Speculation and Recessions – “A Bit of a Punt”

(Reprinted from *Progress*, September-October 2002) Leo Foley

It seems only yesterday that a ticket in "Tatts", a game of two-up on Anzac Day, and a punt on the Melbourne cup was the extent of most Australians gambling. As we commence the 21st century, the corporate marketers have packaged those mild interests into dangerous obsessions. Gambling machines dominate pubs and clubs, multi-million dollar lottos offer false hopes, while casinos flourish around the country. So, a little punt has become the 'main chance'. For those who have fallen behind in the past 30 years, despite being told they are so much better off, now look to the gambling outlets as their salvation. It is more than in interest, or entertainment -- it is a desperate attempt to recover what they have lost. Society is now caught up in a wave of gambling, with governments now captive to the taxes extracted from it.

The same disquiet worries those who might have traditionally invested their money more productively. Long-term investment in productive activity is no longer seen as a viable means of building wealth. It is seen as too slow, where returns might be overtaken by inflationary forces, or currency depreciation, before they have become worthwhile. Or having to endure the 'dot.com' investors flaunt their wealth to arouse the envy of all but the most humble. So, ordinary folk look for faster ways to make a return on their money, and, to beat the odds, they seek higher returns. High returns require high risks. Speculation takes over from investment.

Speculation has long been with us, and readers of this journal will be familiar with the folly of land speculation. Each land boom produces more losers than winners as the land price rises above a figure that will allow productive use. The speculators increase demand for land, which becomes priced for future use, not present-day use. This stalls business investment, but the rising land price for residential property leads to increases in interest rates. Rising costs, and falling investment in machinery, farm equipment, steel and major construction, ensures that the economy will grind to a halt. As workers are laid off, consumer spending falls, and the economy falls into recession.

If the land market behaved like other markets, land speculation would not be so bad. Buying up a commodity, to 'corner' the market, can work only so far in a freely competitive market. The incentive to 'corner' is to increase returns through higher selling prices, but the rising prices encouraging new entrants, thus forcing the price back down. But there can be no increase in the supply of land, or at least of land of the quality required, so the land speculator becomes a monopolist, extracting excess economic rent from users.

Even when the inevitable 'bust' follows the boom, land speculators will behave differently to other investors. Some, who are financially stretched, might sell out at lower prices, but those who can afford to ride out the slump will do so. In this way, market for land resembles that of collectables -- paintings, antiques, coins - which retain their value by virtue of their scarcity. There are no new entrants, so/supply-demand price mechanisms do not apply. The price remains high, in accordance with future expectations.

This holding out of useful land from production leads to land wastage and urban sprawl. Developments must skip over the unused land, stretching infrastructure and services beyond viable limits. The lack of services makes the far-flung developments affordable to lower socio-economic groups, so they tend to live there, while more affluent people tend to live closer to the city, where full services are provided. Since that is where most employment is, those living nearby get more opportunities. People living further away suffer time and travelling cost penalties, so tend to remain unemployed, ensuring they will never be able to bridge the divide, and purchase a house in the prime areas.

Thus, land speculation leads to a circular and cumulative condition that exacerbates existing disadvantages. The housing market operates as a "sorting mechanism", separating those that can afford to buy houses in areas with good access to employment opportunities and social facilities from those who cannot. Land speculation produces nothing in an economy, and rewards the inefficient use of land. It holds money out of the economy, which would otherwise be invested in productive activity, and prevents the economy from creating jobs to keep labour fully employed. But, perhaps the worst aspect, and the saddest, is that so many of us are now land speculators. Our society relies on rising land prices to stay afloat. People borrow big and pay huge interest bills in the belief that the capital gain will be worth the pain. Those who own (heir own home increasingly are purchasing second and third rental properties as investments. In 1993, 750,000 Australians were investors in rental housing. The 2001 census figures are due out as this article goes to print, and 1 confidently predict lhat the figure will now be over one million. Meanwhile, young Australians wiihout parental financial backing cannot get a start.

A recent television article on "A Current Affair", on 20 May 2002, out lined tips for purchasing residential property. The tips contain no surprises, advocating to "purchase a property which is close to essential and desirable facilities. That means within walking distance to schools, public transport, shopping areas and leisure and entertainment options such as public parks, cafes and restaurants and cinemas." The other tips are similarly based on taking advantage of community-provided facilities. But it is not the advice that is galling, but the system that allows the community provided economic rent to be captured by a few privileged individuals.

Increases in land price in Sydney and Melbourne could soon reach the ludicrous situation in London, where the weekly increase in land price exceeds the average wage - making it absolutely impossible for people to save for a home. The collapse of such a market seems inevitable. Only the public collection of land rent can slop it. Removing the unearned gains will stop the free ride now received by landowners, and encourage any excess money into productive investments.

Speculation relies on expectations. An asset is purchased, not for its production or earning capacity, but for an expected increase in price due to some change in supply or demand. While an investor seeks to share in the profits of an enterprise, speculators don't care about dividends or company earnings. They simply speculate about future possibilities in an uncertain world.

But, for all its faults and its ability to wreak havoc in the economy, it may not be land speculation that causes the financial system 10 collapse. The perceived need for quick returns has brought new meaning to phrases like "the higher the risk, the higher the profit," Greed has taken over the financial system and stock markets. Greed has always driven the upside of a market, and Fear rules the downside. The difference now is that people are afraid, not of companies failing to deliver expected returns, but of missing out if and when they take off. Or if some other company takes off, and they are not 'on it'. Fear is now married to Greed. Ordinary folk, who feel that a crash is coming, face a harsh dilemma -- when to get out! Not wanting to missing out on the gains, they stay in an overextended in market, hoping to sell before it's too late. Worse still, they are doing this on borrowed money. The end will be painful.

Individuals feel the need to risk their savings and assets for fear of falling behind if they don't. They are led to this belief by the corporate sector who have taken to gambling in derivatives as if it were their core business. General Electric is now the largest private financial institution in the world, slightly in front of the other multinationals, because of their many financial transactions -- mostly derivatives. The danger of companies having large exposure to the derivatives market is obvious after the Enron collapse. Enron was a big player in the freight derivatives market, and many shipping companies will go bust as a result of its collapse. But it may he that its influence in the credit derivatives market will cause the greatest losses. Because the deals do not show up in the company's balance sheet, the level of exposure is hard to estimate. Standard & Poors estimated an exposure of $6 billion, but it is likely that the estimate is only a small part of the total. Some banks have declared their losses, but the real worry is those that have not. It seems they do not want the bad publicity of admitting really big losses, so they say nothing.

Derivatives (futures trading) originally sought to reduce the risk of bringing crops to market, or fluctuations in exchange rates. They were based on the value of an underlying asset, representing a claim on wealth to be produced in the economy. The contract was made to buy or sell goods at some future date, at a previously negotiated price. It was expected that the goods would actually change hands.

Options were being introduced, and there was no expectation that goods would actually change hands. The contract is purely speculation on what price might become. The goods do not matter. Total wipeouts of crops or industry can reap huge profits if the option buyer has predicted the fall. When the real money is made through speculation, rather than production, it is only a short step to gambling on indexes (a basket of stocks or commodities, or whatever). There is no longer a pretence of assisting a productive firm against a poor yield, but simply a side bet on how the index will move. Fortunes are made and lost, without any real wealth being created. This is obviously unsustainable. A financial merry-go-round is not a proper substitute for real economic activity. Taking future profits now means paying interest on finance, which becomes a burden on the economy into the future.

The sums are staggering. They are too large to comprehend. In 2000, derivatives increased from $300 trillion to $400 trillion, but because trades are short-term, the turnover is probably over a quadrillion dollars per year (whatever that might be!!) I cannot comprehend one trillion, much less a quadrillion. But we can no longer believe balance sheets. Derivatives are not shown there. Bankers Trust, when the US government took it over in 1994, had a derivatives portfolio of $1982 billion -- against assets of only $97 billion and net equity of just $4 billion. Money that should be made available for infrastructure, education and other public services is being sucked into a financial bubble that has no productive reason to exist. The banking system has been taken over by the parasite, in the same way that fleas infest a dog, but the difference is that a 100 kg flea will suck even a big dog dry. What does it do when its host dies?

The physical economy, the production of real goods and services, has been left behind. In 1998, production of farm equipment in the US fell 25 percent; machine tools fell by 39 percent, and steel production fell by 15 percent. The real economy is going backwards, leading to massive unemployment worldwide. Official figures record that 30 million people are unemployed in the West, but unofficial estimates are twice that high. We are in deep trouble.

But what can be done? Foreign exchange transactions based on the real economy are now only 2% of all transactions. 98% are speculative! The annual GDP of the USA is turned over via currency trading every 3 days! It is obvious that some deterrent is required to reduce the speculation. I will now broach a topic that may well be contentious in Georgist ranks. Without necessarily endorsing the "Tobin Tax", it seems that a transaction tax of some kind is necessary to save the financial system from collapse. James Tobin proposed a tax on foreign exchange transactions way back in 1978. There have been many variants proposed since. The basic element is to deter short-term transactions -- that is, those that exist only for a week or two.

In my view, the consequences of doing nothing are too disastrous to contemplate, so I agree with the principle. Tax short-term trades. The detail of how to do that, and at what level, I leave open to debate. There will be a solution that returns the real physical economy to pre-eminence. But it must be done soon. Financial speculation must be curbed, before more countries suffer currency crises, with the associated negative social impacts.

The revenue raised from the tax, and there will be substantial revenue from trades where the risk is seen as worthwhile, can be used for development programs for developing countries. It may well create a model for the redistribution of other global public goods. Derivatives and currency speculation are the challenges of the 21st century. It is a quantum leap from betting on the Melbourne Cup to betting on our very future, but that's what has happened in a generation. Is there a Henry George amongst us who can define our position?