Trading, market-making and price volatility

In the last week's article, I had discussed the proposal in the U.S. to bar deposit taking institutions from undertaking proprietary trading activities. Whatever the genesis of the proposal, the fact is that the huge bank losses in 2007-08 were not really "trading losses": the assets were held in the trading book but they were not being continuously bought or sold as, for example, currencies, bonds and vanilla derivatives are. (In fact, the market for the mortgage securities was/is, extremely ill-liquid. The profit was to come from the difference between funding costs and yields on the securities, and the losses arose from bad credit assessments.)

I had also argued that the dividing line between proprietary trading and market making, which would continue to be permitted, is thin. To be sure, there are theoretical differences between the two. Market making involves a bank quoting both the sale ("offer") and purchase ("bid") prices for an asset – say, a currency. Typically, the two rates, at any given point of time, would be around the price of the last trade in that asset. Again, as soon as a counterparty "hits" the market making bank, on whichever side, it would immediately change the prices: if it has been hit on the bid side, it would make the offer rate more attractive, in the hope of doing a trade on the opposite side to balance its position, without taking a view on future price movements. In principle, the market maker hopes to make money from the difference in the bid offer rates.

On the other hand, the trader/speculator expects to make money primarily from price changes, and takes a deliberate long or short position depending on his expectations. But both trading and market making involve the willingness to take open positions: for a relatively short time in market making, but for a longer time in trading, particularly when the price is moving in the trader's favour. Again, open positions may be larger in trading than in market making. Paul Volcker, the intellectual father of the U.S. proposal, has argued that attempts by banks to evade the rule by engaging in proprietary trading in all

but name, should attract a strong regulatory response. One remains agnostic about the ability of bank supervisors to separate market making from trading.

This apart, the more important issue is who pays for the speculative profits of banks and hedge funds. Some people argue that since, almost by definition, trading in assets without adding any value to them, has to be a zero-sum game, somebody's gains must be counterbalanced by somebody else's losses. Plausible as this sounds, empirical evidence is otherwise: practically all banks' trading activities, and most hedge funds, make large profits year in and year out. Clearly, trading is not a zero-sum game *for the financial economy*. It follows that the cost is borne by the rest of the economy, i.e. the real economy. If, for example, financial economy's speculation in the oil futures contract results in a rise in the price of oil, a few producers and speculators gain, but a much larger number of consumers suffer. If speculation carries the value of the euro higher, all importers of euro-invoiced goods, all those who have borrowed the currency, incur higher costs. To be sure, those with long positions in the euro, savers or exporters in that currency, gain. (The latter's gains could well be temporary, with loss of competitiveness.) Traders in the financial economy of course make money – whether the euro goes up or down, so long as they are on the right side of the trade, and observe the "stop loss" discipline. The difference with the real economy is that players in the financial economy can reverse their positions quickly. True, real economy players on the wrong side can hedge their existing positions in the short term: but all hedging has up-front or opportunity costs and, in any case, can do little to mitigate the long term impact of price changes on competitiveness.

This is not to deny the need for price changes to reflect changes in the underlying demand supply conditions. But the fact is that excessive speculation has too often led to far greater volatility in prices than justified by the dynamics of demand supply changes or other fundamentals. Share prices are, for example, far more volatile than corporate profits. The same goes for currency and commodity prices. Only a few months back, Prime Minister Gordon Brown of U.K. and President Nicolas Sarkozy of France, in an article in the Wall Street Journal, had argued the need to curb excessive speculation which they blamed for the wild gyrations in the price of oil.

Overall, one is doubtful whether, even if the proposal is enacted in the U.S., it would serve much useful purpose. There clearly is a need to limit the excessive speculation and wild gyrations in prices which hurt the real economy, but the solution may be in a transaction tax. The Volcker proposal may do little to improve either the safety of the banking system, or the excessive volatility of market prices.

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