

Chapter 13

On the Nature of Arbitrage and of Speculation

All the proposals for establishing a monetary system in which redemption is to be provided for with a "basket of commodities" have foundered because of their inability to resolve two problems, the problem of how to provide for the cost of storing the commodities, and the problem of how to cope with the instability of commodity prices. It is these two problems which make consideration of arbitrage and of speculation so important.

The costs of storing gold and silver are very low; they can readily be covered from the ordinary income of a bank-of-issue. But this is not true of commodities like corn and wheat. If these have to be stored, the costs would make their use for redemption impossible. If, however, instead of storing such commodities they were arbitrated and title to the desired quantities held by the bank only during transit, two things would happen: (1) the importers who would be buying them would not only pay all the costs of transportation (during which storage is provided) but, (2) if the arbitrating were done as well as in practice it is customarily done, it would yield the bank a substantial revenue.

To provide the commodities which are included in its unit of redemption, the bank should arbitrage those which cannot be economically stored, and store only those which can be stored at low costs. In practice it should have on hand in its own vaults enough of the precious metals—not only gold and silver but platinum whenever it is advantageous to do so—to take care of all calls for redemption. Any calls for redemption in a commodity other than one of these, should be taken care of out of those which it owns while engaged in arbitrating them.

Initially it is probable that redemption calls would probably be restricted to gold. Only if the supply of gold proves insufficient to meet all the calls would it become necessary for calls for redemption to be met with other commodities. It is the fact that the supply of gold is almost certain to prove insufficient that makes it necessary for the bank-of-issue to have both ownership and possession of the other commodities which will be needed to take care of this contingency.

It is also important to bear in mind that as long as each nation has a currency of its own, calls for redemption in these national currencies are certain to be more common than calls for redemption in commodities, including calls for gold.

Perhaps the most conspicuous fact about the prices of commodities today is the wildness of their fluctuations. That they should fluctuate does not call for any but the most obvious of explanation: they fluctuate because both demand and supply fluctuate and both fluctuations are independent variables. What needs explanation is why they fluctuate so widely and why they go way up and then way down so rapidly and so frequently.

The facts are these:

Human needs and human desires change, but they change very slowly. Human beings in the mass do not change their consumption habits suddenly. The demand for wheat, as a result of the consumer's desire for wheat products, is quite stable, and this is true of all staple commodities. That is the reason why they are called staples.

The production of wheat, on the other hand, may increase or decrease very greatly within a specific national growing region, but the variation will take place only between one growing season and another. Such marked increases or decreases, however, are not world-wide; they are national and regional only. Increases in one country tend often to offset decreases in others. World production, in other words, changes more slowly and is much more stable than national and regional production.

On the basis of the variable desire for wheat and the variable production of wheat, wheat prices should be expected to change. But they should change gradually, not suddenly and wildly.

Prices, however, in the modern world are not made on the basis of desire and of production. They are made on the basis of demand and supply. And here something new enters into the equation: speculation. Demand is not determined by desire any more than supply is determined by production. In our modern organized markets the demand for and the supply of any of the basic commodities, such as wheat, is almost wholly determined by speculation.

Here mass-psychology enters into the equation.

Reports of a poor wheat crop in some major wheat producing nations are published. Speculators begin to buy wheat, and the more they buy the faster prices go up. As more and more speculators enter the market in the hope of profiting from the rise, the prices tend to shoot up—sometimes fantastically—with no regard to the equation of desire and production. Finally the shrewdest speculators begin to realize that they have gone too high. They begin to unload; prices begin to drop and all the speculators tend to unload; prices then drop as drastically and as rapidly as they went up. And all this may take place over and over again, as rumors about production spread one way or another, within a single growing year.

To deal with both these problems, the problem of the storage of a commodity reserve, and the price fluctuations,

arbitrage is not only needed but must be enormously increased.

Arbitrage is the act of entering into two transactions simultaneously, one in which the arbitrageur or "dealer" buys a supply of a commodity, of a foreign money, of a security, or of any other kinds of goods from a seller in one place at one price, and another transaction in which he sells it to a buyer in another place at a price high enough to cover all the costs of making both transactions, (including all delivery costs), and to provide him with a profit. Arbitrage is not a new but an old business activity still regularly carried on by banks dealing in foreign exchange and by importers and exporters dealing in commodities.

Speculation, on the other hand, is the act of entering into transactions in which the speculator either (1) buys something at one price in anticipation of subsequently being able to sell it at a higher price, or (2) sells something which he does not then own at one price in anticipation of being able to buy it subsequently before it has to be delivered at a lower price.

The essential difference is that the arbitrageur buys and sells simultaneously while the speculator buys and sells at different times. The effect of arbitrage on price movements is to stabilize them; the effect of speculation is to intensify them.

If arbitrage were to be conducted on a large enough and wide enough scale, speculation would become less and less enticing. But perhaps even more than this, if it were to be promoted and practiced by an independent international agency such as the bank-of-issue I am calling for on the magnitude this would make possible, it would stabilize prices to such a degree that stabilization as a serious problem would disappear. Stabilization would make speculation peripheral instead of central in the determination of the prices of the basic commodities of the world.

To deal with the realities involved in establishing a stable alternative currency system on the basis of a commodity

reserve, the bank-of-issue I propose must engage in two kinds of arbitrage operations and set up two arbitrage departments, one to deal in the staple basic commodities which are most important in world trade and one to deal in foreign currency or foreign exchange.