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Global Casinos: Financial Markets Are a Fraudsters Paradise

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*"Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation. 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" (**John Maynard Keynes**(1)).*

In other words, the financial sector should be the servant of the real economy, not its master.(2) Unfortunately, this is not currently the case.

Many of the biggest banks, and many other financial companies, devote most of their resources to activities that provide no benefit to the real world, but which can have negative consequences for everyone else. This post summarises some of the most problematic activities, such as speculation, private equity, hedge funds, vulture funds, and high frequency trading.

Currency Speculation – It's Just Gambling But It Destroys Economies

Currency speculation is where traders buy and sell different currencies in order to make profits. The trade on the international currency exchange markets is over $6 trillion per day, which totals over $2 quadrillion per year.(3) This is over 100 times greater than the total size of international trade in goods, which is only $19 trillion.(4) It is also many times greater than the economy of the whole world, which totalled about $133 trillion in 2019.(5) The scale of these numbers is rather difficult to comprehend, but for every $1 of genuine trade in physical goods like bananas or cars, there is $100 of currency trading. Therefore, almost all of this is for speculation, which is really just a euphemism for gambling.

Up until the 1970s, this currency trading was much smaller, and it was used to finance genuine trade between countries. Unfortunately banks realised that it could be used as a form of gambling to make enormous profits. Buying and selling large amounts of currency can cause exchange rates to change, sometimes very quickly. A sudden drop in the value of a currency can destabilise a country, as prices for basic essentials rise. In poor countries this can cause widespread poverty virtually overnight.

This system of gambling with the world's currencies causes serious financial crises on a fairly regular basis, and these have become more frequent in the last forty years. In 1997 the currencies of Thailand, Indonesia and South Korea plummeted in value during what became known as the East Asian currency crisis. Indonesia's currency dropped almost to one-tenth of its previous value, causing riots because ordinary people could not afford to buy food. It is estimated that 24 million people lost their jobs in Asia during this crisis and the huge rise in poverty led to an increase in the child sex industry. At the same time, corporations from rich countries were able to move in and buy up large numbers of Asian businesses for fire-sale prices.(6)

For British people, the most notorious currency trader was George Soros. In 1992 he gambled against Sterling (the financial term used to refer to the currency in Britain) and made $1 billion on what became known as Black Wednesday. It is estimated that the cost to the British taxpayer was £3.4 billion. Soros has subsequently spoken out against the worst aspects of the system. He stated:

> "The totally free flow of capital is not advisable, so you need to create some mechanism for introducing stability."(7)

Even longtime believers in the free movement of money, such as the International Monetary Fund (IMF) have admitted that controlling flows of currency is sometimes necessary.(8)

Derivatives – Financial Weapons of Mass Destruction

The system of large-scale gambling carried out by the biggest financial companies is much broader than just buying and selling currencies. This is known as derivatives trading. In 2020 the total value of derivatives trades was $600 trillion.(9) There are a wide variety of derivatives, some of them incredibly complex, with names such as futures, options or swaps. This includes some of the investments that were at the heart of the frauds committed during the financial crisis, such as Credit Default Swaps (CDSs).

Gamblers use derivatives to bet on the future price of all manner of things, such as food and oil. Unfortunately, the betting can cause the prices of food and oil to change. Poverty in poor countries increased dramatically in 2007-2008 because gamblers pushed up the price of basic essentials, leading to food riots around the world.(10) Some of these systems of gambling have been described as 'financial weapons of mass destruction' due to the potential devastation that they can cause.(11)

It is difficult to run a country well if your currency is not fairly stable, or if the cost of essentials is increasing rapidly. In advanced nations like the US and Britain the downsides involve job losses and businesses going bankrupt. In a poor country, the downsides are malnutrition, starvation, disease and death. There are a number of ways to control the gambling, most simply by taxing each bet (this is known as a Tobin Tax) but governments in rich countries have so far shown little inclination to do so because international financiers based in Britain and the US make too much profit from it.(12)

Shadow Banking – Hedge Funds and Private Equity Funds

Shadow banking refers to businesses that carry out banking activities but are not regulated like banks. This includes private equity funds and hedge funds.

Private equity funds have been described as locusts, because they buy, manage and sell companies, siphoning off wealth as they go, by cutting jobs and wages, making fraudulent valuations, and charging excess fees.(13) Inadequate regulation means that they can obtain funds from other countries with no oversight, making them ideal for money launderers.(14) They take payments from selected clients or investors to give them advantages, at the expense of other investors.

Private equity funds borrow huge amounts of money (this is known as leverage) to buy and re-finance companies. If their investment is successful, leverage enables them to make much bigger profits, but if it is unsuccessful, they make much bigger losses. However, the debt is owed by the company, not the private equity firm, so the employees and creditors bear the risk.(15) This makes companies more prone to bankruptcy.

The regulator that is meant to oversee private equity firms in the US is the Securities and Exchange Commission (SEC). Private equity billionaires donated to Donald Trump(16) and in return he appointed a private equity lawyer to run the SEC. He immediately pushed for more deregulation to allow pension funds to invest more into private equity funds. This allows private equity firms to grow enormously and to earn much higher fees.

Courts have no power to punish private equity funds that rip-off investors. At best, a court can insist that money is returned. There have been some fines for misleading investors about fees, and for conflicts of interest(17) butregulators appear powerless to stop fraud. In 2020:

> “The SEC issued a scathing report documenting a private equity crime spree that is fleecing pension funds, university endowments and other investors. The timing of the report is particularly important. The SEC’s report reads like a career regulators’ last-ditch plea for help at the very moment they see private equity billionaires on the verge of creating a lawless autonomous zone for themselves.”(18)

Hedge Funds

Hedge-funds specialise in using complex mathematics and sophisticated trading strategies (known as hedging) to gamble on the markets. If they are successful, they keep a chunk of the profits. If they are unsuccessful, the managers lose nothing, as they are using other people’s money. In 2020, 5 hedge fund managers were paid over $1billion each.(19)

In her book about hedge funds and insider trading, Black Edge,(20) Sheelah Kolhatkar explains that they make much of their profit from illegal activities known as insider trading, which means that they have information that other investors do not have. Corrupt financiers have a long history of insider trading on stock markets, so this is nothing new, but hedge funds have taken it to a new level. As an example Kolhatkar points out that 10% of US doctors have connections to financial companies. They are paid to provide information about pharmaceuticals and healthcare that is not known to the public. In the US, over 70 people have been found guilty of insider trading in recent prosecutions.(21)

Vulture Funds

When a poor country cannot pay its debts, lenders will eventually write them off. However, these debts can be sold to someone else. A vulture fund is a company that buys these debts for a fraction of their original value. If the vulture fund can force the debtor to pay by suing them in court, they make huge profits.(22) It is estimated that two vulture funds made 1,500% profit by suing Argentina.(23) Even the World Bank and the IMF have criticized Vulture Funds, as they undermine efforts to give debt relief to poor countries. In the UK, new laws were introduced in 2010 to block vulture funds from using British courts to pursue these debts.

High Frequency Trading (HFT), Co-location and Microwave Transmitters

Banks invest in technology to get information before anyone else has it. They locate their computers next to financial exchanges (known as co-location), and they build microwave transmitters to carry information between exchanges, such as New York and Chicago.(24) Banks also use computers to make huge numbers of trades in a fraction of a second, with no human involvement (known as high-frequency trading or HFT). The combination of these things enables them to consistently make small profits on huge numbers of trades.

All of these methods give advantages to the biggest, richest companies, but so far, regulators have shown little interest in ending these techniques. They also make the system much more unstable, leading to what are known as 'flash crashes',(25) where multiple computers respond to each others' actions in unpredictable ways. In 2012, Knight Capital lost $440 million dollars after its computers placed huge numbers of incorrect orders because of problems with their software.(26)

HFT is impossible to regulate. Everything takes place within a computer (sometimes called a black box) so no-one really knows what is going on. Most of these trades will never be audited, so fraud and manipulation become almost impossible to detect. If companies use information that is only available to insiders, it is a crime known as insider trading. These new technologies effectively make it legal for insiders to trade with information not yet available to everyone else.

Societies would be better off if these activities were outlawed

Financiers will always try to justify their activities by claiming that they make the markets 'more liquid' (easier to buy and sell) or more efficient. However, these techniques are essentially old wine in new bottles. New forms of obtaining information before everyone else; new forms of complexity to hide information; new forms of gambling with other people's money whilst making someone else take the risks. Insiders have admitted that the purpose of financial engineering is to move around the excess profits (known as rents) in the financial system, and to increase them.(27) If financiers are making huge profits, it is usually coming out of someone else's pocket.

There is a very strong case for making most currency trading, and most derivatives trading, illegal, and for ensuring that any organisation that is allowed to carry out a small amount of trading cannot destabilize the rest of the financial system. There is also a strong case for banning High Frequency Trading, and for banning the activities of the most exploitative types of hedge funds, private equity funds, and vulture funds.

Investing in companies should mostly be a long-term activity, to provide stable financing for business. Instead it has become a gamblers' paradise for insiders and fraudsters. Everything discussed in this post makes the financial system more complex, less transparent, and less stable. It is impossible to regulate or audit. The scale is so great that it poses a risk to the entire economic system. A handful of rich people and corporations should not have the power to gamble with the world's finances.

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Notes

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