In a recent exchange with a friend, a common view of commodity speculators emerged that they drive up prices and extract money from the rest of us. The actual role of speculation in the market does not intuitively make sense, and I had to work with it in some detail to understand why price speculation is actually beneficial. In what follows I assume that the price of the good in question is fairly elastic, that is, that prices go up when there is less of the good, and prices fall when there is plenty of the good. I will first state the conclusion, then explain it.

Conclusion: Accurate speculation – and much probably is, or it could not continue – brings future prices into the present market. In the process, the actions of speculators can flatten the peaks and troughs of the supply of a good. Flattening the extremes in supply can thus help avoid price extremes, and in the case of an anticipated shortfall it can help conserve the scarce goods in play.

To understand why, consider an example of a reduced agricultural harvest, perhaps due to a sustained drought. A price rise after a short harvest is expected; with a reduced supply, buyers will bid up prices on available stocks, because there is less to satisfy demand. As an unintended consequence, the price rise helps conserve the resource. Prices function as a form of communication about availability of and demand for a given product, or about how much there is and how much others want it. As prices rise due to a shorter supply, buyers begin seeking alternatives in order to keep their total costs down. As demand shifts to alternative goods less of the resource is consumed, and pressure on the price of the good is alleviated. This is all part of the normal market dynamic in the event of an actual short supply.

However, one need not wait until the actual harvest to see what will happen. Sophisticated crop forecasts constantly track multiple factors, and the short harvest may well be seen some time in advance. Forecasts of a short harvest communicate valuable information: there will be less of the good in the future, and its price will rise. With the expectation of higher prices, one has an incentive to hold current stocks out of the market in anticipation of higher future prices, or perhaps purchase additional stocks at current prices, because what one holds now will be worth more after prices rise.

However, holding current stocks out of the market or purchasing additional stocks now, in anticipation of a future price rise, restricts the *current* supply, resulting in a *current* price increase, prior to the actual short harvest. This is how speculation on a harvest still some time in the future can actually bring future prices forward to the present time. Additionally, the present price rise reduces current consumption, more than would normally be the case if the short harvest were not foreseen, which conserves the resource.

The reverse holds for bumper crops and lower prices. If a bumper crop is forecast, supply will be higher at harvest, meaning that prices will fall. Those holding the resource have an incentive to sell now before prices fall further, Furthermore, the lower price may stimulate higher consumption, resulting in a lesser supply peak and consequent deeper price trough.

Another example might help better understand both time shifting prices and resource conservation. A harvest is expected to be the same as last year, which is normal. With an anticipated normal harvest there is no incentive to hold stocks back in anticipation of a reduced

supply and higher price, or conversely to sell current stocks now in anticipation of a bumper crop and consequent lower price. With supply and prices remaining steady in anticipation of a normal harvest, consumption continues at current levels.

Quite unexpectedly, a week before harvest a freak storm blows through, dumping rain and hail over a wide area and ruining 20% of the harvest. The reduced harvest immediately causes an upward price shock as buyers and sellers quickly adjust to the new actual supply levels. Because the short harvest was not foreseen, consumption had continued normally up to the sudden storm, with the net effect that the total supply after the short harvest is less than the supply that might have been available had consumption been previously reduced – due to higher prices – in anticipation of the short harvest. And, because the total post-harvest supply is less than what it could have been had the shortfall been foreseen, the price is consequently higher than it otherwise would have been.

The dim view of speculators is not hard to understand if one has the general impression that speculators always tend to drive prices than they would normally otherwise be, and in so doing they are making a killing off of us; that can be a difficult impression to break. If prices happen to fall and the speculator loses money, there may well be a sense that they had it coming for gouging the rest of us. However, when one understands the double benefits over time of flattening prices and resource consumption, there may be reason to see speculators in a softer light.

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