

Speculation serves a useful social function

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In days of yore, oriental despots commonly treated the bearers of bad news in a rather extreme manner: they beheaded them!

We have made great strides in modern Canada, at least as far as humane-ness of punishment is concerned. We no longer execute messengers. But in the case of at least one type of bearer of bad news — the speculator — our present understanding and appreciation of his task rivals even that of the ancient oriental despot — in its ignorance.

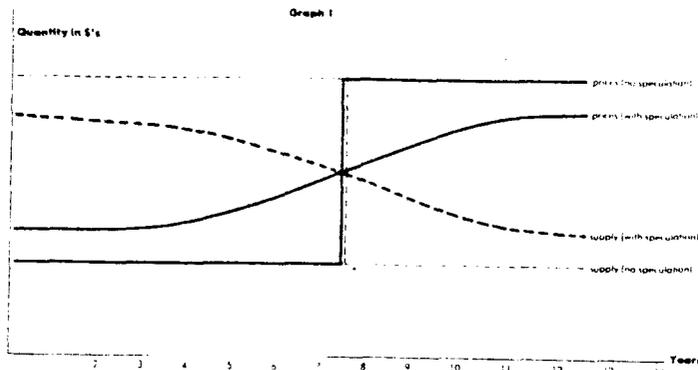
Yes, the speculator delivers bad news: high prices and shortages. Yet very few people interpret speculation in this manner. Instead, our pundits, editorialists and commentators heap abuse upon his head. "Profiteer," "gouger," "flipper," "flogger of paper," "exploiter," "despoiler of the poor," are some of the more polite monikers ascribed to the speculator. The others are not fit to print!

In the past few years, housing and especially land prices in the Vancouver/Lower Mainland area have been catapulting upwards. It is not uncommon for single family home values to have doubled in 1979 and then again in 1980 — according to stories in the local newspapers. And official statistics are broadly consistent with this account, registering a more than three-fold spurt in land prices in the 1971 - 1980 period.

But this phenomenon is by no means limited to British Columbia. As the roller coaster of western land and housing prices has begun to lose some of its momentum in 1981, and since real estate markets in places such as Toronto, Regina, Montreal, Winnipeg, Hamilton, Guelph and Halifax have been lagging

behind, these cities have been recently attracting "smart" investment funds and undergoing, as a result, significant rises in home values there as well.

If Vancouver's experience is any indication, we can soon expect a chorus of complaints blaming the speculator for rising home prices all across Canada — or rather a resumption of same, for since time immemorial speculators have been vilified for high and rising prices.



This view is incorrect; in fact the opposite is true: the result of speculation is to reduce the extent of price rises from what would have prevailed without it. To see this clearly, let us consider the uncontroversial example of "widgets", and then, having established the basic principles for the classic case, apply them to the special and more sensitive issue of land and housing prices in Canada.

Accordingly, we shall suppose that in the absence of speculation, the future supply of widgets is as in the Biblical story: seven fat years followed by seven lean. Given similar demand in the two periods, the years of ample supply would result in low prices and the era of short supply in high prices.

Enter the speculator. What will he do? If he has any sense, he will follow the sage counsel of profit-seeking: buy when prices are low and sell when they are high. His initial purchases will, to be sure, raise prices above the low levels that would otherwise obtain in the first period, as his additional speculative demand is now added to the demand to buy widgets for consumption purposes. But his subsequent sales will reduce prices from the high levels that would prevail, apart from his efforts, in the second time interval. This is because speculative sales, when added to other sales, must depress prices further than all other sales would have done by themselves.

The speculator will be seen by people to be selling at high prices in years 8 to 14. People will thus blame him for these escalated prices, even though they would have been still higher in his absence.

But the speculator does far more than merely iron out prices over time. By dampening price oscillations, he accomplishes something of crucial importance: the stockpiling of widgets during the years of plenty, when they are least needed, and the dissipation of the widget inventory during times of shortage, when they are most useful¹.

Furthermore, the speculator's actions in the market signal to all other businessmen that an era of short supply is expected in the future. His present purchases raise widget prices, and hence the profitability of producing them now. This

encourages others to do so before the lean years strike. The speculator is the Distant Early Warning System of the economy.

But, as in the days of yore when the bearers of ill tidings were put to death for their pains, modern day messengers — the speculators — are blamed for the bad news they bring. There is talk of prohibiting their activities outright, or of taxing their gains at 100% confiscatory rates. Such moves, however, deprive society of the beneficial effects of speculation.

There is only one possible fly in the ointment. If the speculator guesses incorrectly and see years of plenty ahead when belt tightening is really in store for the economy, then chaos will result. Instead of stabilizing prices and supplies of widgets, the speculator will destabilize them; instead of hoarding during the fat years and reducing inventories during famines — and leading others to do so as well — he will encourage needless saving under adversity and wasteful profligacy in good times.

The market, however, has a fail-safe mechanism to prevent just this sort of disaster². The speculator who guesses wrong will buy high and sell low - and incur losses, not profits. If he continues to err, he will go bankrupt, and usually very quickly. Professional speculators who have survived this rigorous market test of profit and loss can be relied upon to forecast the future with far greater accuracy than any other conceivable group, including seers, crystal-ball gazers, bureaucrats, politicians, mystics, marketing boards or swamis.

Now let us consider the effect of speculation on land and housing prices.

As in the case of widgets, the speculator is observed to be selling at high prices, to be holding land off the market until yet higher and higher prices are reached. But if we carefully trace out the effects of such activities, we can see that the only time the speculator could have raised prices is when he buys — and that he bought when prices were low, before the increase in demand. We can likewise see that the only results of speculative sales is to decrease prices. No matter how expensive the level at which the sales take place, prices would have been higher still in the absence of this additional land and housing supply.

The speculator can function as a distant early warning line in this market as well. His initial purchases can encourage the construction of additional housing: at higher home prices, more profits can be earned in building, lumber, cement, wiring and so on. By definition, additional land cannot be created (barring reclamation from the sea, as in the case of Holland) but space can be converted to housing from other uses, such as farming and industry.

Let us now consider the housing and land markets in Vancouver, where prices had been soaring in 1981. Even in the absence of land speculation, there is absolutely no doubt that prices would have risen. In 1980, B.C.'s population had risen by an astounding 70,200 people. This is an average of over 1300 people per week! Although geographical breakdowns are not available, settlement patterns indicate that most of the settlement was in the Lower Mainland area. Net immigration from other provinces had been running at a white-hot pace, reaching an all-time high in the last three months in 1980 of 14,720 people. All those jokes about 17 people crammed in a Volkswagen heading west to B.C. must have some basis in fact.

Why do most housing prices rise under such conditions? (1) Many additional people have been seeking housing. (2) Government has refused to allow for additional building space through its agricultural land reserve policy. (3) Zoning

laws³ have precluded increasing the intensity with which the limited amount of available land may be used. And of course, the supply of land itself is limited — as Will Rogers so accurately observed “they ain’t making any more of it.”

The speculator’s role in all this has been to deliver an economic message — for all those capable of interpreting and translating it back into common parlance. By purchasing land, buildings, homes, and other real estate long before the present price rises, and beginning the process of development or redevelopment, the speculator functions, as we have seen, as a Distant Early Warning System. He gives notice that, at least in his opinion, shortages and higher prices are due in the future.

If others heed this message, they will act so as to solve the crisis before it even gets off the ground. Additional land in the G.V.R.D.* cannot, of course, be created, but more homes could have been built, land taken out of the agricultural land reserve, and more accommodation units placed on a given acre, by constructing highrises or by using smaller lot sizes.

This bewildering array of government activities — all seemingly aimed at worsening the local housing crisis, not solving it — has hemmed in the speculator. Speculators would have loved to convert Fraser Valley farmland worth a few thousand dollars per acre, at best, to home-building parcels worth hundreds of thousands and even millions per acre. But they are prohibited from doing so by the agricultural-land reserve policy. Only a small percentage of Vancouver’s foodstuffs is grown in the Fraser Valley. Yet government has made a fetish out of trying to preserve this status quo, even though virtually everyone would prefer vast savings in their mortgage and rent payments.

Land developers would be more than willing to provide additional housing — on a highly concentrated unit-basis per acre — but are discouraged from doing so by zoning legislation that severely restricts such things as lot size and floor-space ratios and by tax reforms that have taken capital cost allowance privileges off the provision of residential accommodation, while maintaining them for movie production and other nonessentials.

Last but not least, provincial rent controls⁴ diverted what limited funds and land space were available to real estate away from the rental sector, which needs it most. It is in this sector that the highest concentrations of single-parent families, the handicapped, minorities and people on low and fixed income are found.

The hated speculator would love nothing more than to “exploit” these people — by providing for their needs! But when rent controls take away the profit potential and increase the downside risk, they reduce the incentive to do so.

Where bureaucrats tread, landlords, developers and speculators fear to go.

Yes, the speculator raises housing prices through his initial purchases. But when prices turn upwards (because of immigration) and he begins to sell off his properties, the speculator causes housing prices to fall below the levels which would otherwise have been obtained but for his actions. The speculator, in other words, doesn’t just increase prices, rather, he evens them out. His initial buying raises relatively low prices and his sales reduce relatively high ones.

The people to blame for the housing crisis in B.C. are not the speculators. While risking their own hard-earned money, the speculators have acted to

* Greater Vancouver Regional District

provide more housing. It might not have been any part of their intention to help solve the housing crisis, but by “buying low and selling high” they have contributed to the solution. Their actions compare very favourably indeed with those who say they are concerned about people’s access to housing, and yet worsen the housing crisis by maintaining and supporting the agricultural land reserve policy and restrictive zoning legislation. Both of these policies reduce the effective supply of land available for housing, with the consequence, as any school child can predict, of uniformly higher land prices.

If these self-same “public servants” impose a 100% profit tax on land speculation, as they have threatened to do, they will only succeed in neutralizing the one group that has actually done something about housing. The profit seeking, land developing, speculator.

Now consider a speculative incident that recently took place in the Ontario real estate market. Greymac Corp. bought 11,000 rental housing units located in Toronto from Cadillac-Fairview at a price of \$270 million, and resold these properties to Kilderkin at a price of \$312 million, earning a cool \$42 million on the deal. Kilderkin, not to be outdone, sold to Saudi Arabian interests for \$500 million, chalking up a whopping \$188 million profit. Subsequently, Toronto changed its rent control provisions so as to reduce the rentals the Arabians would otherwise have been entitled to collect.

A straight business deal, worthy of, at most, being buried on page six of a newspaper’s financial section? Not so. Instead, this transaction has generated a storm of complaints and recriminations.

Many people objected to the property flip on grounds of speculation. They reason that Greymac exploited Cadillac-Fairview (and that Kilderkin did the same to Greymac) to the extent of the profit each company earned on the flipovers. They see no benefit conferred by either company nor any public interest served by such a financial arrangement.

It must be stressed, however, that none of the sellers were exploited by the buyers, even if resale later took place at a higher price. At the time of the sale, in the best estimation of the vendor, the property in question was worth less than the sale price. The deal would hardly have gone through otherwise. So, each seller gained the difference between its subjective assessment of this higher value, whatever it was, and the sale price. These are big boys involved in all these transactions. They went into these complex deals with their eyes open.

Nor was there any guarantee, at the time of purchase, that any of these properties could later be resold for a profit. On the contrary, each new owner took upon itself the financial risk of residential property ownership in these uncertain times. Each was able to successfully anticipate the future course of values. And this is surely an ability to be encouraged if our economy is to grow and prosper.

According to the controls legislation which existed at the time of the Saudi Arabian purchase, rents were to be set based on the sale price of a building. Under these rules, with the increased sale price, rents in these 11,000 units would have risen by as much as 50 per cent. Faced with this spectre, the Ontario government moved quickly. With the new rent control regulations, allowable rent rises were curtailed, by temporarily limiting the proportion of rent increases based on financing costs to 5 per cent.

