



REBUILDING THE FINANCIAL SYSTEM IN ORDER TO KICK-START THE ECONOMY

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For a long time, finance used to be subordinate to economic activity. In the past twenty years or so, this subordination has been reversed. The crisis we are now going through initially affected the financial sector before spreading to all parts of the economy. Today, we have to tackle the most urgent problems first: the collapse of world economic activity, the rise in unemployment, the risk of protectionism and the threat of social tensions are calling for vigorous policies. The financial crisis has by no means been settled, however. As long as it lasts, the economy will not re-start. Reviving it implies a rebuilding of the financial sector and for that it is necessary to re-establish confidence between the economic players and the financial markets.

This confidence is currently disappearing at a rapid rate, giving way to mistrust and fear. The paralysis engendered in this way means that those with the resources to invest, to purchase and to make the industrial bets needed for tomorrow are doing none of these things and the economy is therefore immobilised.

At the forthcoming G20 summit meeting to be held in London on 2 April, certain crucial decisions may be taken to reverse this cycle of mistrust and change the rules that have led to the catastrophe (how could anyone imagine that the same rules that brought us into the crisis could get us out of it?).

Also, it may help us return to a normal state of affairs in which finance is just a useful, albeit imperfect, stimulant for the economy.

To this end, the Institut Montaigne is proposing four concrete lines for immediate action:

- 1. a suspension of the market rules and practices that are currently the most destabilising;**
- 2. organisation of traceability for financial products;**
- 3. a coordinated programme of temporary bank nationalisations in the G20 countries as a prelude to a separation of commercial banks, on the one hand, from so-called investment banks, on the other;**
- 4. the creation of new instruments to ensure the lasting financing of sovereign states, which is currently in danger.**

Looking beyond these most urgent priorities, the Institut Montaigne, on its Internet site, sets out in detail certain technical proposals aimed at rebuilding the financial system on more solid foundations and at achieving a more permanent economic growth dynamic* .

First things first: get the priorities right

The lessons of the 1929 and 1989 crises

It has become clear that the 1929 crisis in the United States and the crisis of the end-1980s in Japan were aggravated by the absence of immediate public intervention. In 2009, remembering these past experiences, the authorities intervened immediately and on a massive scale - perhaps too massive.

This is one paradox of the present crisis. Everywhere in the world intense efforts are being made to cope with an excess of debt (both public and

* These more detailed proposals will be found on the French version of the website only.

private) by contracting additional (public) debt. The bill for the "stimulus packages", or rather the rescuing of Asian, American and European economies, is going to exceed several thousand billion dollars. But this money does not exist. The result will therefore be an addition to these economies' existing debts. It is future generations that will have to cope with this heavy legacy (through taxation, inflation or both).

Rewarding the bad pupils?

Another surprising feature is that the industries suffering most in the present crisis (banks and automobiles, in particular) are the first to benefit from public aid. There is a risk that the notion of a "reward for being a bad pupil" will take root in people's minds. Meanwhile, **the creators of wealth and future jobs, in other words healthy firms operating in the sectors of the future, feel they have been neglected.**

Since the first G20 meeting in Washington on 15 November 2008, it is as if the need has been to prolong, at any cost, a world economic system that had lived its time, kept alive artificially for several decades by excessive borrowing and structural imbalances.

What is to be done? Three lines of action but a single philosophy

The 2 April G20 meeting will not be able to sort out in a single day the problems and the dysfunctioning that have been building up for at least a generation.

The first imperative for the G20 will no doubt be **to rid itself of any ideological prejudice** liable to pollute or divert public action. For example, the idea of bank nationalisations must not be seen as a heresy but as a temporary and pragmatic technical measure. Similarly, the idea that a firm should be allowed to go bankrupt must not be seen as the end of the world, however important that firm may be.

Take the traditional automobile industry: a process of debt clean-up followed by a re-commissioning of manufacturing capacity on a completely new basis would make it possible to improve the allocation of capital to this refreshed industry and at the same time to other more promising industries (operating in the "green" economy,

renewable energy or biotech sectors).

Along the same lines, the major countries seem to be applying the bulk of their efforts to today's workers and jobseekers rather than to future jobs and the younger generations. Clearly, the former cannot be abandoned, but the latter must also be the subject of attention. This implies, for instance, adopting plans to save over-indebted households (debt rescheduling).

Second imperative: give precedence to investment in the future economy rather than subsidising that of the past. **Giving priority to the insertion in working life of younger generations** lacking both jobs and capital, rather than to preserving the "acquired social benefits" of their elders could be a major objective of a G20 anxious to restore the conditions for economic growth and social stability.

Third imperative: "First things first", as Franklin D. Roosevelt said in April 1933: start with the priorities and the most urgent needs. Today, "the house is ablaze". This is not the time to rewrite the instruction manual for capitalism or to daydream of a new world no longer driven by the quest for individual gain. Extinguishing the fire is a priority, by putting an end to market practices that are now adding fuel to it.

Proposal 1: Suspend the market practices that are currently aggravating the crisis

Let us take inspiration from the precedent of the "bank holiday" which President Roosevelt declared immediately after his investiture in 1933 and which made it possible to reshape the American banking landscape and restore confidence. On these same lines, but in the context of markets that are both worldwide and much more complex than the American banking industry of the 1930s, we recommend that, for a period to be defined, the major governments order the suspension of the norms, activities and practices that are aggravating the current crisis.

Which market practices should be suspended?

The following graph shows the movement in the Chicago Board Options Exchange Volatility Index (VIX) - also nicknamed the "Fear Index" - measuring the implicit volatility of the American equity market. The more frightened and bewildered the market operators, the higher the index. It turns out that they have never been as panicky as today (see graph). This being so, why continue to rely on the signals sent out by such a market? Would anyone entrust his health to a feverish and disoriented doctor?

While it is impossible and dangerous (for liquidity reasons) to suspend quotations in financial centres throughout the world, it is, on the other hand, necessary to deactivate the vectors propagating the present crisis on the markets. We identify four of these vectors here:

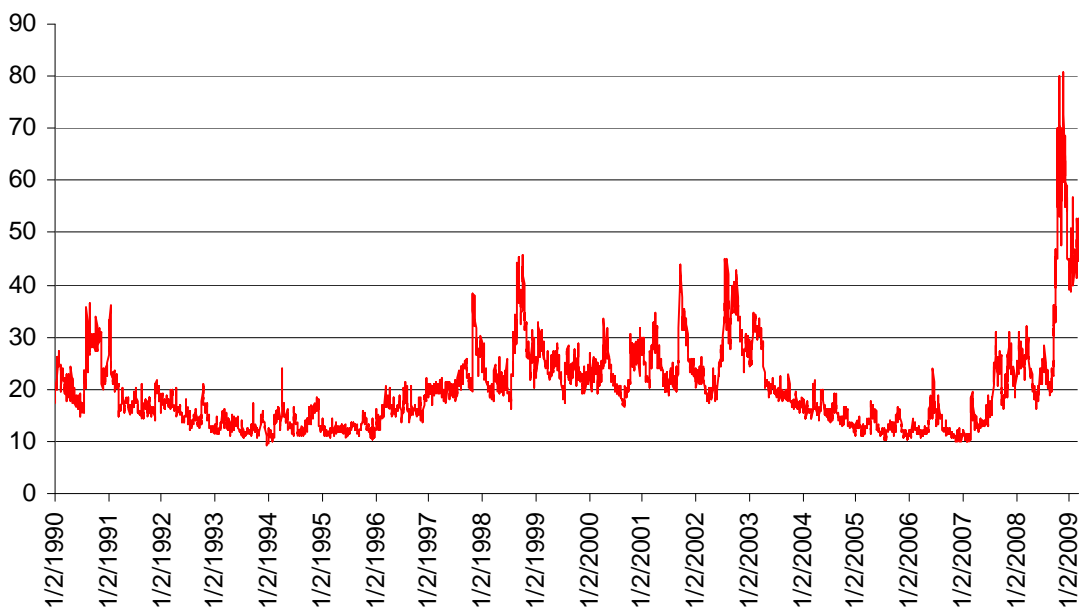
“Mark to market”

Let us take the stock market for what it really is: a place for the exchange of securities between buyers and sellers. It is evident that, for listed firms, the trading of a few shares provides no real indication of the value of the firm. This is proved by the fact that takeovers of firms are never carried out at market prices, but at prices 20, 30 or 50% higher. And yet the principal holders of financial assets are obliged to price them "at market value". This means that a long-term holder of an asset has to use the latest quotation in valuing it, even though he has not the slightest intention of selling. The result is unequivocal: institutions are obliged to make very significant provisioning for assets they nevertheless intend to retain but which are being priced at a discount as a result of a temporary bout of market depression. This forces institutions to recapitalise at the worst possible moment, even to close or to be bailed out by governments -- for no serious economic reason.

- **Recommendation:** during the "market holiday", when new accounting rules and new prudential ratio norms are being defined by governments and approved by the private players, we recommend the total suspension of the use of "mark to market" by all holders of financial assets making calls on public savings. Two alternative methods might be brought into use: "mark-to-model" (accompanied by a detailed explanation of the assumptions underlying the valuation) and

accounting based on purchase cost, amortised over time. One of the objectives of the work of experts and governments aimed at a complete overhaul of accounting norms (ideally, harmonised at world level) will be to create norms that reduce the amplitude of variations in corporate balance sheets and encourage long-term financial investment. For this purpose, the Institut Montaigne is proposing new accounting methods, including valuation by "sliding windows" (for details see the website).

THE VIX MARKET INDEX (THE “FEAR INDEX”) BETWEEN 1.3 AND 2 TIMES ITS POST-9/11 LEVEL



Source: Bloomberg

The lending of anonymous securities facilitating short selling and taking of control

Remunerating the destruction of capital is an aberration and is suicidal for any operator in a market economy. And yet numerous voices are being raised in favour of maintaining such a practice, known as "short selling" (i.e., the sale at some future date of a product that one does not hold, expecting to realise a profit from its depreciation in the meantime). These voices stress the important role of the practice in accelerating and achieving the setting of a price for any financial asset, or in hedging against a net

exposure risk. It is in fact not easy to adopt solutions that are too radical: suddenly placing a ban on short selling at time T would have cataclysmic consequences for the major players on the financial markets, who would find themselves instantly "over-exposed" to net risks they would no longer be able to cover. Lastly, it is necessary to separate the "toxic" derivative products with purely speculative aims from derivatives that are vital for our economies (exchange-rate hedging, forward contracts for commodities, insurance policies, etc.). While accepting these arguments, we recommend the gradual elimination of the more speculative short-selling mechanisms, as follows:

- **Recommendation:** institutions that have lent securities to third parties (in particular, banks, pension funds or insurance companies to hedge funds) will be under an obligation to reveal publicly these loans of securities by the end of the "market holiday" at the latest. Similarly, institutions that have lent money to increase the leverage of the most aggressive operators on the market (hedge funds, traders operating with the capital of banking institutions, etc.) will have to declare and precisely identify these loans at the end of the "market holiday". Loans of securities making it possible to take temporary control of a General Assembly of shareholders will also be subjected to strict rules in order to avoid the practices seen recently in which the managements and hence the strategies of companies have joined the list of subjects of speculation. This measure anticipates the embarrassment of certain institutions, obliged to reveal that they have improved their income statements by permitting hedge funds to carry out short sales of blue chips or to exert dangerous pressure on sovereign bonds. This obligation to publish, spread over several weeks, should make it possible to limit the role of short selling strictly to one of hedging and not destabilisation.

The activities of the rating agencies

Traders' blind confidence in the rating agencies is not unrelated to the present crisis. Against expectations, the system is continuing to function almost as before. The agencies themselves, certainly driven by a concern to "do right" and to ensure that their past errors are forgotten, are today overdoing things, trying to "make up

for the past" by increasing the number of downgradings and issuing noisy public warnings (part of their marketing strategy) of forthcoming downgradings. In a particularly nervous market that is deprived of benchmarks, these public statements are devastating.

- **Recommendation:** the G20 should, as a matter of urgency, address itself to the entirety of the economic model of rating agencies in order to:
 - promote multiplicity of sources of information (intensification of competition through an increase in the number of agencies),
 - impose transparency regarding rating methods (professionalism, training of those doing the rating),
 - propose a reorganisation of the modalities of rating, given that a single agency cannot, with the same professionalism, assess governments, firms and speculative products,
 - incite operators not to put their trust blindly in the agencies by obliging them to make public their automatic passive management mechanisms.

The Institut Montaigne sets out in detail on its website some of these proposals aimed at providing a better base for the future activity and legitimacy of the rating agencies.

The banks' capitalisation ratios and the insurers' solvency ratios

There is a dangerous paradox here. Just when the economic and financial environment is deteriorating, the market seems to be requiring capitalisation and solvency ratios (equity in relation to assets held) higher than those it demanded in prosperous times. These ratios represent the ultimate security for an investor. In a way, they are the *sine qua non* conditions for the return of confidence in financial institutions. What is needed here is reasoning similar to that of an administrator of a company in distress. He has to propose a recovery plan that, temporarily, makes it possible to adopt more flexible rules in order to revive activity. Conversely, demanding increased guarantees in the midst of a systemic crisis can, paradoxically, precipitate catastrophe.

- **Recommendation:** while waiting for the banks and insurance companies, possibly assisted by various committees of experts (notably in the BIS), to propose new capitalisation rules to governments, the "market holiday" will make it possible to suspend these rules. This suspension will have two objectives:
 - stem the current tendency in which banks and insurance companies seem obliged to be recapitalised by their respective governments in order to avoid artificially-provoked bankruptcy,
 - allow establishments to propose recovery plans that respect the particular procedures of each individual country.

Proposal 2: Organise traceability of financial products

Like the food chain, the finance industry devises, sells and distributes products that are "vital" but potentially toxic. We propose a series of measures permitting the effective tracing of financial products. These measures are urgent: how can one "consume" or buy a financial product today without the assurance that it has not been "contaminated" by a failing or ill-intentioned institution?

Transparency vis-à-vis the capital markets

Financial institutions will have to provide the markets with precise and detailed information concerning their consolidated level of exposure (on- and off-balance-sheet) by asset class and also their leverage and their liquidity.

A process similar to that introduced by the United States for the certification by listed companies of their accounts (the Sarbanes-Oxley Act) could be taken as a model, this time applied to financial institutions' exposure and level of debt, by asset class. **The certification document would be signed by the CEO and the Finance Director of the institution concerned**, following certification by each head of operational unit of the level of risk induced by his department's activity.

In a similar manner, the corporate officers will have to explain (notably in annual company reports), under their own personal responsibility, why and to what extent they have used a particular methodology for the quantification of risk and to what extent they have used their own judgement. This obligation could be imposed on them as part of an extended fiduciary duty. In this way, it would no longer be possible to “pass the buck” to the rating agencies, as is the case today.

In order that the level of transparency should be the same for all, investment companies (notably hedge funds) will have to come under the same regime and be obliged to provide this information to their investors. As in the case of the Sarbanes-Oxley regulations, there would be provision for severe penalties for incorrect declarations.

Transparency vis-à-vis institutional investors and savers

The present crisis has shown that **numerous institutional investors and savers do not know what they are buying and do not understand the risks to which they are exposing themselves**. For example, funds have been describing themselves as “money-market” even though their underlying assets include derivative products exposed to risky asset classes (subprimes).

There must therefore be specific rules to protect both savers and the institutional investors in charge of managing public savings (retirement funds, mutual funds, etc.). We set out in detail on our website certain examples of these rules - which should ideally be applicable worldwide - aimed at limiting the creation of incomprehensible and toxic products.

Lastly, in order to ensure the proper application of these rules, there is a very strong argument for setting up a supervisory authority. This body would either be created from scratch or emanate from the United Nations, the G20, the Financial Stability Forum or the IMF. If it is to be respected, this authority will have to be given real powers of sanction and the appropriate financial and human resources.

Proposal 3: Coordinate banking nationalisations / reprivatisations among the G20 countries

"Throwing good money after bad". This expression is particularly relevant today. The world banking and financial system, which is both responsible for and victim of the crisis, is the new bottomless pit, swallowing up public capital without any apparent real impact - so far, at least - on its principal activity, namely the production of lending.

Nationalisation of entire segments of the world finance industry is now inevitable in our view, given the stupendous level of losses (still far from being contained, as a result of the continual deterioration in asset values and economic conditions in the world). We formulate five recommendations to enable this process to succeed:

The nationalisation process must not distort competition

When a European insurance company, a British bank or an American financial institution is nationalised, totally or partially, it immediately benefits from the guarantee of its government, and hence from a capital cost and a "badge of soundness" that give them a competitive advantage vis-à-vis their better-managed rivals remaining in the private sector. This is a vexatious paradox, with the "best pupils" in world finance being disadvantaged as a result. Governments must be careful to neutralise the possible perverse effects of their interventions, for example through the granting of compensation (of a financial or taxation nature) to the "good boys in the class" who have not had recourse to public capital.

The nationalisation process must be coordinated between governments

When Citigroup, Northern Rock, etc., benefit from public funds supplied by their governments, it is expected that these players will be subjected to significant pressure to concentrate their future activities (lending, workforces, etc.) on their

domestic markets rather than abroad. **Banking nationalisations could in this way be a powerful vehicle for a nationalistic inward withdrawal in the future world economy**, jeopardising 60 years' general prosperity. Without wishing to ignore governments' legitimate duty to protect the interests of their economies, we consider it urgent that **the G20 organise and coordinate the monitoring of these bank nationalisation programmes** by a committee responsible for keeping a watch on the threat of protectionism (for details, see the website).

The nationalisation process must follow the sequence successfully applied by the Swedish government in the 1990s

Taking the various stages in order, the programme would then consist of:

- a. nationalising the banks threatened with insolvency;
- b. arranging for governments (and central banks) to hold toxic assets until such time as they regain value;
- c. immediately re-privatising the "good" banks relieved in this way of the dubious assets that had prevented them from continuing to irrigate the economy with new lending.

This sequence has several merits. First, **it spares governments the need to face the virtually insoluble difficulty of setting prices for the purchase of toxic or illiquid assets** – as in the case, for example, of the creation of "bad banks", a step we reject. Second, it clearly announces **the temporary and non-structural nature of the bank nationalisations**.

The nationalisation process must lead in the end to a separation between the activities of commercial banks and so-called investment banks

The taking over of banks' toxic products by governments, for which society at large has to bear the cost, must not be allowed to encourage banks to repeat their past mistakes. To prevent this happening and to **encourage banks to resume the irrigation of the economy with lending and divert them from over-risky market activities liable to threaten their solvency**, we recommend that the

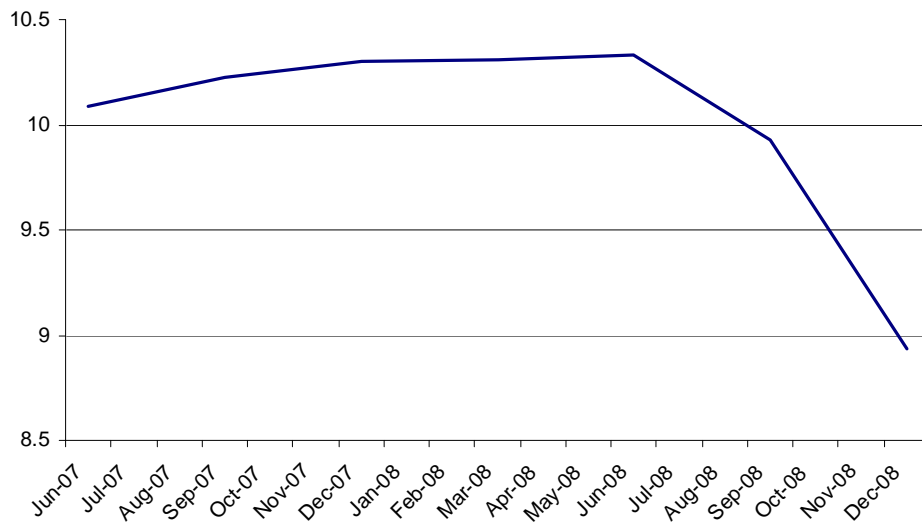
reprivatisations of banks should lead to a separation between the credit banks and the market banks. In other words, this would mean a separation between the commercial banks that finance firms, households and local authorities and the so-called investment banks. This separation, which must be coordinated at world level and initially at the level of the G20, would permit improved allocation of what has become scarce capital in favour of activities capable of directly generating future economic growth.

It will be noted, in this connection, that the repeal in 1999 of the Glass-Steagall Act (the law that prohibited just this type of fusion between commercial banking and investment banking activities) started a race for size among American banks and a **blurring of distinctions** (as in the case of the "integrated banking" activities) and in the end failed to prevent either collusion or conflicts of interest, let alone solvency difficulties - as proved by the present crisis. The finance industry is re-discovering in this crisis that juxtaposition of functions and activities encourages neither the coherence nor the effectiveness of economic action.

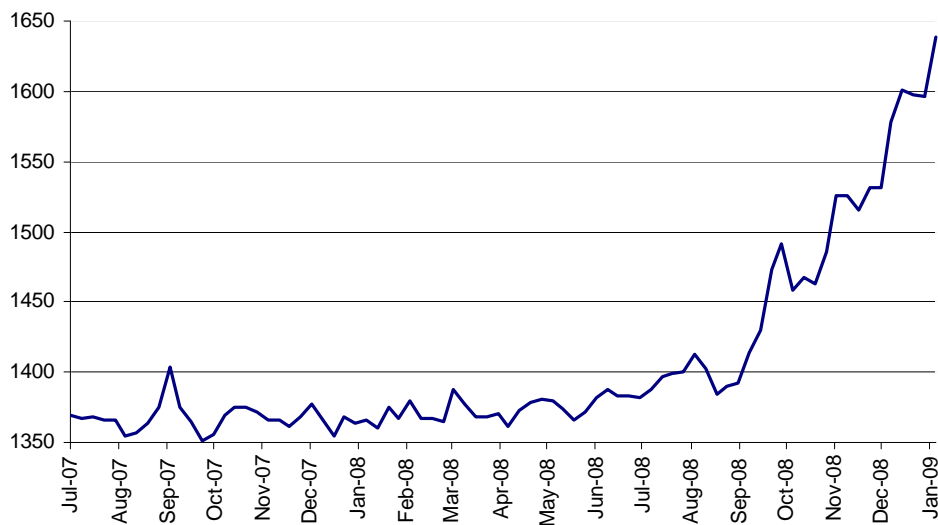
Banks will be given tax incentives to lend quickly and in the right place

At present, banks are reconstituting their equity capital with the help of private or public recapitalisations. But they have no incentive of either a financial or taxation nature to make new loans. The present disequilibrium is worrying: the money supply is soaring but the velocity of circulation is continuing to decline, as shown by the accompanying graphs.

Evolution of the velocity of the money supply (M1) in the United States



Evolution of money supply in the United States



Source: Bloomberg

In order to incite banks to stop hoarding their capital and instead produce lending at a time when the economy needs it most, **we recommend that the G20 governments apply, for a predefined period, a zero tax rate to banking activities that finance the non-speculative economy** (commercial banking, project financing, etc.). This aggressive policy, which could last between 3 and 5 years, will act as a strong incentive to the banks to rapidly irrigate the economy,

thus increasing the velocity of the money supply. At the end of this period of zero tax rates, the banks will find themselves paying a rate that is *a priori* higher than those currently applied.

This is because we believe that the current crisis illustrates the existence of **an implicit "free" government guarantee** enjoyed by the large banks, saved from bankruptcy by their governments. Whether one approves or deplors this tendency, it exists and it is therefore proper at some stage to provide governments with a higher remuneration in return for this guarantee.

In the case of the banks financing speculative activities, we recommend **higher taxation** following their reprivatisation. **A tax rate of 60, 75 or 80% might be envisaged.** A differentiated tax regime along these lines will make it possible to reduce **to a minimum** the proportion of activities in the financial field that have become too dangerous for our economies and our society. The principal difficulty with this measure will be to draw up a precise list of the financial activities to be subjected to such a tax. This could be the responsibility of an *ad hoc* working group emanating from the G20. We consider that proprietary trading, brokerage, production and distribution of derivatives and structured products, securitisation and financing of hedge funds could be included.

Lastly, there should be a prior settlement of the problem of tax havens (see proposals on the website), which already play host to a large number of the more aggressive players on the market (hedge funds, subsidiaries of investment banks) and could find themselves taking in even more banks trying to escape the coordinated tax policies of the major countries.

If such a tax-based incentive policy for the banks were to turn out to be too difficult to implement (notably because of competition in tax matters between the major countries), two alternative lines might be followed:

- first, in order to curb the activities of the market banks and reduce the systemic risk related to excessive securitisation, **any institution wishing to securitise one of its assets** (mortgage loan, company shares, government bonds, etc.) **would be obliged to retain at least one-third of the value of the asset on its balance-sheet.**

As a result, the maximum leverage of these institutions (banks, hedge funds, trading tables , etc.) would be 3 (and not, as at present, more than 30, as in the case of Lehman Brothers, Bear Stearns or Merrill Lynch) ;

- second, in order to encourage the re-privatised commercial banks to lend to firms and households, a system of **government-issued guarantees on certain loans** might be developed, alongside or in replacement of an incentive tax policy.

Proposal 4: Ensure the liquidity and financing of the "players of last resort" i.e. governments

This is one of the major features of the current crisis: the risk of over-indebtedness is being transferred from hard-pressed private players (over-indebted households and firms, under-capitalised banks) to governments that were already crippled with debt even before their rescue and stimulus packages. As a result of the aggravation of the crisis, and of the decline in tax revenues, the risk of default by governments, even the most solid of them, has substantially increased.

This has historically been the case for emerging countries in Africa, Asia and South America. It is currently the case for most of the countries in Eastern Europe, as well as for Ireland. It could be the case tomorrow for Spain and the United Kingdom, countries whose economies are particularly heavily indebted and where the saving ratios are low. Lastly, the United States, which is estimated to have to issue more than \$1800 billion of Treasury securities in 2009, threatens to dry up still further the liquidity available on the debt market, not only for the emerging countries but also for the European countries, which have an urgent need of refinancing.

Faced with these threats, the G20 must give priority to ensuring the liquidity and the refinancing of the major countries. We set out in detail below two practical routes to this objective.

- The "Montaigne Contribution": principles and mechanisms

The introduction of the "Montaigne Contribution" has two objectives: to contribute to the financing of the IMF - a new inter-government bank - and to stabilise the market for derivatives.

In a first stage, we recommend confining the perimeter of such a contribution to the asset markets that are the most risky and the most liable to generate economic disequilibria, notably the credit default swaps (CDS) market, before possibly extending it to all derivatives markets.

The necessary preconditions for this "Montaigne Contribution" are a reorganisation of the credit derivatives market through the creation of a unique clearing-house, the introduction of a system of continuous quotation and a transparent order book (see website for details).

The Contribution would work as follows. Each operator on the CDS market would be obliged to hedge his positions and to deposit with the newly-created clearing-house a collateral amount (serving as a guarantee for the reimbursement of a loan in the event of default by the borrower). The level of indebtedness of the deposit would determine the sum to be deposited with the clearing-house.

The sums accumulated in this way would make it possible not only to protect the community against systemic counterparty risk but also to offer the IMF, which would be given access to this collateral, a new source of financing for its lending.

The following is a simplified example of how the Contribution would function. By setting the average hedge proportion at 1% of the CDS market (whose notional total amounted to roughly \$30,000 billion at the end of 2008), **the amount freed for the IMF would be \$300 billion, thus more than doubling its present resources.**

This means that the IMF would have at its disposal the resources needed to pursue its role of rescuer of countries threatened by difficulties, even to the point of payment default in coming months.

- **The creation of a sovereign euro-issue market**

Just as urgently, the attention of the G20 has to be drawn to the alarming situation concerning the financing of the sovereign debt of numerous members of the Eurogroup, notably but not exclusively in Eastern Europe. Even Germany was unable to place all its bond securities on 11 February 2009, for lack of sufficient demand.

For this purpose, we are formulating a proposal (details on the website) for the creation of a sovereign Eurobond, common to all the Eurogroup countries, of a kind that would enable Europe to maintain its political unity and ensure the financing of its governments at a time when it is going through its worst crisis since the Second World War.

Conclusion

- **Re-establish a world economy based on confidence, stability and duration**

The G20 meeting in London on 2 April 2009 calls for other meetings to follow. This summit will already have been a success if it endorses the principle of regular meetings among the heads of the world's leading countries making it possible to coordinate their approaches and to redefine the rules of world capitalism.

Looking beyond the emergency measures that we have advocated here, we propose others on our website. These can be summarised as follows:

- **encourage the rebirth of “sustainable capitalism”**. The present crisis is also a crisis of the frantic scramble for performance in the short term at the expense of the construction of wealth over the long term. To reverse this process, we propose, among other measures, to replace all the annual bonuses in the finance industry by multi-year bonuses and to favour long-term shareholders over temporary shareholders by giving them increased voting and dividend rights, or by subjecting them to more favourable taxation.

▪ **prepare the introduction of a multi-currency monetary system** while still respecting the reality of the dollar, the currency of the world's leading economic power. The current crisis, which is also a crisis of monetary disorder, provides the opportunity for this. It should be remembered in this connection that since 1971 United States GDP has been multiplied by 3 while over the same period the country's money supply has been multiplied by 21. The rest of the world has followed suit. Expressed another way, it was necessary to produce seven times (21/3) "too much" money to maintain the country's level of consumption and to enable the major manufacturing countries, led by China, to achieve their breakneck development and enrichment, sources of future instability.

▪ **organise, at G20 level, active monitoring of the protectionist threat** in order to bolster the action of the WTO at a time that is particularly critical for the fluidity of world trade, an essential factor for peace and prosperity at world level.

N.B.: in addition to these proposals, we set out on our website other measures that are more technical and are being debated elsewhere (tax havens, regulation of hedge funds and prime brokers, organisation of the CDS market, continuous quotation, etc.).