

God's Work

God must be idle these days as far as financial markets are concerned – there are so many people doing his work! Lloyd Blankfein, the CEO of Goldman Sachs, claimed recently that his firm is doing God's work – it is incidental that Goldman has been sued recently by U.S. regulators for cheating its clients. (Goldman Sachs itself earns 80% of its profit in trading – a polite euphemism for speculation.) The title of an article by Paul Murphy (Financial Times, March 13) was “The truth about speculators: they are doing God's work”. Clearly, the French President and the German Chancellor were not only foolish, but anti-Christ, when calling on the European Commission to ban naked short selling of sovereign bonds and trading in credit default swaps which achieve the same purpose, to curb speculation!

To be sure, speculators do play a role in creating liquid markets. Other players like hedgers, arbitragers and long term investors are not enough to create continuous market liquidity and prices. Again, speculators also sometimes play an important role in “arbitraging” away the difference between current prices and true values by selling or shorting an overpriced asset, or buying an undervalued one – but obviously not always. Indeed, more often than not, they become trend followers rather than value players. One basic law of economics is that higher price of an asset – a share, a dollar in currency market, etc – should reduce demand for it. This law is true if the transaction is between the producer and the consumer: a rise in price of onions will surely reduce demand from the housewife.

But this is rarely true in the case of a speculator who looks upon onions as an “asset class”, and is willing to buy them in the hope of a further increase in price. (In a more innocent age, such people used to be called hoarders). In their case, a price rise often increases demand, creating, for a time, a “virtuous” circle – higher price, higher demand, still higher price, still higher demand virtuous of course for the speculator. The so-called ‘carry trade’ is a good example of this. In any case, as Keynes said a long time back, even otherwise, it is better for one's reputation to be wrong in the company of others than be a contrarian! Therefore, to quote him again, “*we devote out intelligences to anticipating what average opinion expects the average opinion to be*”. As for buying undervalued assets and selling overpriced ones, to arbitrage the difference between price and value, and between different, but similar, assets within the same class, hedge funds were originally doing this. But, as Keynes said, “*Markets can be `irrational' for a lot longer than you can be solvent*”: LTCM and Amaranth, the hedge funds, found this to their huge embarrassment. Therefore, such activity requires a long time horizon and low leverage. It is more “investment” than “speculation”: the basic difference is

to buy an asset for long term returns, or for selling it at a higher price as soon as possible, with no value addition.

I have two basic objections to considering speculation as “God’s work”. For one thing, unlike every other wealthy person who contributes to society by creating employment and producing goods and services, the speculator’s value to society is often negligible. Yes, sometimes their activities do correct asset prices, and they provide market liquidity, which is presumably in long term interests of the economy. Too often, however, speculation is “rent seeking”. The other impact of speculative profits is to make society believe that “the path to riches lies in buying and selling pieces of paper rather than in making things” (Vir Sanghvi, Hindustan Times, May 16, 2010). As Keynes argued, “Speculators ... may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation”. Surely, not in long term societal interests, let alone being God’s work!

Strikes in China

Is it merely coincidental that spates of strikes and hefty pay rises have been reported from China in the weeks preceding the G20 Summit? One doubts. In a way, this takes some pressure off China to upvalue the currency – as does its rise against the euro in parallel with the dollar’s, as cost rises upvalue the currency in “real” terms. That the wage rises were/are needed is another matter: the share of wages in China’s GDP had not gone up despite the very fast growth of the economy. The wage rises may also help increase domestic consumption and hence reduce current account surpluses. To be sure, the surplus as a percentage of GDP has halved over the last 2 years – at a time of global recession. But exports grew almost 50% in May, and the politically sensitive U.S. deficit has stopped falling and may well start growing again despite U.S. exports to China recording 20% growth. The softness in consumer spending in the U.S. also has implications for growth and job creation, and create political pressures to find somebody, preferably a foreigner, to blame! China is obviously a prime candidate.

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