

## SPECULATION FROM MORALITY TO PROFITABILITY

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### 1. Introduction

During the current global crisis, speculation is considered to be one of the reasons which started it. The term speculator became synonymous with a predator which destabilize and blow the much needed balance of national and global markets. The last 20 years were marked by a period of great development for financial markets but with only a few regulations regarding the operations of this new "El Dorado" of global finance. If the life of the derivatives markets developed naturally by the emergence of new products and new trading methods, the scientific community and the financial market supervisory authorities have not developed and implemented any legal framework. Metaphorically speaking it looks like we started to play football but without any rules to follow. What today appears as a normal and spectacular sport could be an inhumane war in the absence of rules that establish penalties and bonuses for those who play. To say that a speculator is a destructive person who should be eliminated, and a long term investor is good for the general equilibrium of the market, could generate massive disruptions on markets, by eliminating more than 90% of participants categorized as speculators.

### 2. Speculator or investor

What is a speculator? A person who seeks profit. What is an investor? An entity who also seeks profits. What is the difference between them? The difference may be due to the motivation of the investment, namely how much risk is

supported by the investor. Risk aversion is the most important feature which differentiates investors within financial markets. The duration of the investment, from my point of view, is not a reason for separation between investors and speculators, as both short and long term investors look for profit. Investment can be done for 30 seconds or can be done for more than 2 years. Investors with risk aversion will sacrifice profit in order to minimize or to limit the risk. The speculator assumes higher or lower risks for a profit with no time limit. From the point of view of the speculators, they represent an overwhelming majority from the total number of participants in international financial markets.

### 3. Speculation - is it a moral or a legal correct operation?

A moral action involves an operation which accepts the ideas and norms of the society. Is profit a common motivation supported by the modern capitalist society? Of course, not only accepted, but even one of its cornerstones. Another feature invoked against speculators is that the yield is not the result of a performed work, but the result of opportunism. If we speak about speculators in general, we can say that their objective is to buy cheap and sell high. On the other hand, the participants have the same job on the derivatives markets, but they have to work a lot and they need specialized employees. Information is more accessible to participants in these financial operations and the use of primary data on traded

securities requires a highly skilled labor for their correct interpretation. Consequently, those involved in trading derivatives do a lot of hard work, accept a lot of risky business and sometimes they obtain important profits.

From the legal point of view, an operation can be performed if it's not prohibited or regulated. Speculators do not use products or operations unauthorized by law, but they use more and more unregulated financial products or investment vehicles. As the derivatives markets are essentially unregulated, important international investors were able to circumvent the legal framework on fair commercial activities, by creating Special Purpose Vehicles (SPV). These vehicles allowed massive diversion of funds, such as the Enron case.

From this point of view, the speculators are not guilty for breaking the law. Legislative and control authorities are responsible for no action as a response for the emergence of new investment opportunities and for the lack of legal rules for derivatives operations.

A controversial issue at this point is the participation of commercial banks in investments on financial derivatives markets. Their first motivation was to use derivatives in order to cover risks from their classical banking activity. From the hedge operations was only one step to the investment operations with a clear goal for a big profit. Consequently, banks have joined the speculators club. High risk-taking without the existence of guarantees, especially for entities which invest in third parties, money goes in conflict with one of the main operation principle of a commercial bank - prudence. This principle change breaks the dependency between profit and banks cautious and therefore the commercial banks turned to highly profitable business which assumes risks using third-party deposits. Breaking the line between the investment banks and the commercial banks in the late 90's,

opened Pandora's box<sup>1</sup>. Responsibility for these actions is not only the job of bank managers. A significant part from the responsibility lies upon supervisory and control authorities which have not acted properly to restore the normal market order. Those willing to risk the money invested on extremely risky markets and those who want stability and safety, put money in deposits in the commercial banks. Mixing these two categories does not allow the market to take the right decision to invest according to risk aversion. From this point of view, speculators are not guilty; authorities' and credit institutions' greed allowed to mix the two markets which normally can't be joined because of their goal. A commercial bank should transmit trust and this is not compatible in any respect to the risks assumed by a speculator. Also, there is no comparison between the general public deposits and speculator's own funds.

#### **4. Speculation, as a trigger for financial crisis**

Due to the large number of speculators and the financial derivatives market size, a size figured by a multiple of global GDP, government and market control authorities said that one of the reasons for which global crisis started, is the activity for profit held by speculators. It has been widely presented and analyzed the situation of the worldwide losses from investments in financial derivatives. But one aspect which wasn't reviewed by the authorities is represented by profits. Even if many talked about derivatives market volume and the size of losses, one particular aspect has not been emphasized, a loss or a win cannot be registered by both parties in a transaction. Therefore, it is important to mention that for the large number of investors with losses there are

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<sup>1</sup> Legea Glass-Steagall act had separeted the activity of investment banks and commercial banks untill 1999 when Gramm-Leach-Bliley Act had repealed it.

some investors who win the equivalent of loss. From this point of view, money invested is not lost in the nothingness, it has been transferred from one account to another. Financial derivatives market is a zero sum game, the total market profits are equal to total market losses.

The assertion that the speculators' desire for profit induced changes in the price of derivatives and then into the price of the underlying assets is true. This statement is true but it must be supplemented by the fact that these changes represent the participants' expectations over time, regarding the evolution of the underlying asset. The changes in the price of the derivative acts on the underlying asset as an additive, sometimes it stimulates or inhibits its production or trading. A downtick could be transmitted as a restraint for the underlying asset market. The fact that the participants' actions can be regarded as pro-cyclical from the macroeconomic point of view, do not justifies the authorities' wish to prohibit the use of financial derivatives or to stop the innovation in this field. Governments and central banks have not taken responsibility for promoting pro-cyclical policy, but the actions of participants on the various financial markets are considered responsible for the economic crisis.

"Short" sales transactions are blamed by the authorities, due to an alleged financial crisis spread. The German Chancellor Angela Merkel took an official position and suggested to ban such transactions. However three years have passed since the outbreak of the crisis and operations of "short selling" still aren't prohibited. From the historical point of view, this type of trading has been accused for the emergence of numerous bubbles. Following this crisis, on the capital markets have been more complete or partial ban on "short" selling. If an investor wishes to cover a particular risk which affects him on the underlying asset market, the short selling allows him

to perform this operation at minimum costs. This is why in periods of high economic growth prohibitions on short selling were removed. If these operations would not be possible, financial derivatives markets become less liquid and by discouraging speculators would be much harder to find the required counterparty. The use of these transactions allows the investors to trade profitably when the market is declining. This particular aspect gives the speculators the chance to exploit in an aggressive way the moments of weakness or the recession of the market. A method used in the USA from 1940 to 2007 was limiting short selling when a downtick appeared.

The moral transmitted by these operations is that any regulation should be judged by the authorities for both periods of growth and especially for the unwanted crisis.

## 5. Methods to regulate speculation

One of the issues raised by speculators is the trading price. As speculators may not be interested in the real value of an investment, the price of securities, that are the subject of intense speculation may have a distorted rate and high fluctuations. On derivatives markets, in addition to speculators you can find also trade hedgers and arbitrageur. Changing the title rate does not influence the activity of this participants, due to the specific operations performed. When it comes to hedging, profit is sacrificed for safety. Thus, for any increase or decrease of quotation, the hedgers will secure their portfolio. For the arbitrageurs, the differences in quotation for the same asset on two markets, will be speculated in real-time. Title quotation change will not affect the arbitrageurs' activity only if the chances will allow them to arbitrage price differences for the same title. Practically, the only investors which are strongly affected by price fluctuations in derivatives market are the speculators.

But, they want fluctuations in order to obtain bigger profits.

The problem is represented by speculation which puts in danger the life of companies in real economy. If speculation can be the fuel for market liquidity, it may also be the poison to destroy it. The discussion should be conducted not on the existence of speculation but on how and when it is performed.

A practical measure was proposed by the Nobel laureate, James Tobin in 1972, in order to discourage currency speculation. The proposed method was a tax on every transaction made on short term. This fee would have acted as a penalty for speculative transactions.

I believe that solving the speculation "problem" on the capital markets could be solved only by establishing a clear legal framework and

by imposing a "Tobin tax" to all transactions on derivatives markets. This fee can fluctuate over time, depending on the macroeconomic context and the vision of the supervising authorities.

The supervisors' work should be subject to a long term vision on the development of capital markets and the global economy as a whole. Speculation is a specific operation that is part of the psyche of the human race. The desire to record profits assuming increased risk has been permanently present in human history. Prohibition of these operations will generate the emergence of new types of markets, due to human inventiveness and willingness to risk everything for profit. It is desirable to channel this trend on a legal track and not to cover it and to find ourselves in front of new challenges probably more dangerous than the financial derivatives.

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