a stock in the future at a lower price than it is trading at today in the spot market.[3] This kind of transaction is possible because, while some investors gamble that future prices will fall, others are equally convinced that prices will rise.[4] Across market participants, differences in views about the future imply that a market will exist where investors can trade securities on the basis of asymmetric expectations about the future outlook for a stock.

Since equities have also long been thought to contain information about the future performance of the firm whose stock is being traded or, more generally, future aggregate economic outcomes, the ability to engage in short selling is viewed as essential to the smooth operation of a financial system. Richard Whitney, president of the New York Stock Exchange in the early 1930s, when the memory of the stock market crash of 1929 was fresh in the minds of the public, described short selling as an activity that "…smooths the waves but never affects

2 Keynes (1973) argued that herd-like behaviour among institutional investors was the norm: "Worldly wisdom teaches us that it is better for reputation to fail conventionally than to succeed unconventionally" (158).

3 This assumes that the stock in question is owned or has been borrowed by the short seller. It is also possible to engage in this kind of activity without actually owning the security in question, in which case this kind of activity is called "naked" short selling. A broker, who collects a fee, is typically required to carry out the transaction.

4 The short seller can return the share to the lender any time until the expiry of the "loan." In the European context, the option, if it exists, can only be exercised at maturity.

the tide" (Sloan, 2010: 75). This quote leads to the conclusion, now supported by academic evidence, that short selling ensures the liquidity of equity markets but does not, by itself, sow the seeds of a stock market crash. At least since the Dutch "tulip mania" episode of the seventeenth century (Garber, 2001), when the market for tulip bulbs collapsed after experiencing price increases that constituted the archetypical example of a "bubble," politicians have imposed restrictions on the contractual obligations of buyers versus sellers, effectively creating a market for options contracts. Politicians have always sought to deflect the public's fears concerning the consequences of declining markets, by labelling short sellers as speculators who precipitate stock market collapses. In the twentieth century, perhaps the most famous manifestation of this took place during the Great Depression, when US President Herbert Hoover helped launch a campaign against the practice of short selling by declaring, "I want the shorts investigated…and the quicker the better" (Perino 2010: 47). At the time, there were numerous reports of short sellers circulating false rumours in an attempt to manipulate equity markets, to ensure they were on the right side of their bets that stock prices would fall. Since the belief was that short sellers, as a group, encouraged conspiracies that would drive stock market prices down, they were known as "bear pools."

In the aftermath of the Great Depression, regulations were enacted aimed at limiting the perceived threat to equity market stability by short sellers, such as the uptick and downtick rules that persist in various forms to this day.[5] Although today fears of the consequences of short selling no longer rely on the conspiracy theories

5 The typical uptick rule limits price declines by preventing short sales at prices lower than the last sale price. The downtick rule gives purchasers of a stock the opportunity to sell their securities before investors who borrow shares can sell them short.

that held sway during the 1930s, they now rest on concerns that equity markets will become unhinged in some fashion, as short sellers, possibly based on non-fundamental worries over future economic prospects, flock to make bets that future stock prices can only be headed in a downward direction. The other notable change since the stock market crash of the 1930s has been the growth to prominence, if not dominance, of institutional investors, including hedge funds, a group which regularly engages in the practice of short selling.[6]

Even if the source of policy makers' reactions to crises associated with downturns in equity prices has changed, the outcome is predictably the same. The mere hint of a destabilizing downturn in stock prices prompts authorities to impose a short-selling ban. In contrast, the vast empirical and theoretical literature on the subject concludes, rather decisively, that short-selling bans lead to a deterioration in market liquidity and efficiency. This is not to say that there is unanimous agreement on these findings. For example, as noted above, since short-selling bans tend to be imposed around the time of stock market booms or bubbles, a short-selling ban could actually give the impression that a crash may have been prevented. Again, however, the theoretical and empirical studies, and even numerous government investigations over the decades, have rejected this conclusion. Assuming that short sellers are relatively more informed investors, their retreat, in particular, from the market would actually hinder the price discovery that is essential for a properly functioning stock market.[7] Another difficulty (discussed in the following section) is that short-selling bans are typically in place for short periods of time.[8]

THE GLOBAL FINANCIAL CRISIS AND SHORT-SELLING BANS

Bris, Goetzmann and Zhu (2007) reviewed the evidence on the impact of short-selling bans in 46 countries around the world, primarily during the 1990s, and conclude that market liquidity and price discovery are both negatively affected by the imposition of such restrictions. Beber and Pagano (2012) provide the most recent post-mortem on short selling bans for 20 countries, where restrictions were imposed in the aftermath of the 2007–2009 "global" financial crisis.[9] Interestingly, the latest episode of bans was restricted to countries in the industrial world, especially in Europe. Indeed, the bans — typically short-lived in countries such as Canada, Switzerland, the United States and the United Kingdom — were in place for nearly a year in much of Europe (for example, from September 2008 to June 2009). In fact, in the wake of the ongoing sovereign debt crisis, several

6 For example, see Bohl, Klein and Siklos (2011), and references therein.

7 Price discovery is the process by which buyers and sellers rely on available information to set prices at which transactions take place. If certain groups of potential buyers or sellers are prevented from transacting in the market place, this is said to impede price discovery. There is no recent academic survey of the literature on short-selling restrictions. Bris, Goetzmann and Zhu (2007), however, provide many of the most important references on the topic, while Gruenwald, Wagner and Weber (2010) provide a descriptive and legalistic account of short-selling bans imposed around the world since the 2008 financial crisis. See also the following section.

8 An interesting exception is Taiwan, where a short-selling ban was in place for many years. Bohl, Essid and Siklos (forthcoming 2012) conclude that the bans have negative consequences for the volatility of stock returns and do not prevent stock market collapses during recessions, while impeding stock price increases during economic recoveries.

9 Bans typically apply to all stocks or to a selection of stocks (for example, banks and financial institutions) that are thought to be more likely to be the target of short sellers.

European countries, notably Germany, re-introduced a short-selling ban in August 2011. Even if one is not entirely convinced that short-selling bans are harmful to equity markets, one has to wonder, given the timing of the bans, whether institutional investors were the "canary in the mineshaft" (Bolton, 2009) that presaged subsequent financial crises. Perhaps more striking is that the earlier conclusions reached by Bris, Goetzmann and Zhu (2007) did not change — short-selling bans reduce market liquidity and hinder price discovery. Finally, Bohl, Klein and Siklos (2011) investigated short-selling bans in six stock markets during the financial crisis of 2008-2009, focusing on the possibility that, since it is institutional investors who overwhelmingly engage in the practice of short selling, a ban might create herding-type behaviour among these sophisticated investors. The study concludes that while there is no evidence of herding as a result of the imposition of restrictions on short sales, there is some evidence of adverse herding. This means that the dispersion of returns around the market increases in the presence of these bans. If this is interpreted as a reflection of greater uncertainty in stock markets, then short-selling bans pose an even greater hindrance on the smooth functioning of equity markets.

CONCLUSIONS AND POLICY OPTIONS

The evidence against resorting to a ban on short sales appears overwhelming. Indeed, in spite of former regulators acknowledging that the costs of such restrictions appear to outweigh the benefits, there is little evidence that policy makers will eschew the practice the next time there is a hint of a large decline in equity prices. What then can be done to convince policy makers of the strength of the academic research against short-selling bans? What are the policy options?

First and foremost, the "politics" of the imposition of short-selling bans must be removed as a first-resort policy option. Officials should be required to explain why, in light of conclusive academic research, they continue to rely on the unjustified fears of a downward spiral in equity prices to impose such bans. Second, to the extent that the academic research has failed to identify the "black swan" lurking in the shadows, emerging if a ban that might have been effective was not enacted, regulators may apply some useful lessons from monetary policy. In particular, monetary policy in much of the industrial world became more successful when policy makers were both more forward looking and transparent as to their motives. In the present case, this

would imply that regulators undertake not to impose bans, even when there are fears of significant equity price declines, but reserve the right to a pre-emptive strike if there is convincing evidence, transparently and effectively communicated to the market, that conditions will become destabilized if they do not act. In other words, the policy ought to be that short-selling bans are to be introduced only as a last resort. Finally, given the evidence that equity markets around the world appear to move more or less in tandem, even if fundamentals cannot explain the rising correlations in stock returns,[10] efforts (underway since the beginning of the financial crisis) at coordinating financial regulation on a global scale undertaken by the G20 and the Financial Stability Board should be applied when considering at what time and what type of short-selling bans are permitted.

10 For example, see Burdekin and Siklos (forthcoming 2012), who investigate the possibility that there are contagion-type effects between equity markets in China and the Asia-Pacific region and the US equity market, in spite of the legal and other restrictions preventing the easy movement of funds between these markets.

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CIGI was founded in 2001 by Jim Balsillie, then co-CEO of Research In Motion, and collaborates with and gratefully acknowledges support from a number of strategic partners, in particular the Government of Canada and the Government of Ontario.

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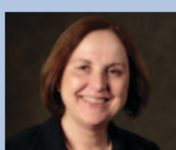

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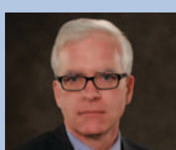

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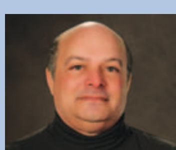

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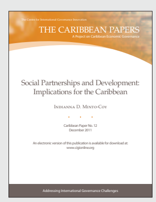

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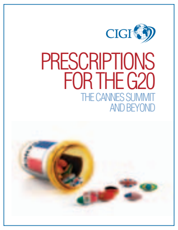

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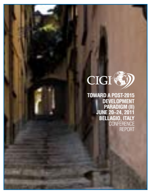

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