IN DEFENSE OF SPECULATION

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As commodity prices rise and economic slowdown looms, attention in many influential segments of society has turned to speculators. A May 2008 paper by the International Food Policy Research Institute (IFPRI) identified eight initiatives to address rising commodity prices, and while acknowledging that speculation is not the cause of the problem but its consequence, proceeded to recommend a need for policies that "calm markets with the use of market-oriented regulation of speculation . . ."

Speculation seems to be looked down upon and speculators are talked about in common parlance as some aberration in the marketplace. But while people have a right to their private feeling about what other people do, the situation changes when lack of understanding of speculation lends support for regulation when the market consistently does that work efficiently. Because the calls are coming from such varied segment—from academics and politicians to news media personalities—it is important to try and offer another lens through which speculation and speculators may be perceived. Doing this may help in improving the definition of the problem and hence in the crafting of the solution. This may help us avoid responding to what Hahn and Passell calls "the compelling case to do something when the something is not."

Speculators as Entrepreneurs

The fifth definition of speculation in Webster's 3rd Edition (Online) is ". . . engaging in business out of the ordinary, by dealing with a view to making a profit from conjectural

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fluctuations in the price rather than from earnings of the ordinary profit of trade, or by entering into a business venture involving unusual risks for a chance of an unusually large gain or profit." Thus, speculators pursue unordinary ventures, taking on unusual risks with the view of earning economic rents—profit over and above the market. While the risks of their decisions are often apparent to them, they discount them on the belief that they are more likely to be right in those decisions than conventional wisdom would suggest. Typically, commodity markets see speculators as those who enter the market purely to benefit from price movements without any intention of delivering or receiving the products they sell or buy. It is widely believed that this implies they increase price volatility in the markets. But Radalj and McAleer recently showed that Milton Freidman's assertion that speculators have to exert a calming influence on prices in order to make profit is generally right.

Like entrepreneurs, speculators act on their beliefs about which future has the highest probability of occurring. Sometimes, this belief is based on no more than their interpretation of existing data available to everyone in the market. Other times, their belief is based on nothing but a gut feeling, a hunch or sheer entrepreneurial hubris. And at other times, they act deliberately after analyzing historical data for trends and evaluating the potential effects of seemingly unrelated external factors on the observed trends in the future.

Speculators' confidence in their belief about the future may cause them to invest their money and their reputation, like entrepreneurs, in this belief in the hope of generating higher than market return on investment. If they are right in their beliefs and actions, the market often rewards them. The market also punishes them without discrimination if they are wrong: they lose their investments—money and some shine off their reputation. The loss of reputation can be very expensive because it can be difficult to repair. Therefore, it is not something that reputable people risk lightly.

Instead of vilifying speculation, it is important to recognize it as an essential component of any efficient entrepreneurial system. Its ability to see potential when tested wisdom suggests failure allows it to drive economic and social agents to move away from the status quo in order to earn above market profits or other valuable treasures offered by society. Indeed, undertaking unordinary ventures is what leads every entrepreneur to believe their mousetrap will work where previous ones have failed. Speculation is an essential ingredient in innovation and fundamental to ensuring progress in any free society. Attempting to regulate speculation is akin to preventing people from expressing and acting upon their belief that they have superior knowledge or abilities to those around them. If we look at speculation within the foregoing context, then speculators are no different from anyone in our society exhibiting entrepreneurial hubris with the hope that they succeed in extracting rewards from the market for being right.

Dealing with Rising Commodity Prices

Economists supporting regulation of speculators argue that speculation creates bad results for society as a whole—e.g., higher price volatility and higher prices. But regulations offer second best solutions and can sometime lead to unintended consequences that are worse than the problems they intended to address. When second best solutions have worked, they have been applied to well-defined problems that the market is truly incapable of addressing. Such cases include monopolies with control over the supply of essential products and service. Regulation of these has generally worked and easing those regulations when the market indicates its ability to control behavior has also been shown to work.

Recent commodity price increases has fueled the calls to regulate speculators. For example, the World Bank recently reported that global food grain prices have more than doubled since January 2006. But rising food and commodity prices is a complex issue that involves systemic and dynamic interrelationships among numerous domestic and international variables: energy demand and supply, exchange rates, climate change, changing diets, rising incomes in developing countries, the food and agricultural policies, drought conditions, etc. Rising income in developing countries, for example, leads to diets shifting from plant to animal products. This leads to increasing demand for grain to feed food animals, signaling farmers to shift production from human cereals to feed grains. Increasing feed grain needs as well as for bio-energy has contributed to tight stock-to-use ratios over the past several years, forcing prices to increase gradually, and then sharply. Those not familiar with these price movements only became aware of them when they became news, and the search for culprits.

U.S. futures markets are regulated by the Commodity Futures Trading Commission (CFTC), which reviews exchange activities and trade patterns to ensure the integrity of the market is maintained. Our analysis of food commodities did not show any escalation in the share of speculative trade in the last two years to warrant new regulations for speculators. In the same vein, an interim report on crude oil by the Interagency Task Force on Commodity Markets concluded that current oil prices and the recent increases are principally a result of supply and demand conditions.

It is important to recognize that the CFTC has the tools it needs to maintain orderly trading in all the commodity markets under its jurisdiction. It has the ability to prosecute illegal actions that hurt the smooth operation of the markets. Therefore, unless the CFTC lacks the tools to control certain *emerging* actions of speculators that are adversely affecting the market, it will be unnecessary to impose new regulations on a specific group of economic agents for no justifiable reason. A knee-jerk reaction to regulate speculators when in fact there may be an emergence of new trajectories in commodity markets due to major shifts in the global economy is not going to address the concerns people have about rising commodity prices and may indeed exacerbate them. In a transparent marketplace, the best regulation for speculation is the undiscriminating and proverbial invisible hand of the market. It is, when left undisturbed, indeed the only force that is effective at regulating economic agents with little or no unintended consequences.

References and Further Reading

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