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Oil, onions and why speculators are a necessary evil

by David M. Blanchett

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These are times that try one's wallet: we appear to be in a recession, the stock market is churning, and gas prices are through the roof. A barrel of crude oil, the substance used to make gasoline, is selling at an all-time high, whether or not one examines it in nominal (actual dollar) or real (inflation adjusted) terms. The recent rise in oil prices has many Americans wondering: who is to blame for this crisis?

Unfortunately, as is often true with any market, the only real force to blame is the market itself. Prices typically rise with increases in demand or decreases in supply. However, in today's environment many people are "blaming" the recent increase in oil prices on excessive speculation. While it's true that speculation causes prices to rise, it can also cause them to fall. Not surprisingly, though, no one complains when something is cheap – only when it becomes expensive. In reality, the culprit is likely some combination of poor timing, the growing energy needs of developing countries, and the person you see when you look in the mirror.

Back to the futures

There are two ways to purchase a commodity: in the spot market or in the futures market. The spot market, or cash market, is a market in which goods are sold for cash and delivered instantaneously. A futures market is a market where someone buys specific quantities of a commodity or financial instrument at a specified price with delivery set at a specified time in the future, and typically with no delivery of the actual underlying commodity. There is a limited supply of physical commodities in the spot market, but the supply in the futures market is seemingly infinite, assuming a willing number of buyers and sellers exist.

Futures are a form of a derivative. A derivative is something that derives its value (hence its name) from some underlying physical commodity (such as corn or natural gas or oil), a financial security (like the stock market or bonds), or something more abstract (like a price index). The futures market, though, unlike the stock market (which is a spot market), is a zero sum game, which means that for every dollar someone makes, someone else has to lose a dollar.

For every futures contract, there must be someone willing to buy it (referred to as going long) and someone willing to sell it (i.e., going short). Prices change as the market adjusts to new information or change in supply and demand. The stock market, unlike the futures market, is not a zero sum game. People can make money in the stock market with no one else directly losing money, apart from opportunity cost. This means that price increases can resemble a ponzi scheme with everyone making money initially and the only people losing money are the last people holding the bag. For the futures market, there are not winners and losers in the net, just market participants.

Speculation

There are two parties that engage in transactions in the futures market: hedgers and speculators. Hedgers have an interest in the underlying commodity and are seeking to hedge out the risk of price changes (e.g., a farmer locking in the price to sell his crop or a company purchasing steel for use in its manufacturing plant), while speculators seek to make a profit by predicting market moves and buying a commodity. Speculators are an important component of futures markets because they provide liquidity, or extra cash, to the markets. The more people interested in buying and selling an item, the greater the price discovery and the easier it is for hedgers (and speculators) to trade a given futures contract.

Speculation is not exactly a new endeavor for us humans. Speculative mania has existed as long as things have been bought and sold. One of the earliest known widespread speculative bubbles was the Dutch tulip craze during the 17th century, which led to the development of the first futures market for tulip bulbs in 1636. Like most speculative bubbles, the market for tulips collapsed (in 1637). The problem with speculative bubbles, though, is that no one knows for sure whether it’s actually a bubble or a structural change in prices, and if it’s a bubble, when it’s going to burst.

Markets are dynamic systems with a large number of participants, each typically looking out for his or her best interests. The best markets are those with many participants, who are both diverse and independent. Blaming the market for prices is like blaming a thermometer for the temperature, a comparison made by Everette Harris, past president of the Chicago Mercantile Exchange, during the Congressional hearings on onion prices in the 1950s. Harris went on to note, “You would not want to pass a law against thermometers just because we had a short spell of zero weather.”

Fair value

So what do we hear every day? Speculators are evil. Speculators are to blame for today’s oil prices. Speculators eat their first-born children. I may be pushing it with the last one, but there appears to be a growing consensus in America that speculation has bid up the price of oil beyond what it’s actually “worth.” This is an interesting contention (note the quotations), since in a market economy, a good is only deemed to be worth what someone else is willing to pay for it, despite what the implied “fundamental” or “intrinsic” value is. This is often referred to as fair market value. Let’s say you need to sell your house. You may have bought it for $200,000, but if the most anyone is willing to offer you for it is $150,000, your home is only worth $150,000, regardless of what you consider it to be worth or what you paid for it. Markets dictate fair prices.

It’s impossible to say what oil is “worth” at a fundamental level. Professors, economists, market strategists and random “experts” can build impressive models and testify before Congress about why their methodology is valid, but markets tend to be the best long-run indicator of the underlying value of something. Therefore, the best guess for the value of a barrel of oil is not what someone thinks it is worth, but rather what the market “says” it is worth. Speculators have a vested interest in correctly guessing what something is actually worth, because if they’re wrong, they lose money (and their jobs). Therefore the consensus opinion of speculators (i.e., the market price) should not be taken lightly.

Onions

Everette Harris’s comments on the role of futures markets in price discovery were made during a time when onion prices were plummeting and speculators were made to blame. Onion farmers lobbied Congress to amend the Commodity Exchange Act to add onions to the list of regulated commodities. These efforts proved successful and on August 28, 1958, the Onion Futures Act was enacted, banning futures trading in onions, a regulation which remains in effect to this day.

How has the lack of a formal futures market affected the price of onions? While many may think oil prices have been volatile, the price swings in onions make crude oil look tame. For example, at $150 a barrel, crude oil is up around 300 percent from where it was trading in January of 2007. Ouch. Things are much worse in the world of onions, though; from April 2007 to March 2008, the price of onions fell 95 percent, then increased 1,070 percent from March 2008 to May 2008, and then decreased 35 percent from May 2008 to June 2008. That’s volatility. Clearly the market forces driving onions are different than those driving oil prices. However, even when comparing historical price movements to other similar commodities, like potatoes and tomatoes, that have futures markets, the recent price swings in onions are extreme.

Speculators provide liquidity to markets, which ends up dampening volatility. If there were speculators in the onion market today, though, they would likely be blamed for such extreme price behavior, like they were back in the 1950s when the Onion Futures Act was passed; however, the price movements merely reflect the changing dimensions of supply and demand. Ironically enough, the recent volatility in onion prices has become so extreme that the son of one of the original onion growers who lobbied Congress for the trading ban now thinks the onion market would operate more smoothly if a futures contract were in place. Onion growers are coming to realize that a world with speculators is likely far better than the current world without one.

What next?

I'd rather not make a prediction about the future, since making market predictions is a difficult and typically inaccurate venture, but if I had to guess how this will all unfold, I think people will continue to complain about oil prices until some type of meaningless legislation is enacted that is more hype than substance. Anyone who opposes said legislation will be called things like "anti-American;" some may go so far as to refer to these individuals as "communists" or indifferent to the suffering of the American working class. Sometime after the legislation is enacted, or perhaps during the legislative process since Congress is not known for its relative speed, the price of crude will drop as market forces intervene. Politicians will be hailed as heroes and term limits for the original adopters will be extended. What few will realize is that it will actually be our greatest enemy — the evil speculators, the ones who supposedly caused this awful mess, who end up "correcting" oil prices, causing them to fall. While the price of oil will rise again in the future, our addiction to oil will continue, and Hummer dealerships will flourish once more.

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