

\$140 Million for Pollock?! Contemporary Art Market Explained

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Recent breathtaking prices of art were blunted by the actual global recession - according to The Economist, average prices fell 40% from its peak in 2007 (Rocco & Thorton, 2009a), nevertheless the market value of art is still thrilling.

When mentioning enormous art prices, we mainly remain in the realm of contemporary art. Out of the ten most expensive art pieces, nine items were created after 1900 and five in a post WWII period (Whats Art, 2009). What are the mechanisms which are driving up price of contemporary art?

Let's look at the frame. There are two basic contemporary art markets and two types of interaction on them. Interaction can be either in a form of auction, or direct sale (often with an agent acting as an intermediary). Considering markets, primary market deals art pieces coming directly from studios and artists themselves. On the other hand, secondary (or resale) market deals production of both living and dead artists, which is owned usually by private collectors.

Although the border between these markets is a bit foggy, there is a certain difference in market behavior. Primary market collectors are often more risk takers, each aiming at single emerging author and creating long term personal involvement with an author (Rocco & Thorton, 2009b). Nevertheless, it is the resale market which boasts the record prices; therefore we will try to keep its perspective.

What factors shape the supply side? Most important to consider is the heterogeneity. Art is highly unique, but it depends on the buyer's motivation, if he is able to accept de Kooning as a substitute of Bacon. While on primary market probably not, more investment oriented resale buyer may consider it. Baumol (1985) in his canonical work considers private collectors as monopolists; however having in mind the latest boom and bust of contemporary art market (Times Online, 2009), I believe secondary contemporary art market is fuelled by broader range of motivations and allows substitution to some extent.

Primary market is influenced by its specific production function. Art is a risky employment, with strong non-pecuniary returns (this topic is broadly covered in [Cowen & Tabarrok, 2000]). Outcome can be improved by adding capital or workforce only in a very limited way; higher productivity of artist can often change the inner character of his production. Artist's death has another serious impact on the supply side – it further lowers the reproducibility to zero.

Secondary market is supplied mainly by private collectors, who can retain production of the primary market. With virtually constant primary production, all supply fluctuations are influenced by global market and business cycle and reflecting investment and speculation motives, with personal and corporate bankruptcies (and subsequent collections' sell offs) on the one hand and art as a security on the other. Similarities and differences (no dividend and

no asset based technical value) between stock market and art market are broadly described in Baumol (1985).

Therefore the supply of resale market is bounded with 'boom and bust' excess or insufficient liquidity, where market price is just a subjective indicator for proper timing of holding or selling private collections. *Ceteris paribus* supply is constant in relation with price.

The key factor of contemporary art demand is to decompose the utility value of such art. Sagot-Duvaurox suggests three components of art's value – physical properties, date of sale and place of sale (Sagot-Duvaurox, 2003). I add the fourth one – a buyer. While on the metal sheets market object is far more important than the subject of exchange, on the art market the person of buyer and its characteristics are crucial and most complicated variable.

Physical properties of an art have various influent over buyers pricing (oiled canvas has zero alternate use compared to alternate use of 8601 diamonds on Hirst's *For the Love of God*), but this contribution can be considered fixed. Physical property involves also author's signature, which is a form of branding (Sagot-Duvaurox, 2003) and symbolizes cultural, national and historical value of the art. This value is obviously variable of time and cultural trends.

Considering globalize and open world with excellent communication channels and abstracting local taxes and other distortions, the variable of place of sale can be omitted in our analysis.

Most important component is buyer's interest. Art serves two kinds of interest – speculative and psychological. Speculative interest is related with cyclical behavior already mentioned in the supply side analysis. Demand is driven by potential gains (price growth compared to inflation and alternate investments) and risks (change in the market mood, discovery of lost pieces). Again, price is more a buy-sell indicator.

Psychological factors are of two kinds:

1. Aesthetic pleasure – negative elasticity. Buyer's satisfaction grows with rising number of art pieces acquired for the same price.
2. Effects of prestige – positive elasticity. Satisfaction comes from ownership of prestigious expensive art piece, or from winning a bidding war - an example of Veblen good. High price of an art piece can be considered an internal part of his characteristics

We see basic background of the mechanism; how this mechanism drives the prices of contemporary art upon the prices of other art styles and makes art one of the priciest product on the global market?

The process begins at the stage of creation. As Cowen and Tabarok (2000) write, the *cognoscenti* (art consumers with special taste) have to outbid the masses and prevent the artist from mass production. As we described, subsequent art market has characteristics of monopoly with minimal options for substitution and extremely limited supply (especially when compared to the vast numbers of potential buyers). Finally, an institute of minimal price

comes to question – both dealers and auction houses often use guaranteed minimal price to protect artist's and institution's reputation, which may be damaged by unexpectedly low price. (Salmon, 2008). This makes the prices downward-rigid to some extent.

Such a limited supply meets with the demand for contemporary art. This has cyclical component, which drives the prices up in conjecture times. As we cannot say contemporary art is more aesthetic than renaissance art or impressionists, the pleasure component does not have specific influence; however the effect of Veblen good is important. Contemporary art can be considered kind of a top fashion, which well serves the prestige of both individuals and corporations. Due to the perceived ability to hold value in a long term, they even tend to shift consumption of other luxury goods (yachts, cars, social events...) to consumption of art during recession (Rocco & Thorton, 2009a), thus moderating the potential market price drops.

This combination of market structure, prestigious position of the most fashionable art and recent years of global prosperity and subsequent hunt for investments drives the prices of contemporary art up.

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