Name: **Polito Fabio**

Student number: **2006196**

BMI 231 Introduction to Political Economy, Dr David Rees

"Currency Speculation"

Table of Contents

Introduction 1
From Self-Fulfilled Prophecies to Assured Earnings 2
Impact on Global Economy 3
Conclusion 4
Bibliography 6

Introduction

Speculation: *"the activity of guessing possible answers to a question without having enough information to be certain"* (Cambridge Dictionary).

In the financial world, the term is mainly used to describe the acquisition of an asset with the hope of gaining profit soon after. It consists in taking a certain amount of risk in attempt to gain profit in a short term.

More in particular, currency speculation is a kind of speculation which has the scope to gain profit based on the evolution of the exchange rate in between foreign currencies.

Currency speculation takes place in the Foreign Exchange Market also called FOREX; it is open 24 hours a day for 5 days a week. The actors are Investment Funds, International Financial Institution, Central Banks, Investment and Commercial Banks and rarely individuals.

Based on the rule of buying low and selling high, at first, currency exchange is meant to buy foreign currency for importing or investing in foreign businesses, and of course lower the cost of this operations, nowadays the so-called Forex Market is mainly composed of speculators whose only objective is to increment their income. A concrete example is the difference in sums of transactions in between the "primary exchange market", which is directly related to trade and investment, and the "secondary or speculative market", in which 5 time more money flows than the first one.

Today the exchange market speculation consists in 70% of all the speculation on the markets. To give an image of the vastity of its transactions, each day, a total amount of 6 595 billion of dollars are exchanged on Forex Market, with United Kingdom treating more than 50% of the volume. (3 576 billion dollars). It means that each second 4,6 billion are exchanged in the market.

There are two kind of regimes for exchange rates: flexible, it changes and fluctuate according to supply and demand, and fixed, either against one (unilateral) or more (multilateral) foreign currencies, the latter was for example installed afterwards the Bretton Woods Agreement until '73, and the European Monetary System until '93 and today the European Exchange Rate Mechanism (ERM).

In short time, rates change very little, about less than 1%. But if the exchange rate in between currency fluctuate so little, how can speculator make so much money out of it? Because of the enormous volume of each transaction, in the order of millions of dollars, and that with just a fluctuation of +0.1, the result is thousands and thousands of earnings, for just 15/20 minutes of "working time". Now this is the real issue about currency speculation, the injection in the market of huge volumes of currency for short time, destabilizing the market and the risk of bringing down economies due to economic international relationships.

How can the currency market be more regulated and safer? And how to avoid injecting such volumes in the market, that can result in economic crises or disasters?

From Self-Fulfilled Prophecies to Assured Earnings

The market is very influenced by "professional" speculators, they come first and place the "bet" justifying that the currency will appreciate (increase) or depreciate (decrease), then the provide enough information to the market to make everyone see in the same direction, in reason of their "expertise", other speculators will follow the money and buying the same value. Eventually the currency will increase or decrease as predicted and making the "prediction" true, which is what we call a self-fulfilled prophecy. At this time when the currency has gained enough value and when "professional" speculators have a sense that the value is about to lower, they convert it back, make a profit, and everybody else will follow, making less and less profit as the time pass (cause the currency will fluctuate back in the opposite direction).

Another important aspect is the high-risk currency speculators take to accomplish these transactions, the capital they use to exchange is money they do not have, which is composed of savings from their client, treasury from companies they "take care of" and borrowed money, all along with high leverage ratio. Why should they take such risk? Risking billions and billions of dollars for a very low percentage of income, consistent but low compared to the sum "invested". It makes us question if maybe there is no risk at all, and revenues are certain.

Multinational firms and banks make a large part of their benefits from this kind of transactions and are specialising in this direction. Internet, big data, algorithms play a big role in speculation, with Speed Trading, such institutions are now able to make profit doing

even less work than before, and with an impressive degree of certainty. One of the last technological innovation for trading department is the High Frequency Trading (HFT), considered as the first meeting of algorithms with finance. The algorithm used on very sophisticated and powerful machines, analyse markets, and execute commands for trading assets at high frequency. The characteristic is to do not accumulate positions or use a buy and hold strategy, but they move high quantity of volumes in high speed in and out of their positions to gain fractions of cents of profit. Thanks to this new technology, Sharpe Ratio, which is the measure of reward for risk, is ten times higher than the traditional system. HFT produce a huge quantity of liquidity and it has improved liquidity compared to before, but if the volume augmented, the operations happen so quick it is impossible for the "traders" to take advantage of the benefits. The computerization of the process also causes some discontent in the industry because it replaces many trader and brokers taking the human component out.

Today HFT represent a certain revenue for financial institutions, algorithms make sure bet to earn very little but in great quantity and faster than ever. But on the other hand, it also means that the market is subjected to computer decisions, and without a proper control disaster can happen, as the 2010 flash crises, in which Dow Jones Index lost and regained 1000 points in just 20 minutes. Still nowadays it is difficult to explain the causes.

Impact on Global Economy

Some consider that the speculative side of the market ensure the liquidity in the primary markets, hence speculation is necessary for importers, exporters and investors, and the more speculators are present in the market, the easier and more accessible is to buy and sell currency when they need, and so avoiding the market to be stuck. Although this lovely and reassuring image of speculation, it can have severe consequences on economics, as it has already been shown repeatedly in the past. It can in fact disrupt international trade and countries' economic development. Yes, sur the speculation works as a kind of a guessing game at very high risk, and speculators can either win or lose money, but to minimize their risk, thanks to new technologies and access to information, they adopt strategies that make their guesses much more accurate, and privilege self-benefit to a country's economic stability. Take as an example George Soros, who speculated on British Sterling, the currency of his own country, during a very difficult economic period of United Kingdom, hoping for the Pound to crush. Long story short, he made a profit of 1 billion dollars and

costed 3.3 billion pounds to United Kingdom and its taxpayers and followed by a period of great recession for the country.

The market is very influenced by "professional" speculators, they come first and place the "bet" justifying that the currency will appreciate (increase) or depreciate (decrease), then the provide enough information to the market to make everyone see in the same direction, in reason of their "expertise", other speculators will follow the money and buying the same value. Eventually the currency will increase or decrease as predicted and making the "prediction" true. At this time when the currency has gained enough value and when "professional" speculators have a sense that the value is about to lose it, they convert it back, make a profit, and everybody else will follow, making less and less profit as the time pass.

We could think that the solution is in the Fixed Exchange Rate, with no fluctuation of currencies there should be no speculation, nevertheless is not the case and it occurs to be extremely dangerous for country's economy. In fact, in Fixed Exchange Rate, is not the rate by itself which is fixed, but is the country which has a commitment to purchase and sell its own currency to keep it at a fixed rate, until is feasible, with its resources or buying its own currency. Although, a country has no unlimited resources or money, and the breaking point will result in either recession, or setting a new and lower fixed exchange rate or to switch to a flexible regime. If we take United Kingdom as example again, we see that the situation was so drastic that the country had to resort to all three option, resulting in great depression. Even if they were part of the European Exchange Rate Mechanism, with a fixed rate, it did not stop speculators to aggressively bid against the pound, effectively make it crush and collect their earnings at the expenses of the economic stability of the country.

Conclusion

We have seen causes and effects of currency exchange and its main risks. The problem is not speculation itself, but the poor and inappropriate use of currencies exchange in the market. Make a profit from it is not an issue, but the cost or the eventual cost to gain this profit could have such a disastrous impact on our economy and detriment to governments. If only these transactions could be overviewed, controlled and regulated, the possibility to avoid the risk upstream would be higher, market would be safer, and crises minimized.

A solution could be implementing a tax such as the Tobin Tax or a tax on the transfers as Maynard Keynes proposed. I would tailor the tax on only transfers, or cumulated transfers from a single institution, above a certain amount, to avoid huge injection of capital in the market and to avoid economic instability. This could be interesting since the speculation is on the currency, and being the currency directly related to a country's economic situation, a tax could reinject some capital in governmental resources and make it easier to readjust and stabilise the rate of the currency in case of a fixed regime. Thus, it can have a double effect; speculators could just increase the volume of the transactions even more to reach the same amounts of profit as before, therefore a higher level of risk and instability than before. I believe that taxing any foreign exchange unconditionally would not be fair for importers or Foreign Direct Investment, for which the only scope is to protect their "real" business transaction from the depreciation of foreign currencies.

Also, as a strict policy and regulation, exchanges should be subjected to a minimum time hold up. As repeated several times, originally currency exchange was for importers and business investments, which have a long-term vision and a growth objective, therefore they have no reason for buying and selling in a short amount of time. In such a way Spot Market (on the day, or in very short amount of time), can be reduced to the tiniest possible, even if it coincides to only 33% of transaction on FOREX.

For this to be workable, the key factor would be to establish and impose a central and international regulator to administrate, control and sanction. Foreign Exchange has no central regulation, but several governmental and independent bodies supervise forex trading around the world. As long as no action is taken to make common regulations and standards for everybody to respect and follow, market manipulation and speculation attacks will continue to put at risk countries' economy and international relations.

Bibliography

Cambridge Dictionary, Speculation

Currency speculation. By: Weller, Christian, Dollars & Sense, 00125245, May/Jun98, Issue 217

https://www.lafinancepourtous.com/decryptages/marches-financiers/fonctionnement-du-marche/marche-des-changes-forex/transactions-quotidiennes-sur-le-marche-des-changes-forex/ Updated 4 November 2020

https://www.lafinancepourtous.com/decryptages/marches-financiers/fonctionnement-du-marche/marche-des-changes-forex/ Updated 16 February 2018

The General Theory of Employment, Interest and Money. Chapter 12. By John Maynard Keynes

https://www.forex.com/en-uk/education/education-themes/trading-concepts/how-is-forex-regulated/

https://www.theguardian.com/business/2012/sep/13/black-wednesday-20-years-pound-erm

https://www.investopedia.com/terms/h/high-frequency-trading.asp Updated 22 January 2021

https://www.ft.com/video/6e7cd4df-18c2-440a-8b20-01ed789d556d HFT