

SPECULATIVE ACTIVITIES IN THE FINANCIAL MARKETS AND ITS RELATION TO THE REAL ECONOMY

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Abstract: *Nowadays, financial markets are criticized for a high proportion of speculative activities and an unsustainable game of risk. The function of speculation as a stimulus for activities in financial markets has changed radically during last decades. At present, speculation has nevermore served the real economy as a mean for more efficient market functioning. The real economy has become a victim of uncontrolled and unsustainable increase of speculative activities. The main problem of speculation concept is a leverage principle that causes layering risk and creating in the world economy systematic risk that the market is not able to bear. The specific examples are the events of the past decade, especially the global financial and economic crisis. The main aim of contribution is to discuss the questionable relation between speculative activities in the financial markets and the real economy.*

Keywords: *speculations, financial markets*

JEL Classification: G15

1. INTRODUCTION

Financial markets are nowadays criticized for a weak relation with the real economy. The world economy of this century can be described as an economy based on the dominance of the financial markets sector. Recently, during global financial crisis, we have witnessed an enormous impact of the unhealthy functioning of the financial sector. At present, functioning of global financial system is criticized for a high share of speculative financial transactions, in this contribution presented by financial derivative trading. In this contribution we would like to describe the relation between financial derivative instruments and the real economy sector represented by their underlying assets. The main aim of the article is to point out on some aspects that could prove the weak relation between current financial markets' functioning and the real economy.

2. SPECULATIVE ACTIVITIES

Many years ago, the economist John M. Keynes emphasized the negative role of excessive speculation in the economy as a serious problem "when enterprise becomes the bubble on a whirlpool of speculation". He described the unhealthy process of risky capital creation „when the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done“(Keynes, 2002). Similarly, the present world economy, especially financial markets sector is facing the serious problem of unsustainable speculative activities

increase. In this paper we would like to point out on questionable relation between speculative activities in the financial markets and the real economy.

The term speculation is defined as the forming of a theory or conjecture without firm evidence or as an investment in stocks, property in the hope of gain but with the risk of loss (Oxford Dictionaries, 2014). There are at least two different views on the existence of speculation in the financial markets. Some authors emphasize the positive feature of speculation as a benefit for market functioning. According Samuelson we can consider speculation as a benefit for society if it fills its economic function that means if speculation is moving goods from the time of their surplus to the period of scarcity and thus help to improve market efficiency (Samuelson & Nordhaus, 2010, p.189). Speculation causes the moves that tend to establish definite patterns of prices over time as well as over space (Samuelson & Nordhaus, 2010, p.190). In this way many academics agree that speculation is one of the tools which help in price discovery, because its presence on market induces that all information about supply, demand and possible future fluctuations become absorbed in the price (FTI, 2011, p.23).

On the other hand, the present modern economy in recent decades has transformed its form and is increasingly dependent on the functioning or non-functioning financial sector. In this regard, growing process of risky capital creation based on speculative behaviour could cause a serious danger for financial stability on markets. Friedman refuses the generalization of argument that speculation has to be necessarily a destabilizing factor on markets and says that speculation in the market is destabilizing only in case when subjects behave in irrational way (if speculators sell when the price is low and buy when the price is high) (Friedman, 1960). The question about rational way of subject's behaviour on international financial markets still remains. The problem brake out with the introduction of derivative financial instruments.

2.1 Derivative financial instruments

For purpose of this paper we define speculation as the activity which involves making profits from the fluctuations in prices (Samuelson & Nordhaus, 2010) by purchasing during the upswing and selling during the downswing (Baumol, 1957). As a specific example of a speculative activity in the financial market we can consider trading of derivative financial instruments. International Monetary Fund provides a definition of financial derivatives as financial instruments that are linked to a specific financial instrument or indicator or commodity, and through which specific financial risks can be traded in financial markets in their own right (IMF, 2002).

Speculative trading has become more attractive because it offers the possibility of higher profits and also at the same time more dangerous because it equivalently increases the risk of loss. The introduction of new volatile financial instruments provided a great opportunity not only for the standard operators of financial markets, but also for public to become participants in speculative trading (Mitchell, 2007). Inexperienced market participants tend to underestimate the risk. Derivative financial instruments themselves are a game of risk (Chorafas, 2008, p.227). According to the OECD report, the global financial crisis was caused by a combination of risk underestimation plus innovative changes of such derivative instruments that allowed leverage to increase uncontrollably.

Leverage, which can be regarded as a fundamental principle of speculative financial transactions, provides its holder a possibility to trade with a whole range of rate risk. The level of

risk is often difficult to estimate. Moreover, leverage principle causes the illusion of increasing the perceived value of the underlying asset. We can increase the illusion of increased value of underlying assets by gradual layering of risk, thus by increasing leverage. Derivative financial instruments allow its holder to simulate any financial activity because he has the opportunity to dispose of large volumes of assets and combine different types of exposure.

At present, there is possible to identify on financial markets a trend of increasing concentration and accumulation of commercial activities associated with derivatives and their connecting to larger units. In recent years, the OECD has published several documents with a focus on global systemically important financial institutions. Systemic risk created during the crisis by global systemically important financial institutions, which unsustainable interlinked risks in the derivative market is still an alarming danger. The key importance of these important financial institutions is the fact they have huge amount of capital, which is theoretically able to absorb large shocks in financial markets and thereby avoid a system loss on the market (Wingnall & Atkinson, 2011).

3. THE RELATION OF FINANCIAL DERIVATIVES TO THE REAL ECONOMY

The second chapter of this paper will focus on the questionable relation between derivative trading in the financial markets and the real economy. The events of last decade, especially the period before the global financial and economic crisis are a specific example of an increasing trend in relation between financial sector and the real economy. We will outline the basic areas where we can describe the relation between derivative financial instruments and the real economy as a troubleshooting one.

3.1 The relationship of the derivative and its underlying

Derivatives are financial products whose value is derived and changes in response to a change in the price of an underlying (Chorafas, 2008, p.33). The underlying asset can represent for instance interest rate, currency exchange rate, commodity, security price, index or even another financial instrument. This relationship between derivative financial instrument and its underlying can be nowadays defined as very instable and predictable only in very uncertain matters. In case that the invention of derivative instruments had remained in their simplest basic forms, we would have considered the linear behaviour between derivative and its underlying. The perfect relationship between derivative and its underlying can be defined as a direct response of underlying asset's value change into a change in the price of derivative instrument.

With the gradual development of a derivative financial instruments, the financial market have become the witnesses of own derivative's environment creation. The results of this own environment with specific trade condition is a formation of current new difficult and complex forms of derivatives which have minimal relationship to its underlying. The main reasons for nonlinear relationship between derivative and its underlying are caused by derivatives market. First of all, the value of the derivative does not move mechanically in line with a given cash market. Secondly, in many cases, the derivatives market itself determines prices in the underlying (Chorafas, 2008, p.38).

Derivatives market price determination which is not based on real value of the underlying of derivative instruments is the one of the basic reasons of nonlinear behaviour of derivatives.

The others indicators which have considerable impact on derivatives price determination are for instance the value of other products on derivatives market, the risk level of derivative, the amount of potential profit, the structure and complexity of the instrument, the credibility of company and many others.

The current nonlinear behaviour of derivatives to its underlying assets can cause such kind of derivatives' development that is not easy and reliable to predict. Uncertain and unpredictable development of derivatives behaviour is a factor that contributes to the financial markets instability and thus affects the real economy.

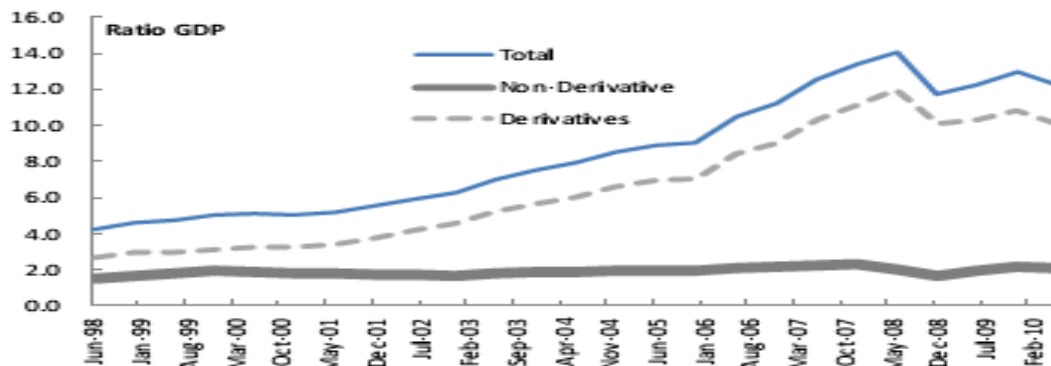
3.2. The disproportionate growth of derivatives

The particular example of decreasing dependence between derivatives and its underlying asset is the fact that derivatives have grown exponentially versus world GDP in the pre-crisis period.

Figure 1 shows a development of notional global value of derivatives as a share of global GDP and primary global financial instruments during the period 1998 - 2010. It shows that in the last decade the amount of derivatives has increased exponentially faster than the amount of primary securities (de facto their underlying assets) have increased. The total amount of underlying assets in 2010 reached a value equally high to double GDP produced in the same year. In comparison with the year 1998 it represents only a minimal increase (in 1998 this ratio was 1,5 times with global GDP) (Wingnall & Atkinson, 2011, p.3). On the other hand, there is an obvious asymmetry with comparison to an increase of derivatives business. In mentioned period the quantity of derivatives has grown radically. The notional value of derivatives in 1998 was 81 trillion dollars, which represented approximately 2,5 times the global GDP in that year. In 2010 their value rose to 605 trillion dollars, which represented around 10 times the global GDP in 2010 (Wingnall & Atkinson, 2011, p.3).

The exponential increase in global notional derivatives compared with an increase of the underlying assets shows a decreasing dependence between the value of derivative and the actual value of its underlying. The basic element of derivatives has become speculation. Financial markets, which driving force is trading of financial instruments based on speculation may not be stable in the long term.

Figure 1 Global notional derivative versus primary securities 1998-2010



Source: Wingnall & Atkinson, 2011, p.4.

4. CONCLUSIONS

The global economic and financial crisis (2008) is direct evidence that the presence and implementation of high-risk financial instruments destabilize the financial sector. High-risk financial instruments, also called toxic assets are the result of uncontrolled speculative using of leverage. The basic principle of the financial system has radically changed - the financial system has no longer served to the real economy, but the real economy has served the financial system based on speculative financial transactions.

We identified two aspects of questionable relationship between financial markets tools and the real economy. The first one is the nonlinear behavior between derivative and its underlying. A weak relationship between them, that means a decreasing dependence of derivatives and its underlying asset, is a factor that contributes to the financial markets instability and thus affects the real economy. The second aspect is the example is the exponentially higher growth of derivatives in comparison with world GDP in the pre-crisis period.

We can conclude that with respect to important role of the international financial sector in the global economy, solving the issue of speculative financial operations, particularly in international derivative markets, and their impact on the overall stability of the global economy is inevitable in further discussion.

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