Following the previous post on the role of speculators in markets, this is a more conceptual view of what is happening with the information system of prices in markets.

We do not normally think of prices as communicating information, but a price is actually a bit of information that sums up much information about many other aspects in an economy.

The price of a good in a market is a snapshot of a dynamic balance of the supply of the good and the demand for it, however supply and demand are determined. If carrots are in short supply, perhaps because of a transportation strike or a low harvest, the price of carrots will rise as long as people are willing to pay the asking price. As a consumer one need not know or care about the causes of the short supply; what ultimately matters is that given an available supply, prices reflect the value that one's fellow consumers are willing to pay for that supply. If the price is above what I want to pay for carrots, I will look for alternatives; that carrots remain at the higher price communicates that there are other consumers who are willing to pay more than me. In other words, if not enough people were willing to buy carrots at the higher offered price, the price would fall.

A price includes elements of objective cost and subjective value. Producing carrots has hard costs in land, seed, fertilizer, labor, equipment, and so forth; transporting carrots to market has hard costs in fuel, equipment, labor, and profits the local retailer must make. If all those costs are not lower than consumers' collective willingness to buy carrots at the price required to cover those costs, there will not be any carrots in the market (barring federal price support programs that distort the market price).

Note however that a consumer's valuation of carrots is subjective, based on what value he gives to carrots in the overall basket of goods he wants to eat. Nothing requires him to buy carrots; if the price of carrots is low with respect to other vegetables, he may eat carrots more often. How he assigns value to carrots is a highly individualistic and dynamic process that is unique to him, a process that is repeated in each consumer.

Here is how price distills a great deal of information. The producer knows nothing of the grocer's costs; he only knows that he must sell carrots for a certain price to make enough to stay in business. The grocer need know nothing of how her customers arrive at their valuations of carrots; all she needs to know is that she must sell them at a certain minimum price in order to make an adequate profit to keep her store open. Consumers need know nothing of the costs incurred by producers, transporters, grocers, or other consumers to evaluate how much they want to pay for carrots; if the offered price – the result of all the processes required to make carrots available – is within the dynamic value assigned to carrots by enough consumers, a market for carrots will sustain.

Speculators fit in this situation because they have specialized knowledge about the future availability of a good. The speculator tracks that information because she sees an opportunity to make money by working with the difference between current prices, based on current supply and demand balances, and future prices based on the anticipated supply. As described in the previous post, in so doing they bring future prices into present markets, which tends to flatten the extremes in the consumption of a good, and the key to that is the information on which they act about the future supply of a good.

In so doing – without this being their goal – the result of speculation is to align the current price of the good to communicate more accurate information about the supply that will soon develop.

Most of us, if we know that the price of something will go up in the future, for whatever reason, will at least hold on to the supply we have or perhaps buy more if we can while the price is still low. If enough people have that knowledge of a price increase and act on it to buy more of the product now, the effect is exactly the same as speculation, in that current prices will increase and current consumption will tend to decrease, bringing future conditions into present markets.

Are speculators immoral in acting as they do? Not necessarily any more or less than the rest of us. The knowledge of a short or abundant carrot harvest may be available to anyone who cares to look for it, but just how many of us care to track carrot harvest forecasts – or for broccoli, apples, mangos, and every good we consume? None of us can track the highly dynamic information available in that many specific situations. Speculators, by acting on that specialized knowledge, bring about the same effects as if all of us were to know and act on it.

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