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Speculators and Markets: The Role of Risk-Takers in the Economy

The speculator is the market's most useful villain. He produces nothing you can hold and profits when others panic, which makes him the natural suspect whenever a market breaks. But the risk he is blamed for existed before he arrived, and most of what gets pinned on speculation turns out to be the work of whoever distorted the price he was only reading.

ECONOMICS

The speculator is the market's most useful villain. He produces nothing you can hold and profits when others panic, which makes him the natural suspect whenever a market breaks. After 2008 the case against him wrote itself: a gambler who bet against homeowners and cashed in on the crash, a parasite skimming winnings from a zero-sum game. But the case has the story backwards. The risk in a market exists before the speculator arrives, and his trade only decides who holds it. He is usually the only volunteer. Drive him out and the market keeps every risk it had, minus the one participant paid to see trouble coming.

He works like a shock absorber in a vehicle. A shock absorber takes the road as given and converts jolts that would throw the car into movements the passengers barely feel. Speculators do the same with new information. They adjust their positions the moment conditions shift, so prices move early and in small steps rather than late and all at once. And nobody blames the suspension for the potholes.

The blame is convenient, and convenience has consequences. Every crisis reliably produces calls to regulate the speculator, and each of those regulations weakens the discovery process that markets run on. His role only becomes legible once the market is understood as a dynamic process that coordinates scattered knowledge through the choices of the people who hold it, and the record from Wirecard to the housing bust shows what it costs to silence him.

What Speculation Is, and What It Is Not

Speculation resists the familiar categories. At its core it involves buying and selling assets to profit from short-term price movements rather than holding them for long-term returns, and that short-term focus is what convinces critics that speculators extract value without adding any.

Most people are comfortable with the logic of investment. Capital is committed to assets like stocks

or real estate in the expectation of generating value over time, and the investor backs the businesses or projects he believes will succeed, accepting a manageable amount of risk in return for steady growth. Speculators, however, work over much shorter horizons. They seek profits from rapid price changes, often caused by information gaps or market inefficiencies, and when they see that a price fails to reflect what can be known, they act on the discrepancy.

But the line between the two is thinner than it looks. All human action is speculative in a sense, because every action reaches into an uncertain future. The merchant who buys eggs today at a price set by tomorrow's expected demand is speculating, so is the farmer choosing which crop to plant, and so is the investor who commits capital for a decade. What the public calls a speculator simply occupies one end of a spectrum every market participant stands on, the end where the uncertainty is greatest and the exposure most deliberately chosen. And that spectrum dissolves the moral hierarchy the critics rely on. Every market participant bets on the future. They differ only in how much of the burden they choose to carry, and the heaviest carriers attract the most hatred. In everything that follows, speculator means that specialist, the one who works the short, uncertain end of the spectrum full time.

Two other activities are constantly mistaken for speculation, and both confusions are worth clearing away. The first is gambling. A speculator's risks exist outside his choices, since the harvest was always uncertain and the accounts were always fraudulent or sound long before anyone traded on either, and all he does is transfer an existing risk in the hope of profit. The gambler, by contrast, creates a risk that would otherwise never exist. A roulette wheel carries no risk until someone places a chip on it. The second confusion is with manipulation, which sits further away still. Manipulation corrupts the price signal for private gain, through false information or artificial demand, and it undermines the integrity of the market. Speculation does the opposite. It reads the signal and bets on the reading.

One claim anchors everything that follows. Speculators respond to signals that exist before their trades and independently of them. The fraud existed before the short seller found it, and the poor harvest existed before the futures buyer priced it. The trade made each visible earlier than anyone wanted to look, and much of the anger directed at speculators is really anger at the facts their trades reveal.

How Speculators Make Markets Work

Price discovery

Price discovery is among the most important functions in any market economy, and it is also among the hardest. The knowledge relevant to any price is scattered across millions of minds, in local harvest conditions, a factory manager's order book, a shipping delay, a shift in taste. No central authority can collect it. Prices are the mechanism that gathers this scattered knowledge into a single usable number, and the speculator is the participant who works that mechanism hardest. Whoever holds a scrap of knowledge the current price fails to reflect can profit by trading on it, and in trading pushes the price toward what is known. It is the same alertness that defines the entrepreneur, the profit that comes from noticing a discrepancy others overlooked. Speculators make prices less erroneous, which is the most any market process can achieve. They are not chasing some true value

hidden beneath the market, because no such value exists. There is only the best available reading of scattered and shifting conditions, and the speculator is the one who keeps supplying it.

Short selling shows the mechanism in its least popular form. By selling borrowed shares of a company they expect to decline, short sellers push an inflated price down toward what their information suggests, and their willingness to lose money if wrong is what makes the signal credible. Wirecard is the cautionary tale of what happens when that signal is suppressed. For years, short sellers and journalists warned that the German fintech company's accounts could not be trusted, and the German authorities responded by protecting the company from its critics. In February 2019, the country's financial regulator banned new bets against Wirecard's stock, the first such ban it had ever imposed on a single company, and prosecutors opened investigations against the short sellers and the Financial Times journalists reporting on the fraud. Then, in June 2020, Wirecard admitted that 1.9 billion euros on its balance sheet did not exist, and the company collapsed within days. The speculators, it turned out, had been right all along. The regulator had done more than ignore the message. It had criminalized the messengers and defended the fraud, and Wirecard's investors paid for the silence.

Liquidity and transaction costs

Speculators also supply liquidity, the ease with which assets can be bought or sold without moving their price. In liquid markets participants trade freely, knowing their transactions will settle near the quoted price, and speculators, as constant buyers and sellers, provide much of that depth. When sentiment turns and holders rush for the exit, speculators willing to buy what everyone else is selling put a floor under prices, and when euphoria runs ahead of conditions, their selling leans against the surge.

2008 showed the limit of this countercyclical story. In a leveraged crisis, liquidity evaporates exactly when it is needed most. Speculators financed with short-term borrowed money hit their funding constraints and become forced sellers alongside everyone else, amplifying the fall. But what failed in 2008 was the funding structure beneath the speculation, and that structure was built elsewhere, out of years of cheap credit and the standing expectation of rescue. A speculator risking his own capital is a shock absorber. A speculator running on borrowed short-term money is a shock absorber bolted on with borrowed screws, and the screws were priced by the central bank.

Depth pays a quieter dividend as well. Institutional investors in the bond and currency markets routinely need to execute large trades, and speculators absorb them, spreading the impact across many transactions. A liquid market also carries a narrower gap between what buyers offer and sellers ask, so every participant from pension fund to first-time saver trades at lower cost.

Risk absorption

The risks a speculator takes off other people's hands come in several forms. The most familiar is the risk of a price moving the wrong way. Farmers who fear falling crop prices sell futures contracts and lock in a price today, and businesses exposed to raw material costs hedge against rising ones the same way, with the speculator willingly taking the other side. There is also the risk that an asset cannot be sold quickly when the moment comes, and here too the speculator stands ready to buy, so

that a counterparty always exists. And in more exotic markets he absorbs the risk that the other side of a contract simply defaults, carrying the very exposure the hedger is paying to shed.

Critics who call this risk-adding confuse speculative risk, borne by the individual who chose it, with systemic risk, which threatens the financial system as a whole. Risk becomes systemic when positions are piled on borrowed money and lashed together, so that one failure pulls down the next. Neither condition is inherent to speculation, and both are products of cheap credit and rescue guarantees. The risk a speculator absorbs already existed, since the farmer's harvest was uncertain before anyone traded a future on it, and the trade merely moves that risk to someone better positioned and better paid to carry it. That transfer is a service. It lets a farmer be a farmer and a manufacturer be a manufacturer, instead of forcing every producer to double as an amateur risk manager.

Resource allocation

Markets rely on price signals to indicate where resources should flow, and speculators pull tomorrow's conditions into today's prices. When they anticipate a shortage in a commodity, they buy contracts in advance and prices rise now, which signals producers to expand output or store goods before the shortage arrives. When they foresee a surplus, they sell, and producers scale back before the glut. The adjustment happens preemptively, so producers and consumers plan ahead of events instead of being ambushed by them.

The same pressure drives innovation. When speculative buying raises the price of oil against anticipated supply trouble, producers are pushed toward more efficient extraction and consumers toward alternatives. A price moved by expectation is a message about the future, delivered early enough to act on.

Speculation in the Real World

The oil market

The oil market shows the shock absorber working under real stress. When conflict looms in an oil-producing region, speculators reposition on their expectations of future supply, and prices can move sharply. The volatility is the terrain, transmitted through the suspension.

The Gulf War of 1990 is the clean example. As uncertainty over oil production grew, speculators anticipating supply disruptions drove prices from around \$21 a barrel before the invasion of Kuwait to a peak near \$40 that autumn. Importing countries rationed consumption and looked for alternatives while producers ramped up output. Then, once it became clear that production outside Kuwait would stay largely intact and other exporters increased supply, speculators sold and prices fell back toward \$20. The signal adjusted in both directions, pricing risk in before it materialized and out again when it dissolved, with the physical market following smoothly behind.

The reverse accusation surfaced in 2008, when oil hit a record \$147 a barrel and critics blamed speculators for manufacturing a bubble. The federal task force assembled to find the culprits concluded that fundamentals drove the surge, chiefly booming demand from China and India, geopolitical tension, and a weakening dollar, and that speculative positions were responding to those

forces rather than creating them. Later studies of commodity markets mostly pointed the same way, finding little in the price data that the fundamentals could not explain. The episode shows how readily speculation is blamed for movements it merely transmits.

The 2008 housing crisis

Housing in the early 2000s is the hardest case for any defense of speculation, and the honest version of the charge has force. Speculative flipping was real. Between 2000 and 2006, prices in the hottest American markets roughly doubled, and a visible share of purchases were flips, homes bought for resale within months. That demand pushed prices further and faster than owner-occupiers alone would have, and speculators also crowded into the complex mortgage securities that layered borrowed money onto the boom. Anyone defending speculation has to concede that speculative activity amplified the bubble. The suspension, for once, added to the bounce.

But amplifying a fire is different from lighting it, and the ignition source is not hard to name. When the central bank holds interest rates below the level that saving and investment would set, credit is created that no one's savings back, and businesses across the economy are misled into a cluster of investments the underlying resources cannot support. Misallocation on that scale is the predictable response to a falsified price for money itself. In the housing boom the falsification was layered. The Federal Reserve's low interest rates after 2001 made borrowing artificially cheap, while Fannie Mae and Freddie Mac, the government-backed companies that stood behind much of the country's mortgage lending, guaranteed the credit and shielded lenders from the consequences of bad loans. Flippers and subprime lenders read the signals in front of them, and the signals told all of them the same thing, that money was cheap and every exit was guaranteed. The signals were lies, and the man who wrote them sat in Washington. The flipper amplified a distortion he had no part in creating, and when it corrected, he took his losses with everyone else.

Real estate speculation outside the bubble years shows what the same behavior does when the signals are honest. Brooklyn in the early 2000s is the standard example. Speculative capital moved into Williamsburg and DUMBO, bought neglected properties, renovated them, and resold them, and in the process the neighborhoods gained housing stock, jobs, and commercial life. But rising prices also displaced long-standing lower-income residents, and for them the revitalization arrived as expulsion. The displacement is genuine, and how severe it gets depends on supply. Where new construction is legal and fast, investment demand calls forth new housing and the price pressure dissipates. Where zoning, permit delays, and rent regulation choke the supply response, the same demand can only bid up the existing stock. The pain blamed on the speculator is manufactured by the constraints that keep the market from answering him.

Technology and innovation

Technology shows speculative capital at its best, and it also shows the spectrum from earlier most clearly. Venture capitalists sit far along it. They commit capital for years to ventures whose futures are radically uncertain, knowing most will fail and betting that the few successes repay the whole portfolio. By their horizon they resemble investors, but by the sheer uncertainty they take on, they are speculators, bearing exposure no bank would touch. Companies like Apple, Google, and Amazon exist

because that kind of capital was willing to back them while they were still unproven.

The dot-com bubble shows the same capital misfiring. Investors poured money into unproven startups in the late 1990s, valuations inflated beyond any plausible earnings path, and the crash wiped out most of the companies. But even the misfire left something behind, the fiber networks and the trained engineers on which the digital economy was soon built. Speculative capital funds an exploration of the possible, and exploration produces dead ends. An economy that wants the discoveries has to tolerate the dead ends.

Answering the Critics

The serious version of the case against speculation deserves better than the folk version, so it is worth stating properly. Keynes compared professional speculation to a newspaper beauty contest, where the winning entry is the one that guesses what everyone else will guess, so the trader profits by anticipating the average opinion rather than any fact about the world. Later economists sharpened the point. A crowd trading on noise can survive indefinitely, because the very turbulence it creates scares off the sober money that would otherwise correct it, and a rational trader who sees a bubble inflating can make more riding it than betting against it. Momentum traders who buy simply because prices rose are the direct refutation of the countercyclical ideal. All of this describes real behavior, and no honest defense of speculation can pretend otherwise.

Part of it has to be conceded. Friedman's famous answer, that destabilizing speculators buy high, sell low, and bleed themselves out of the market, does not settle the matter on its own, because a noise trader gambling his own money can survive his own turbulence. What Friedman's logic still disciplines is scale. A trader destabilizing prices with his own capital distorts one price, for a while, at his own risk, and the damage stops at his account. Destabilization of the kind critics actually fear, the economy-wide and sustained kind, runs on borrowed money. Riding a bubble at scale takes leverage, and surviving its collapse takes rescue, and both have a price that policy sets. Cheap credit makes the leverage affordable, and the expectation of a bailout makes ruin survivable. The claim can be tested against history. Traders who destabilize prices persistently and profitably, funded at ordinary market rates and backed by no guarantee, would break it, and yet the great destabilizations keep clustering in the eras of cheapest credit. Remove the subsidy and the mechanism the critics fear becomes self-liquidating. Market discipline only ever asked that destabilizing prices be unprofitable, and left alone, it is.

Volatility, the second standing charge, is largely the same argument in different clothes. Speculative trading can move prices fast, but a fast-moving price is often just a market digesting real news, and the alternative to fast adjustment is slow adjustment, the same correction paid for in months of misallocation instead of days. Many of the sharpest episodes trace back to policy itself, to a surprise regulatory change or a sudden central bank reversal, events the speculator reacts to and is then blamed for.

History also answers the demand that someone must police speculative excess, because someone did, and it was the speculators' own institutions. The Chicago Board of Trade, the proving ground of modern futures trading, adopted rules against cornering the market as far back as 1868 and expelled

the members who tried it, decades before any government regulator existed. Enforcement was imperfect and famous corners still slipped through, but the incentive was real and remains so. An exchange that tolerates manipulation loses the honest traders who are its customers, and market integrity is a commercial asset the institutions living off speculation have always paid to protect.

The newest criticism is hoarding. Speculators, critics say, buy up housing and hold it off the market, deliberately starving supply to drive prices up. Holding an empty asset is rational whenever the expected gain in its price beats the cost of holding it, and in a boom that is exactly the case. The empty buy-to-leave flats of London and Vancouver are the visible result. But that gap between expected gain and holding cost is itself the work of policy. Appreciation on that scale is a creature of cheap money, and against a large enough expected gain the rent forgone on an empty flat barely registers. The rest is the same supply constraint that turned Brooklyn's investment into displacement. Hoarding can only move prices where new construction is forbidden, and a speculator sitting on ten apartments in a city that lets people build is an irrelevance. The affordability crisis is real, and it was written into the zoning code long before any speculator arrived.

Follow the Anger Upstream

Speculators carry the risks others shed and push prices toward what is currently known, and they manage both by accepting more exposure to the future than anyone else in the market will. The shock absorber earns its keep on bad roads. Most of what gets blamed on speculation, the bubbles and the crashes alike, is the road itself, faithfully transmitted, credit distorted by the central bank and supply strangled by the planning board. Stripping the shock absorbers does not make a vehicle safer, and history records no market calmed by silencing its speculators. What silencing produces is blindness, and Wirecard's shareholders can price it in full.

The demand to restrain speculation is a demand to be spared certain facts. A speculator's profit is a report, that a company is fraudulent, that money has grown too cheap. Shoot the messenger and the report still arrives, later and at a higher price. The productive question asks who set the signals the trader was reading, and it leads away from the trading floor, toward the central banks, guarantee programs, and planning boards that write the prices everyone else has to obey. Anyone angry at speculators should follow the anger upstream.

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