

Speculation

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While mainstream economists tend to regard speculation as useful, if not always comfortable, radical political economists invariably consider speculation a negative, if inevitable, consequence of free markets. At the root of the division is a different view of the capacity of markets to identify what Alfred Marshall (1920, Book V) called the 'normal price', Adam Smith (1976, Book I, chapter VII) the 'natural price', and Thomas Aquinas (1955, 2-2, q.77), the 'just price'. From this difference follows quite opposed attitudes to the social value, or cost, of speculation.

Speculation can be defined as trading in assets 'in order to profit by the rise or fall in the market value, as distinct from regular trading or investment' (OED). Speculation differs from gambling in requiring delivery of the asset when due. Pure speculation should be distinguished from the abuses with which it is often associated, such as market manipulation, naked shorting (selling without the capacity to deliver, in the expectation of buying the asset before delivery falls due), insider trading and extortion. A capital gain is not intrinsically speculative, since price may increase to reflect changes in productivity or other economic characteristics (e.g. of an underlying business, or of wine maturing in a cellar).

Furthermore, since any decision to buy or sell an asset in a fluctuating market involves timing in an attempt to obtain the best price, the term speculation is best reserved for transactions that are intended from the outset to be reversed, with no account being taken of the economic benefits of ownership, apart from the price. Thus while direct speculation in physical assets is an ancient practice, speculation on a large scale required the emergence of organised exchanges, for transferable contracts for standardised commodities and for currencies and financial securities, which permit 'short' positions (sales for delivery at a future date) and the ability to profit from falling as well as rising prices.

The social desirability of speculation can be assessed from a variety of perspectives. Speculation has been condemned outright on moral grounds since the days of Aristotle, along with money-changing and usury, as creating money from barren money and thereby promoting the vices of avarice and gambling. Political objections focus on the infringement of national sovereignty by speculative attacks on currency pegs or government debt. An economic assessment of the social value of speculation centres on its contribution, or otherwise, to the smooth functioning of markets.

The benign view sees speculation as a form of insurance or risk-bearing which stabilizes markets, a form of specialisation and extension of the division of labour between producers and merchants. This view was first clearly articulated by Emery (1896) and developed by Friedman (1953), who argued that destabilizing speculators would go out of business (although critics responded by showing how destabilizing trade could be profitable). From this perspective, the panoply of sophisticated trading tools such as futures, options, swaps and derivatives does not alter the basic case for speculation. Futures contracts were introduced into the American commodity exchanges precisely to make it easier for primary producers and processors to hedge against the volatility of spot markets. There is historical evidence that temporary bans on futures trading increased volatility (Jacks, 2007), although this does not tell us the

extent to which volatility is exogenous (through variations in supply and demand conditions) or endogenous (through speculation in spot markets).

The radical critique of commodity speculation recognises questions of the distribution of power and income, notably between small-scale agricultural producers in the global South and transnational importers and manufacturers. There is a clear market failure in the asymmetry of the availability of hedging to buyers and sellers, resulting from the different production periods of agriculture and industry, quite apart from the asymmetry between small and large firms in terms of access to credit and futures markets. The longer production periods of agriculture (and also of extractive industries) create an excess demand for longer-term forward contracts which are not needed by the industrial buyers and processors of commodities. This creates an imbalance of bargaining power between primary producers (small farmers, in particular) and speculative buyers. Furthermore, radical economists emphasise the endogenous volatility generated by speculation and the degree to which 'fundamentals' themselves respond to speculative prices (Chick, 1992). Small farmers and commodity-dependent countries are poorly equipped to deal with volatility and no advanced country fails to protect its own agricultural sector or to intervene to stabilize prices. Although recent World Bank policy has aimed to extend small farmers' access to futures markets, there is a long radical tradition of arguing for commodity stabilization funds: we return to this below.

It is plausible that trends in commodity prices are influenced by the conditions of production and final demand. In Marshall's terms, it can be argued that there is a normal price at which production and final demand would match over the medium term, given the productive resources in place, the available technology and the preferences of consumers. The social role of the speculator should be to identify these fundamental factors and profit by smoothing the path of prices over the production period and eliminating the cobweb cycle. Nevertheless high carrying costs and the availability of finance limit the ability of a private speculator to take more than a very short term position. Thus destabilizing activity may be the only profitable option:

Experience teaches those who are able and willing to run the speculative risk that when the market starts to move downwards it is safer and more profitable to await a further decline ... Even if it would pay [the speculative purchaser] to buy at the existing price on longer-period considerations, it will often pay him better to wait for a still lower price. (Keynes, 1938, p. 449).

Nevertheless, even if a theoretical case might be made for speculation in commodities, it does not follow that it extends to speculation in currencies or securities. Radical economics does not accept that markets can identify normal, or fundamental, values for currencies or equities. The reasons differ slightly in the two cases.

On currencies, mainstream economists argue that flexible prices and exchange rates produce a tendency towards equilibrium in the balance of payments so that, conversely, balance of payments equilibrium defines the fundamental value of a currency. This argument is based on a standard supply-side model which assumes, among other things, a similar tendency towards full employment in the long run. Radical economists reject this claim on both theoretical and empirical grounds. Changes in aggregate income, differences in sectoral productivity and an evolution of the composition of demand dominate price effects as the determinants of the balance of trade, while there are substantial barriers to the free movement of factors of

production across borders, notably labour, but also physical capital (which can be understood as foreign direct investment, as opposed to portfolio investment in debts and equities). The historical evidence suggests that any stability of exchange rates is not natural, but the result of particular circumstances underpinned by a large trade surplus. The Gold Standard depended on Britain's willingness to lend its surplus to its colonial territories, while today the ability of emerging economies to peg their currencies against the dollar has depended on running and accumulating trade surpluses as a war chest against speculative attack. Deficit countries are forced to restrict output in order to keep their balance of payments in line with the level of capital inflow permitted by the multilateral institutions, whose main interest has been to secure the repayment of their own and private bank lending. Exchange rates are therefore conventional and within broad limits, arbitrary. Currency markets are a speculator's playground and furthermore, with the free movement of capital, sovereign states lose the power to enforce the adjustable peg which could be used to manage the balance of trade over the long term in the social interest. Instead, they are forced either to float, to join a currency union and lose the ability to realign their exchange rate, or to amass foreign currency reserves in order to peg their rate against a major currency.

With regard to equities, the premise of mainstream economics is the idea that stock market prices reflect fundamental value, usually referred to as the 'efficient markets hypothesis'. We have already noted in the case of commodities that market prices may have some connection with the 'normal price' based on the fundamentals of supply and demand, even if in practice so much can change over a horizon of even one or two years that the connection is tenuous. By contrast, the value of a long-term capital asset (or a share in a bundle of assets) is the stream of future income that it generates over a period of many years. In principle, this value could be identified in retrospect by observing the market interest rates and the money yield of an asset over its economic life. However the attempt to estimate that value in advance faces the insuperable obstacle of the irreversible, historical nature of time. As Keynes (1936) puts it:

The outstanding fact is the extreme precariousness of the basis of knowledge on which our estimates of prospective yield have to be made. Our knowledge of the factors which will govern the yield of an investment some years hence is usually very slight and often negligible. If we speak frankly, we have to admit that our basis of knowledge for estimating the yield ten years hence of a railway, a copper mine, a textile factory, the goodwill of a patent medicine, an Atlantic liner, a building in the City of London amounts to little and sometimes to nothing; or even five years hence. (p. 149)

The problem is the durable character of physical capital assets: if the expectations upon which an investment was based prove mistaken, it is not possible either to reverse the investment today or to go back in time, adjust the original investment decision, and then check the revised results in the present. It is only in a stationary or steady state (allowing for stochastic risk, an 'ergodic' system) that adjustments made today might (given stable dynamics) be expected to have the same effect in the future as the same adjustments, made in the past, would have had today. So the convergent feedback mechanism necessary for supply and demand to generate a set of long-term equilibrium 'normal' prices, as a fundamental basis for the prospective yield of a capital asset, is absent in a world subject to unforeseeable change.

In the face of such inescapable uncertainty, the prices of capital assets are in practice based not on fundamental value, but on a convention as to what those prices should

be. A convention may be simple (e.g. tomorrow will be the same as today, or during a bubble, that prices always go up), or grounded in a sophisticated valuation model which takes into account a wide set of present information that may change from day to day. However wide that set, it cannot contain factual information about the future and is therefore subject to sudden discontinuous change if new information alters the underlying assumptions. Furthermore, in the context of a highly liquid investment market, it is only rational to pay more attention to tomorrow's market price than to tentative and unreliable expectations of fundamental value. Indeed the only thing that matters is the intentions of other investors. The real business of the professional investor must, perforce, be the study of market sentiment, in which the study of fundamental value is at best a minority option. Keynes (1936) writes:

Investment based on genuine long-term expectation is so difficult to-day as to be scarcely practicable. He who attempts it must surely lead much more laborious days and run greater risks than he who tries to guess better than the crowd how the crowd will behave; and, given equal intelligence, he may make more disastrous mistakes. There is no clear evidence from experience that the investment policy which is socially advantageous coincides with that which is most profitable. It needs more intelligence to defeat the forces of time and our ignorance of the future than to beat the gun ... it is the long-term investor, he who most promotes the public interest, who will in practice come in for most criticism, wherever investment funds are managed by committees or boards or banks. For it is in the essence of his behaviour that he should be eccentric, unconventional and rash in the eyes of average opinion. If he is successful, that will only confirm the general belief in his rashness; and if in the short run he is unsuccessful, which is very likely, he will not receive much mercy. Worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally. (p. 157)

Thus, as in the case of currencies, the value of equities cannot reasonably be held to be anchored by fundamental forces of productivity and preferences and the case for speculation as a stabilizing force cannot be sustained. There can be no stability if 'the centre does not hold', if the tendency towards equilibrium is not only weak, as in the case of commodities, but devoid of practical content.

Furthermore, the social justification for the stock market has a second element: not only the idea that it values assets correctly, but that it allocates finance accordingly to the best new investments. Keynes's own criticisms (1936, pp. 158–161) were tempered by the perceived advantages of liquidity to this allocative role, but he may have conceded too much. The empirical evidence (Hayes, 2003, considers data for the UK and US for the 50 years 1952-2001) supports Kalecki's view (1971) that the bulk of real investment, property and regulated monopolies apart, is financed by accumulation (corporate cashflow), both directly and indirectly through corporate borrowing. Corporations raise new equity to finance acquisitions or occasionally, to reduce borrowings when expectations have been disappointed. The exceptional cases, such as the uncritical flood of speculative equity into technology stocks in the late 1990s are, just as in the South Sea Bubble of 1720, more likely to have encouraged waste and misallocation than to have supported enterprise and innovation. The primary purpose of the stock exchange has always been the transfer of existing assets in the secondary market, whether between long-term investors or speculators.

So, by way of reckoning, defenders of speculation claim that it provides liquidity, insurance and price stabilization. The last claim is the key one: insurance through forward contracts can to a great extent be created by hedging buyers and sellers without the help of speculators, liquidity is a function of turnover; an important

distinction should be made between the speculator and the market-maker. The claim that speculation is stabilizing depends on the ability of markets to discover fundamental value or normal prices. The high volatility of commodity markets suggests they are grounded only weakly, at best, in fundamentals, while the claim that currencies and equities have fundamental values to which the market will naturally tend over some period has no solid grounds. There is no evidence that equity markets play a significant role in the finance of real investment. Speculation adds an endogenous source of volatility to all asset markets, bearing particularly hard on the poor; it removes the sovereignty of states to manage exchange rates in the social interest; and it misallocates resources, including some of our best young minds, to gambling on market psychology rather than productive enterprise.

A number of radical policy implications follow. States must have the power to manage their exchange rates in the social interest through an adjustable peg system: this requires limits on the freedom of portfolio investment including bonds and bank deposits, without prejudice to trade in goods and services and to long-term lending and foreign direct investment. A corollary is the need for fundamental reform in the international monetary system, which might be based on the commodity reserve currency suggested by Kaldor et al. (1964). Although the main purpose of this innovation would be to stabilize global income rather than individual commodity prices, it would help to reduce volatility in commodity markets and by providing an anchor to the price of a bundle of the main commodities would tend to make the remaining speculative activity indeed stabilizing. Such a scheme would transfer significant carrying costs from the private to the public sector (and incur still more) and require a degree of political consensus that has rarely been achieved, yet the social gain in terms of global income and its distribution, as well as the control of inflation, would far outweigh this. Finally, given that the equity market plays no significant role in the finance of new investment, the speculative element of its activity can and should be taxed as an addictive luxury, just like any other form of gambling, without fear of lasting damage to the real economy, once any resources released from the financial services sector are redeployed to better uses.

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