Two propositions about private speculation are widely held: first, that speculation is in fact often destabilizing, in the sense that it makes fluctuations in prices wider than they would “otherwise” be; second, that destabilizing speculation necessarily involves economic loss. This pair of propositions underlies much current opinion about commodity policy—where they lead to support for “buffer stocks” and similar plans—and about balance of payments policy—where they constitute a chief criticism of floating exchange rates.

This note is not intended to be an exhaustive analysis of this pair of propositions, or of speculation in general. Its purpose is much more limited: to point out that the second proposition is invalid, that destabilizing speculation, though it may in some cases lead to economic loss, may in others confer economic benefit. The empirical generalization about the prevalence of destabilizing speculation—which is what gives the theoretical proposition its interest—seems to be one of those propositions that has gained currency the way a rumor does—each man believes it because the next man does—and despite the absence of any substantial body of well documented evidence for it. It is a proposition that badly needs intensive empirical investigation. My own conjecture is that such an investigation would show it to be unfounded. But this is simply a conjecture and plays no part in what follows.

The ready acceptance of the proposition that destabilizing speculation is economically harmful reflects, I believe, a natural bias of the academic student against gambling and in favor of insurance. It is natural for him to regard a futures market, for example, as a market in which a “legitimate” producer hedges his risks by transferring them to a “speculator”; the producer is viewed as buying “insurance” from the speculator. But granted that this is a possible and indeed likely interpretation of an actual futures market, it is not the only possible one. May such a market not be one in which the “legitimate” producer engages as a side-line in selling “gambles” to speculators willing to pay a price for gambling and knowingly doing so? And if so, moral scruples about gambling aside, is any economic loss involved?

In arguing that destabilizing speculation need not involve economic loss I do not mean in any way to deny the usual view that stabilizing speculation confers benefit. In this usual view, the economic function of speculation is taken to be the reduction of inter-temporal differences in price. In a commodity market, for example, a speculator is viewed as performing this function by buying when the crop is plentiful and prices “abnormally” low, holding stocks of the commodity until prices have risen, and then selling when the crop is short and prices “abnormally” high. In this way, speculators transfer resources from less to more urgent uses. The difference between the prices at which they sell and buy is their margin, which must cover costs of storage and furnish their remuneration. The excess over storage costs is a payment for specialized skill in knowing when to buy and when to sell and perhaps also for bearing risk.
This model takes for granted that there is a meaningful distinction between speculative and other transactions, that one can speak of what the price would have been in the absence of speculation. This is a point that raises many difficulties and requires careful examination in any full analysis of speculation. We can, however, evade it for our purposes by narrowing the question under discussion. Consider any market in operation. Suppose that an additional set of transactions are made in that market by an additional group of people whom we shall call “speculators” or “new speculators”. We shall then deal only with the question whether this additional set of transactions increases the fluctuations in price and, if it increases them, whether it involves an economic loss or confers a gain. By dealing in this way with a change in the amount of speculation, we can avoid the troublesome intellectual problem of defining zero speculation without any essential loss in generality. We shall make one further assumption to evade a troublesome problem: namely, that the activities of speculators do not affect the quantities demanded and supplied by other participants in the market at each current price. This implies that there is a well-defined price that will clear the market at each point in the absence of speculation and that this price is not affected by speculation.

With these assumptions, it is clear that, if carrying costs are neglected, our model implies that speculators gain if they reduce inter-temporal differences in price, and lose if they widen such differences. Speculators can fill in the troughs of price movements only by buying net when prices would otherwise be low; they can flatten out the peaks only by selling net when prices would otherwise be high; unless they carry this so far as to reverse peaks and troughs, they gain by the difference. Conversely, speculators can make fluctuations wider (in the same direction) only by selling net when prices would otherwise be low and buying net when prices would otherwise be high. But this means that they sell at a lower price than they buy and so make losses. Our model therefore implicitly defines stabilizing speculation as speculation yielding gains (carrying costs aside) and destabilizing speculation as speculation yielding losses. The circumstances, if any, under which this will not be true deserve extensive examination in a full analysis of speculation but can be accepted for our more limited purposes, which is simply to show that destabilizing speculation need not involve economic loss, not that it cannot do so.

One reason why actual speculation might not conform to the model described in the preceding three paragraphs is avoidable ignorance. By no means all actions that are mistakes when viewed ex post fall into this category. If I wager even money that a coin will come up tails and it comes up heads, I clearly have made a mistake ex post, in the sense that I shall wish that I had chosen heads. If, in addition, I discover by an examination of the coin that it has heads on both sides or in some other way is biased toward heads, and if I could have made this examination before the wager, then I have also made a mistake ex ante. On the other hand, if such additional examination gives me no more reason than I had before to question my belief that the coin is fair, then my initial choice of tails may be bad luck but cannot be described as a mistake. The distinction between the two cases is, in principle, whether I would have acted differently in advance of the actual toss if I had had the knowledge I gained after the toss except for the actual outcome itself, i.e., if I had had the knowledge that it would have been possible for me to have had before the toss. In the same way, the mere fact that speculators make losses over a particular period and in fact destabilize prices for that period is no evidence either that the losses could have been avoided given the general state of knowledge when the speculation was entered into or that speculation is on balance destabilizing in any more fundamental sense.
If destabilizing speculation does arise from avoidable ignorance, it must be granted immediately that there is an economic loss. The loss is borne primarily by the speculators, though if the operation is sufficiently large, second order effects on others may not be negligible in the aggregate. It may be noted in passing that insofar as this case justifies any action by government, it justifies solely the distribution of knowledge. Suppose private speculation is destabilizing because ignorant speculators behave against their own interests, but speculation by government officials trying to achieve the same end as private speculators would be stabilizing because of greater knowledge. The appropriate solution is then for the government officials to make their knowledge available either by providing the information on which their price forecasts rest or by making and publishing the price forecasts themselves. If these are more accurate, on the whole, than the forecasts private speculators would otherwise use, private speculators have a strong incentive to act in accordance with them and in the process will produce the same results as government speculation in accordance with the same forecasts. If the forecasts are not more accurate, they will tend to be disregarded and no great harm will be done.\(^3\)

To see how destabilizing speculation can arise without avoidable ignorance, let us start with a commodity market which is in operation. Suppose that there exists independent gambling establishments in which all gambling takes the form of betting on the future price of the commodity in question—say rubber. The people who bet on the price of rubber in the hypothetical gambling establishment do not buy or sell rubber, and neither do the people who run the establishment. Their operations therefore have no direct effect on the price of rubber; the rubber market simply takes the place of the roulette wheel at Monte Carlo.\(^4\) We may suppose the proprietors of an establishment to operate solely as brokers, engaging in no gambling themselves but being paid a fee for providing facilities and bringing together people willing to take opposite sides of a common wager. And we suppose throughout that the people engaging in the gambling do so deliberately and are reasonably well informed: they like to gamble and are willing to pay a price to do so. Let us put to one side any moral objections to gambling, and suppose that the gambling services are provided under competitive conditions. The proprietors of the gambling house are then devoting economic resources to producing services to satisfy the wants of consumers, who are willingly buying the services and paying a price equal to the cost of the alternative services that could have been obtained with the same resources. Clearly there is economic gain rather than loss through the operation of the gambling house.\(^5\)

Of course, there may in fact be no demand for this service at a price sufficient to call it forth. Whether there is depends on the preferences of the public for gambling of various types, the kind of gambling provided by the rubber market—that is, the probability distribution of the price of rubber—the alternative sources of gambling services, their cost and character, and so on. The willingness of people to buy lottery tickets at less than their actuarial value even though they know full well the probabilities of prizes of various size is sufficient evidence that people are willing to pay a price to bear at least certain kinds of risks, to be subjected to increased uncertainty. In any event, our concern is not with the likelihood that gambling establishments of the kind described would be profitable but only with the consequences if they were.

Consider an individual who wants to bet that the price of rubber will be higher a month from now than it is now. He can place such a bet in the gambling establishment at some odds and subject to paying a commission to the proprietors. An alternative way in which he can subject himself to the same uncertainty is to buy rubber in the market, store it for a month, and then sell
it: he can accumulate positive stocks. The cost in this case is the cost of storage over the month. Similarly an individual who wants to bet that the price will fall can accomplish the same objective by selling rubber now, borrowing the physical commodity in order to make delivery currently: he can accumulate negative stocks. He may be paid for doing so, because he saves someone storage costs. Presumably however, the amount he is paid will be less than the storage costs, the difference being the fee for lending the commodity. And if the loan requires dipping into stocks needed, say, to facilitate production, storage costs may be, as it were, negative and he may have to pay to borrow the goods. (Remember that we are considering the effect of the actions of an additional group of people. Their holding negative stocks simply means that total stocks are less than they would otherwise be). Suppose individuals find this alternative way of gambling cheaper. The gambling establishments will then disappear and the gambling services be provided by the rubber market.

If purchases and sales just offset, there is no effect on current price and the net costs are the various commissions paid to transact the business. The market dealers have taken the business of providing gambling services away from the gambling institutions proper. But purchases and sales need not just offset one another—indeed, the lack of necessity for them to do so may be one of the advantages of operating through the market, though a similar possibility could be provided by the gambling establishments if their proprietors “made book” rather than simply acted as brokers. If purchases and sales do not offset one another, the price of the commodity is affected.

We have now combined the two activities: gambling on the price of rubber, and the rubber market proper. Given competitive conditions, this combination will occur only if it is a cheaper way to provide gambling services and so in this respect represents increased efficiency in the use of resources. If the total expenditures of the gamblers on gambling services exceeds the commissions involved, this is equivalent to saying that, viewed as a body of speculators, they engage in destabilizing speculation. But their losses are someone’s gain. In the first instance, they will be the gain of the initial participants in the rubber market. Operating on the rubber market has now become a more attractive business since one can now engage in joint production, producing gambling services as well as trading services. The result will be to attract more people into the activity. Temporary gains will be competed away and the trading margin proper reduced, so raising the average net price of rubber to the producer. But this in turn will stimulate output and so reduce the average net price of rubber to the consumer. The provision of gambling services is now being rendered jointly by the producers of rubber, the middle men, and the consumers of rubber. In return for wider fluctuations in price—which are required to provide the gamblers or speculators with the uncertainty they want to bear—the producer gets a higher average price and the consumer pays a lower average price.

Any individual producer or consumer who disliked the wider fluctuation of prices could insure himself against it. But, given our assumptions, it cannot be that producers and consumers would be willing to pay more on the average than the difference between old and new average prices to insure themselves against the wider fluctuations. For this would contradict the initial assumption that there was a demand for the services of the gambling establishments at a positive price. The people who were willing to make bets on the price of rubber—willing to assume risks—would then have found that they were paid, instead of having to pay, for doing so. Instead of the market
being supplemented by gambling institutions, it would have been supplemented by insurance companies, insuring people against the fluctuations in prices.

I grant readily that this picture of a world in which increasing fluctuations in the prices of commodities is a service that commands a positive price is hard to accept as a valid description of the actual world; not so much because people are not willing to pay for gambling—they clearly are—but because there seem to be so many cheaper ways of producing the gambles that people want to buy, though it must be noted that some of these are illegal in many countries. However, this is the picture that is implicit in the acceptance of the empirical generalization that destabilizing speculation often occurs in practice, except for such destabilizing speculation as is attributable to avoidable ignorance, or as may be consistent with deviations from our initial assumptions.

Whether particular services command a positive or negative price—are consumption services or productive services—is not determined by physical or technical considerations alone; it depends also on the tastes and preferences and the capacities and opportunities, of the community at large. Painting a fence is generally regarded as a productive service that must be paid for, as an activity yielding disutility, and so the price of painting a fence is generally negative; Tom Sawyer was able to reverse this attitude and to make it an activity yielding utility; he was able to charge a positive price for the privilege of painting a fence. This is the essential issue involved in judging speculation. Is bearing uncertainty a service that must be paid for? Or a privilege for which people are willing to pay? Is speculation the rendering of a productive service that commands a reward? Or is it a means of gaining utility on which people spend part of their income? If it turns out to be the second rather than the first, is this any reason for regarding it as involving economic loss? Does not the tendency to do so simply reflect the preconceptions of the academic?

Notes

* I am indebted for comments on an earlier draft to Martin Bailey, Harry Johnson, James Meade, Joan Robinson, and Dennis Robertson.
2 See *ibid.* for one such fuller examination. It will be clear that our assumptions rule out the main case there considered.
Baumol also considers a special case corresponding to our assumptions (pp. 269–70). His own conclusion is ambiguous but only because in judging the profitability of the speculation he does not require it to be carried through to completion, in the sense that the speculators end up in their initial position with respect to the holdings of the speculative commodity.
3 One case in which publication of forecasts or the equivalent might be especially called for is if the authorities feel it necessary to suppress some relevant information for security reasons. They might be able to offset the effects of such suppression on the judgments of traders by issuing price forecasts.
4 There could be an indirect effect if, for example, information about the odds ruling in the gambling transactions altered the expectations about future prices of the people trading on the spot market and so changed amounts diverted to stocks.
5 It will be noted that a pure futures market is very close to such a gambling establishment. A transaction on a futures market does not by itself have any effect on the spot market. It affects current price only to the extent that
the price established leads to operations on the spot market and thereby to a change in the size of stocks carried over. This is analogous to the indirect effect described in the preceding footnote.


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