Let's Stop Rolling the Market Dice

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The drama on the stock markets is largely the product of gambler's panic. Better regulation would see less volatile markets - and better returns in the real economy, writes Ian McAuley.

John Maynard Keynes knew what harm could be wrought by financial speculation. In his 1936 magnum opus, The General Theory of Employment, Interest and Money, he wrote: "When the capital development of a country becomes a by-product of a casino, the job is likely to be ill-done".

If he were alive today, witnessing the turmoil in financial markets over the last two weeks, Keynes would find the casino is still running strongly, and he would conclude that we have learned little from the experience of the Great Depression, or the more recent Global Financial Crisis. He would find all manner of novel financial gambling instruments (under the generic description "derivatives") which were not around in the 1930s — CDOs, CFDs, CDSs — to name a few. (I won't bother the reader with an explanation of these acronyms. As a matter of fact, many Wall Street traders get by without understanding them.)

In the 10 days between 28 July and 8 August, the Dow Jones index fell by 17 per cent, before making a partial recovery with equal rapidity. In part the fall was a response to the clumsily stitched-together deficit reduction deal in the US Congress, and the downgrading by Standard & Poor's of US government debt.

In Europe there were similar moves, most notably a panic triggered by a rumour about the health of the French banking system, which led to speculative selling of French bank stocks. (As an analogy, imagine if someone shouts "fire" in a crowded cinema, and then plunders the belongings of those who are fleeing.) More recently, a decision by the European Central Bank to buy Italian and Spanish bonds has seen a recovery in European stocks.

To put it mildly, those who work in financial markets are jittery and subject to panic. They are gripped by bouts of over-reaction and irrationality, the most notable of which has been the flight of loose finance to US Government bonds. If markets were at all rational, an economically irresponsible deficit reduction deal and a downgrading of a country's credit rating would see a flight from that country's bonds — as has happened in Greece. The flight to the US dollar is akin to the way people in a burning building may rush toward the fire because that's the only part that's illuminated.

There are good reasons why share and bond prices should move up or down. But, apart from events like Japan's tsunami and subsequent nuclear catastrophes, the economic developments which influence companies' and nations' prospects develop slowly. America's problems — such as over-valuation of housing and public debt — have accumulated over many years. The vulnerabilities in what was to become the Eurozone have been known since 1993 when deficit rules were built into the Treaty of Maastricht.

A first year economics student, answering an exam question "what is the function of stock, bond and currency markets" might give a textbook answer about their role in serving the economy by allocating financial capital to its most productive use. The values revealed in those markets reflect the collective wisdom of well-informed investors who have analysed corporate and government data and other sources of information.

If markets behaved according to that model, we would have seen little movement over the last two weeks — perhaps a modest fall in US stocks and a small fall in the US dollar, with little change in other equity markets or currencies. The stock of physical and human capital in American and European economies on 8 August was much the same as it had been 11 days earlier, but over those few days the market downgraded the value of that stock by trillions of dollars. Similarly, over the week from Monday 8 August to last Friday 12 August, that stock would have been much the same, but those same markets increased its value by several trillions of dollars.

Ideally, financial markets should provide a service function: they are there to serve the real economy, where people grow food, bring up children, build houses, care for the sick and so on. But in the lead up to financial crises, they take on a life of their own. Those who deal in currency swaps, CDOs and other derivatives come to see these instruments as having value in their own right, rather than denoting value somewhere in the real economy. Derivatives, by their very nature, are detached from the assets to which they refer.

The volatility of the last few weeks has been costly to the real economy. One easily traced cost is the amount taken in buying and selling transactions as speculators have sold and bought stocks: Glenn Dyer, writing in last Wednesday's Crikey, calculates that in buying and selling equities over this period of volatility, Australian "lemming like" fund managers — the people to whom most of us entrust our superannuation savings —

incurred $400 million in fees and commissions as they frantically sold in the morning and bought back those same equities in the afternoon, at a higher price. Everyone, except for those who live off the commissions on financial transactions, would have been better off if those trusted to manage our superannuation savings had taken a month's holiday starting on 28 July.

These costs are minor, however, in comparison with the systemic damage done to the real economy. A modern economy needs a stock market: it allows firms to raise capital, and the demands of investors discipline a firm's management. History demonstrates that openly traded currencies facilitate trade and investment, and protect against the drastic realignments which occur when fixed exchange rates can no longer hold. But when those markets lose connection to rational valuations and fluctuate wildly, the result is net damage to the real economy.

This damage is manifest as a loss of confidence in financial markets. As potential investors take fright, firms find it hard to raise capital; those individuals and institutions seeking long-term value desert equity markets, leaving them to the mercies of speculators who have little if any knowledge of the firms in whose securities they are trading. In other words the speculators frighten away the investors.

When there are speculative runs on a company's shares, even well-managed firms can find themselves subject to hostile takeovers. In response to financial volatility, many managers in the real economy become conservative, eschewing both debt and equity finance. In other cases managers of public companies have to engage in producing impressive short-term financial results, rather than long-term investment. The general result is a drying up of capital in the real economy.

When confidence falls, those who have funds to invest seek "safe" havens away from equity markets. Many individuals seek the safety of "capital stable" superannuation funds, losing the opportunity to avail themselves of better-yielding securities. Others put their money into housing, gold or old masters, raising the price of those assets, but hardly contributing to the nation's productive potential.

If they are to do their job, financial markets need to be underpinned with trust; it's no coincidence that the word "credit" derives from the Latin verb "credere", to believe or trust. Money in its various forms is part of our social capital; just as we need to trust the value of the banknotes in our billfold, so too do lenders need to trust that borrowers will repay and shareholders need to trust the information generated by company reports. When that trust dries up, money dries up. It's akin to draining the water from a steam engine, or removing the wires that connect power stations to households.

As with equity markets, volatile exchange rates make life hard for everyone — except those who can take advantage of a temporarily high Australian dollar and take an overseas trip. For importing or exporting businesses currency volatility renders any planning a nightmare: the safest bet is to minimise long term investment.

Does it have to be like this? Not really. The solution lies in taming financial markets with a view to making them less volatile and by eliminating the loops of positive feedback which give rises and falls their self-sustaining momentum. Engineers designing autopilots for airplanes and steering mechanisms for ships make sure that they respond gently to changing winds and currents. Planes and ships need to adjust to those external conditions, but if their servomechanisms are too responsive the result can be violent and possibly destructive instability. Engineers designing such systems deliberately "dampen" those responses.

Similarly, financial markets need dampening. It would not be difficult to prohibit speculative practices such as short-selling. Computerised "stop-loss" programs could be prohibited — these are programs which automatically sell an equity or currency once a certain fall has been detected, a highly destructive positive feedback mechanism. More generally, a Tobin tax — a small tax on all financial transactions — would have a dampening effect. If set at, say, 0.01 per cent, it would have a negligible effect on genuine trade and investment transactions, but it would remove much of the gain from rapid transactions. (In fact until the 1980s there were quite substantial stamp duties on share transactions in Australia.)

Such a policy development needs to be based on a changed perception of the financial sector, whereby policymakers see it as a service to the real economy, and realise that risk-taking in the financial sector leads to risk-aversion in the real economy. The fact that the finance sector in the last 30 years has grown from 6 to 10 per cent of GDP should be seen in the same way as any business sees a growth in "overhead" costs as problematic.

Above all, we need to understand the difference between money and wealth: money is a measure of wealth and it facilitates transactions in the real economy, but otherwise it has little value. Real wealth lies in our physical, human, environmental, social and institutional capital.

That may mean our financial institutions come to look a little less glamorous. It may mean that bank shares revert to their historical role as low-yield "safe" investments. It may mean that our best students are attracted to courses in engineering, medicine and other disciplines where they can make real economic contributions, rather than courses in finance where they can live off the contributions of others. Above all, such a re-casting of our financial sector would provide Australia with some protection against outbreaks of gamblers' panics in other parts of the world.