

Finance Assembly

This morning, I'd like to think about a subject that falls under the Economics Department's area of focus. I'd like to reflect on banking and specifically the speculative trading that banks do. For this assembly I am grateful to John Lanchester, whose words and thinking inform my own.

Most people do not fully understand what contemporary finance is and does. We might think that banking is mostly about transferring money from place A to place B. I think we all understand that money deposited in a savings account need not simply sit there, accumulating interest. It could instead be redeployed to support a start-up business with a bank loan or a first-time buyer with their mortgage. Everyone benefits and the money is efficiently recycled through the system. In this example, real money is employed by real people to make a real difference in the world. Of course, banks do still act in this manner. However, this idea is very outdated. This use of money is not the main activity of modern finance.

The UK banking sector has assets of trillions and trillions and trillions of pounds, many times the aggregate income of everyone in the country. But these assets are not like the money we described in the previous scenario.

These bank assets are mostly claims on other banks. The liabilities of banks are mostly obligations to other banks. The sort of activity that most people assume is the principal business of the bank - lending to firms and individuals who are actually making things or actually offering services - is less than 3% of their total business.

What, then, is happening with the other 97%? What are these claims on other banks or obligations to other banks? Much of it can be positive force in society. Investment banks deal with wealth management, both for rich people and to support everyone's pensions. The banking sector creates a lot of jobs in the UK: 2.5 million people in the UK work in financial services or related professional services. The sector accounts for 12% of GDP according to HM Treasury in 2023. I think that the business of finance and banking is essential and the vast majority of those involved in it are doing good work.

However, there are some activities that are more worrying. A goodly chunk of the 97% is speculative trading, derivatives, foreign exchange and shorting. You might not know what that means - the easiest word to use to describe it is 'gambling'.

Modern traders make their money by speculating on the movement of prices: they make bets on their direction of travel – whether prices go up or down.

It works something like this: imagine a community that is self-sufficient but over the course of the year produces one cash crop of a hundred crates of fruit. Because it's always helpful to have money sooner rather than later, the community sells the future ownership of their fruit harvest to a broker for a pound a crate. That broker then immediately sells the rights to the crop to a dealer who has heard a rumour that there will be a rainy summer this year. He thinks that the bad weather will make fruit more scarce and therefore more valuable, so the dealer is willing to pay £1.10 a crate. The rumour about the weather spreads more widely, and a speculator hears it. That speculator is willing to pay £1.20 for the as yet unripe and unharvested fruit. A specialist 'momentum trader', whose job it is to pick up on trends in the market, piles in and is willing to offer £1.30 per crate. At this point the non-existent fruit is looking pretty expensive, so a further trader takes a contrary view and short sells the imaginary fruit for £1.20. Others spot the move and react to the short selling by bidding the prices back down to £1.10 and then finally to £1 pound a crate. Now, there is a new

development: long-range weather forecasts predict a particularly pleasing summer for fruit production. It looks like there will be a glut on the market and too much fruit. So, another trader further shorts the price to just 90p per crate. At this point in the story our original broker re-enters the market and buys back the notional fruit, which causes the price to return to £1. The fruit ripens and is harvested. The crates are packed with fruit and sold in the shops where an actual customer buys the fruit for £1.10 per crate.

The only real transaction was that final purchase of actual fruit. In that transaction real money changed hands, as did real fruit. All of the other transactions were trading: speculation on the movement of the price of the fruit in our story. Between the time when the fruit was growing and when it was bought there were nine transactions. All were basically zero-sum activities: some people made money and some lost it and it all cancelled out. No value was created in the process.

And, boiled down to the essentials, that process is a significant element of the activity in financial centres. The total value of all the economic activity in the world is estimated at \$105 trillion. That's real things - that's the fruit growing in the story. The value of the financial derivatives which arise from this activity - that's the trading - is \$667 trillion. By a very large margin, that is the biggest business in the world. And much of that business is essentially useless. It does nothing and it adds no value. It's just one person gambling against another; for every winner there is another equivalent loser.

This type of speculation is a problem. It creates something from nothing and goes on, and on, and on... until the underlying asset is a distant memory. This has led to many problems, such as the financial crisis in 2008, where automated systems created a huge chain of 'assets' that were based on faulty assumptions and quickly became liabilities.

There are two legitimate ways of acquiring something in our society. You can either earn it or be given it. By far, the most successful way of earning is to get involved in finance.

People who engage in speculative trading are paid fortunes for the gambling they undertake. But what the traders do, all day and for great reward, is absolutely useless. Their work produces nothing and creates no benefit for society overall, since every financial win is matched by another's financial loss. Perhaps you are thinking that these traders will pay tax - perhaps that is society's gain. However, if the losers offset their lost money against their tax, then it all heads back towards neutrality.

Do you remember the recent pandemic? Do you remember stepping outside your home and banging pots and pans together to celebrate the work of the nurses in the NHS? Do you remember that for a moment the values of society were turned upside down and we appreciated and celebrated those employed in the worst paid jobs? Ironically, they turned out to be the very people upon which society and our families depended. It didn't take long to forget. Nurses remain woefully poorly paid, whilst the traders have had the cap restricting the scale of their bonuses removed.

Now, I'm very aware that my words are countercultural. There will be many listeners in the room whose dearest ambition is to become a trader. I hope they will think hard about their choices. Those in the room who disagree with my argument may be drawn to the size of salary offered by that career. They may feel that the job's particular focus upon mathematics and logical thinking suits their mindset. They may feel that they have a right to tend their own garden and look after their own interests. Fair enough, I can understand that point of view, even as I disagree with it.

However, if you do find yourself taking that point of view, I would take care in expressing it in university interviews. The kind of interview you must do well in, in order to get you admitted to the Mathematics, Economics or Finance course that will allow you a safe passage to the trading career you seek. You see, the Maths or Economics lecturer who is interviewing you will certainly have had the option of pursuing a career in finance. They didn't choose that path. Instead, they chose a life of the mind - a life of intellectual endeavour. They chose to value the communication of their passion for Mathematics or Economics to willing students. The same is true of your teachers here at Merchant Taylors'.

In other words, from a position of academic and intellectual strength, some very clever people have rejected what you seek. They have valued learning, communication of knowledge and intellectual endeavour.

If they're so smart, maybe they have a point. It's worth the effort to think again.