In Defense of Speculation

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Whenever there is a shortage of any particular commodity, the media is sure to draw our attention to profits being made by "greedy speculators" who reap their windfalls while the ordinary citizens struggle to survive. The recent run-up in the prices of crude oil and gasoline has, predictably, resulted in calls for regulations to limit the activities of speculators in the oil market. Should we allow government to "protect" us from this speculation? Let's take a deeper look.

Let me start by saying that the analysis contained in this article is applicable to all commodities and products, not just the current surge in petroleum products. This is true because of the principle that is involved here. It is good for us to start every inquiry into a specific topic or situation by looking to see if there is a fundamental principle at stake.

The principle:

The principle consideration here has nothing to do with oil supply or prices, but it has everything to do with our analysis of the proper role of government and whether we should allow our government to regulate this aspect of the economy.

The key principle here is property rights.

All private parties have the God-given right to own property, whether tangible or intangible. Inherent in the right to own property is the right to buy, sell, or trade that property with other willing parties. The right of property ownership is not limited by the intended duration of the ownership nor by the reasons for the purchase. How can it be? If ownership rights were subject to conditions of motive, there could never be secure ownership since motives can never be determined without some ability of the state to accurately read minds.

The speculator is purchasing a commodity with the intent of reselling it later at a higher price.[1] The commodity is purchased from a willing seller at a mutually-agreed price—a price that both seller and buyer perceived to be beneficial, or they would not have voluntarily engaged in the exchange. After some period of time, the speculator will sell the commodity to a willing buyer at another mutually-agreed price. There is no coercion or fraud in either of the exchanges.

How can government interfere with this process without violating the very core principle of property rights? If we allow that it is permissible for government to limit the property rights of the oil speculator, then we must allow for an infinite list of other interventions.

Speculation is not limited to Wall Street

We have this warped perspective that speculation is limited to those Wall Street types who speculate for a living full-time. But this is not the case. In fact, most of us are speculators of one kind or another. If we have ever made a purchase of anything that will later be resold for a profit, we are speculating.

When I purchased my house, I fully expected to sell it for a profit at some future time. I do differ from the Wall Street speculator in that I will use my house in the interim, but this does not eliminate speculation as a partial motive for my purchase. Again, I would ask, "Can we limit the right of free exchange of goods and services based on the use or nonuse of that product or service?" The answer must be a resounding, "No".

I would suggest that a good law cannot regulate the activities of the full-time speculator and ignore the activities of the part-time speculator. To do so would amount to a significant inconsistency in our policy.

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The practicality:

It is my firm conviction that all public policy decisions should be "principle-based". Unfortunately, our thinking—and especially the thinking of those in government—quickly sets aside principle and focuses on the practical instead.

There is a danger in even discussing the practicality of an issue that is clearly a matter of principle. To defend the practicality of a public policy matter may imply that the principle is somehow insufficient for decision-making. Sound principles, however, should always be our basis for our decisions.

With that said, however, there still are those who do not subscribe to a principle-based decision-making paradigm. So I will briefly address the practical aspects of market speculation. My motive for discussing the practical is to demonstrate that decisions made on good principle will also produce the best practical outcome—even though it may be difficult to see exactly how.

In a time of scarcity, what are society's collective goals? I would suggest that the practically-minded person might desire to achieve the following objectives:

• Increase production,
• Reduce consumption, and
• Assure supply for the most essential uses

Voluntary, private speculation, if it has any effect at all, only promotes these goals. Because speculators buy and hold a commodity, their actions temporarily increase scarcity of the product. The speculators' purchases increase the demand for the commodity in question while simultaneously reducing its supply. If prices are unregulated, this scarcity will drive up prices. It is this increase in the commodity's price that is the key to our macroeconomic objectives. The resulting price increases will further the first two objectives on our list: increased production and reduced consumption. The price rise will create incentives for conservation and reduced consumption.

That incentive can occur even in the absence of speculation, but speculation and the higher prices that it creates will accelerate this desire to conserve. These same price increases will also provide additional incentive for producers to bring more of the scarce commodity to the market. Whether through research, exploration, technology, or the addition of more plants and facilities, higher prices will stimulate more production.

Our third objective is to assure adequate supply for the most essential uses. Again the pricing mechanisms of the market come to our rescue. As a commodity's price increases, some buyers will drop out of the market. Those who drop out of the market first will be those who receive the least benefit or utility from the use of that commodity. As the price continues to increase, only the highest and best uses of the product will continue to be met. In contrast, government rationing of scarce commodities, as opposed to the natural regulation of rising prices, always relies on the wisdom and integrity of government officials to determine who will and won't have access to the product.

Is there an optimal amount of speculation? Perhaps, but it is impossible to know exactly what it is. What we can say is that there is no profit potential for a speculator if the supply and demand for a product are relatively stable. When a commodity is becoming scarce (either because of increasing demand, decreasing supply, or a combination of the two), speculation is only profitable as long as the speculator buys the commodity below its ultimate price. Speculators therefore are motivated to limit their speculation. If they buy and hold the commodity above the non-speculated market price for any window of time, they will eventually lose money.

Does too much speculation hurt consumers or producers?

First, we must recognize that excess speculation is only an abstract academic concept. In a market that is free of government intervention and manipulation, speculators will make decisions based on their best available information. Any speculation that occurs, therefore, will be based on the best available information at that point in time. In theory, we can only identify excess speculation in hind-sight.

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The profit potential in speculation is directly proportional to the need for that speculation. If there is excess speculation, then speculative investors will lose money. "Excess speculation" will, in the near term, work to the benefit of producers and to the detriment of consumers because it increases prices. But in the longer term, excess speculation will produce the opposite effect: benefiting consumers and hurting producers. Speculation that drives the price up too high or that drives it up for too long will eventually cause a more precipitous decline in prices, benefiting consumers of that product. This is a natural balancing effect that is inherent in an unregulated free market economy.

Speculators who misread market conditions will lose money, but those who more accurately judge the conditions will make money. As always, the free market rewards those whose actions benefit others. Unfortunately, we can't say the same for government regulators who might say that they are protecting us from greedy speculators.

Conclusion

The overarching consideration in any nation's economic policy should be the preservation and protection of individual rights. Chief among these God-given rights is the right to own property—and property ownership, by logical and ethical necessity, entails the right to purchase, hold, sell, modify, or give away this property. This right is absolute and is only limited by the equivalent rights of others to do the same. The right of property ownership and its voluntary exchange is the heart of the free market. Take away this right, and by definition you have socialism. In the study of political economy, there are only two economic systems: free market capitalism and socialism. America has already breached this line in numerous ways, and it is these breaches that are causing the economic crises of the day. We must be extremely vigilant to avoid any crossing of the line toward socialism. More than any other consideration, a nation's policies toward property rights are what determine whether that nation has free market capitalism or socialism.

The practical economic considerations relating to market speculation are certainly more complex than the principle considerations, yet sound economic analysis will demonstrate that the free market will meet our economic goals better than any plan involving government regulation or intervention.

To sacrifice individual rights on the altar of any economic theory is tantamount to drinking poison to treat a cold. Let us make the recognition of our rights and the preservation of our liberties the paramount objective of our political system. If we follow this course, prosperity will always follow.

1 I must note that not all speculation involves the actual buying and holding of the commodity. A wide variety of complex financial contracts and systems provide many different ways to speculate. A full discussion of these is beyond the scope of this paper, but each of these sophisticated speculative tools has effects that are very similar to the simpler form of speculation referred to here.

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