

The Role Of Oil Speculation On The Economy: The Problem With The View Of Fattouth, Kilian, And Mahadeva

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ABSTRACT

On July 30, 2012, Fattouth, Kilian, and Mahadeva published an online paper titled, “The Role of Oil Speculation in Oil Markets: What Have We Learned So Far?” They concluded that the existing evidence is not supportive of an important role of speculation in driving the spot price of oil after 2003. This paper aims to show that the conclusion of their paper, which challenges the finding of direct correlation between oil speculation and rising spot oil prices in Ajuzie et al. (published in 2009) is fraught with omissions that have led to mistaken conclusions. In their literature review, they failed to include opposing findings, even when those views are in public domain. Because of the enormous negative consequences that will result from misapplication of economic policies based on such mistaken conclusions, it is important to address the error in their finding.

Keywords: Oil Speculation; Inflation; Interest Rate; Inflationary Pressure; Vector-Autoregression; Consumer Price Index; Import; Growth Rate; Spot Oil Price; Goods And Services; General Price Level; Oil Futures Markets; Financialization; Commodity Futures Trading Commission

INTRODUCTION

On July 30, 2012, Fattouth, Kilian, and Mahadeva published an online paper entitled, “The Role of Oil Speculation in Oil Markets: What Have We Learned So Far”. They concluded that the existing evidence is not supportive of an important role of speculation in driving the spot price of oil after 2003. They claimed to have strong evidence that the co-movement between spot and futures prices reflect common economic fundamentals rather than the financialization of oil futures markets.

It is believed that the economic fundamentals the authors are speaking about refer primarily to the supply and demand for oil. In other words, they argue that the rise in spot oil prices, and hence gas prices, has to do with the supply and demand for the commodity. They prefer to concentrate on oil futures prices. After defining and discussing excessive speculation as the manipulation of oil prices, they concluded, “For example, the increased financialization of oil market does not, by itself, mean that market manipulation is on the rise. Nor is there widespread evidence of market manipulation, notwithstanding some isolated cases in recent years.”

According to the authors, their paper came about because “A popular view is that the surge in real price of oil during 2003-2008 cannot be explained by economic fundamentals, but was caused by the increased financialization of oil futures markets, which, in turn, allowed speculation to become a major determinant of the spot price of oil.” Their paper, thus, set out to debunk the finding that speculation has something to do with the recent meteoric rises in oil prices.

Most of the authors they cited in the literature review, such as Singleton (2012), Hirshleifer (1988, 1989), Chang (1985), De Roon et al. (2001) and Hong and Yogo (2012), to mention just a few, concentrated on the use of the futures prices of oil in measuring the extent to which the price of the commodity is affected by speculation. We refer to it as literature review because there is no model where they analyzed data to confirm their conclusion.

Link To 2009 Oil Speculation Paper

In a paper titled “Oil Speculation: Impact on Prices, Inflation, Interest Rates, and the Economy” (Ajuzie and Ike, 2009), a vector autoregression (VAR) model was used to determine that oil speculation has a statistically significant positive impact on general price level, especially oil prices. The influence comes through spot oil prices and not futures prices of oil. The price of crude oil was a variable in the model as well and was statistically insignificant in its effect on general price level or inflation.

Data were collected from secondary sources and not from the Commodity Futures Trading Commission (CFTC). An inquiry was unsuccessfully made to collect spot oil prices from CFTC, hence, the decision to go outside and use data from other sources, such as the bureau of economic services (BLS). Because of observed occurrences where gas-pump prices always react to spot oil prices and not crude oil prices and futures prices of oil, we included spot oil prices in the analysis. Most people pass two or three gas stations on their way to work. Pump prices always seem to react to what the spot oil price was the previous day. To ignore that relationship and go to use crude oil or futures prices of oil - which do not move at the same increasing rate as spot oil prices but have traditionally been used in investigations, such as those cited by Fattouh et al. - does not seem quite rational if we want to determine how to fix the problem. In fact, using any other oil price, except spot oil price, to search for the role of speculation in oil markets will always underestimate the significance of its impact.

The result of the Ajuzie et al. (2009) paper was published in a hard journal, as well as online. That is why it is puzzling to find that Fattouh et al. did not make any reference to the paper, which is the only one that would have differed from their finding of no relationship between speculation and the rises in oil prices. The authors (Ajuzie et al.), when requested to do so contributed to CFTC’s position paper to argue for a limit on oil speculation because of its effect on the rise in general price level, especially oil prices with a spill-over to gas prices at the pump.

In order to emphasize the significance of the finding in Ajuzie et al. (2009), which we are discussing here, we refer to an earlier journal article published in 2008 titled “Import Response and Inflationary Pressures In The New Economy: The Quantity Theory Of Money Revisited” (Ajuzie et al., 2008). It has a long history, which dates to the time of Chairman Greenspan at the Fed, of arguing about the need to observe and incorporate present economic conditions and applying them to the age-old economic definition of inflation as a monetary phenomenon. This means that inflationary pressures are triggered when excess money in the economy is pursuing fewer goods and services, but since the second half of the Clinton Administration when trade was opened up and pursued between U.S. and other nations, more goods and services have continuously been imported into the economy to offset the shortage or gap between domestic demand and supply, thus dampening or reducing incidences of inflationary pressures.

Estimation Process And Result

The vector autoregression (VAR) process was used to estimate the model. Results show that import of goods and services is significant in its impact in the reduction of the growth rate of CPI inflation or the general price level, thereby dampening the weight of inflationary pressures on economic policy formulations. Because of the present economic environment, coupled with the author’s fulfilled seven-year prediction, the urgency of incorporating the findings into our economic policy determination was emphasized. A threshold was established in the paper. As long as the value of imports of goods and services exceeds that threshold, we would not have any inflation in the economy. That was in 2008 and the study has been validated. On Tuesday, March 12, 2013, a newscaster announced that “wholesale prices increased slightly due to increase in oil prices and there is no sign of inflation anywhere in the economy.” As quantitative easing (QE) continues and money supply increases in the economy, in the previous economic thinking, significant inflationary pressures would have been triggered, but it is no longer the case following above finding, which will be elaborated on later.

The relationship with oil speculation and this import paper is that the same model was employed to look at the effect of oil speculation a year later. The only variable added was the spot price of oil (STP). Results show that an increase in spot oil price last period has a highly statistically significant positive effect on CPI inflation. In other words, it increased the general price level, which especially includes the spot price of oil. This effect is strong

enough to eliminate the negative significant impact of import of goods and services on CPI inflation found in the paper of May 2008. Put differently, the spot oil price, represented by the variable STP, made import of goods and services less effective in reducing inflationary pressure. In fact, when we do have the pressure, it goes away within three or four months according to the import paper. Based on this finding, we recommended that oil speculation should be discouraged with a limit placed on how high or low STP should go. This is very reasonable especially when we do not have pressing oil shortage in the U.S. We are presently exporting oil and/or gasoline.

In an article written elsewhere, a comment was made that oil is the only commodity with the ability to spread its price effects throughout the economy simultaneously. If we agree that it has such an effect, should we treat it as we do other commodities with less impact on the economy as a whole worldwide?

After stating that “sometime excessive speculation is equated with market manipulation”, the paper(s) we are critiquing here commented that there has been no significant evidence of oil speculation in driving the spot price of oil since 2003. Should we accept their definition of speculation and excessive speculation, we must fail to accept their view that the phenomena did not lead to the rise in spot price of oil since 2003. If we make the mistake of accepting such conclusion, how then do we categorize the behavior of STP during the beginning of the Libyan conflict? Immediately it was announced that rebels were attacking government forces, speculators began to panic, and bid oil price above \$100, from approximately \$85 within two days. Then the King of Saudi Arabia announced that his country would produce enough oil to offset any shortage that could arise from Libya, if it occurred. Within hours that day, STP came down by \$3.00. We should remember that no crude oil changed hands when all this went on. In addition to our finding in the speculation paper, this episode led one to conclude that there are no “economic fundamentals” or supply and demand playing a significant role in the determination of STP or spot oil price. It is all based on the action of speculators.

This is a clear example of one type of speculation that is known to affect oil prices significantly. It is achieved by placing short bets, or a combination of long and short positions. Short bets could cause huge price spikes and volatilities if those speculators have to cover their positions due to an unexpected and sudden rise of or anticipated rise of the underlying commodity price, which occurred in the Libyan case.

The detrimental effect of oil speculation, coupled with the quantitative easing (QE) policy of the Federal Reserve, have led to further decline in the rank of the middle class in the U.S. On one hand, through QE, enormous wealth is transferred to big banks and other wealthy businesses and individuals who hold significant amounts of government securities. As was stated elsewhere in another article, the recipients of these funds use them to purchase more securities, including oil. This is the reason for the unprecedented recent rise in the Dow Jones Industrial Average (DJA). While the concerned individuals and businesses are growing wealthier, the middle class and the poor are getting poorer. They continue to deplete their meager disposable income to buy the high priced gas made so by those same actions that are creating more wealth for the wealthy. The result is the fast shrinking of the middleclass. The class is not shrinking because they are climbing into the ranks of the wealthy but because they are moving to the ranks of the poor.

The special category of producers who are hurt by the increases in oil prices are mostly the small farmers who grow the food we eat. They cannot even transfer their costs of production effectively to consumers because they operate in a competitive market environment where they cannot influence or dictate the price of their products.

The banks, which are getting the QE funds, are not giving loans to small businesses to create jobs and hire workers at reasonable wages. The reason is that their business inventory is not being depleted at the rate they should need workers fast enough to replenish goods and services on their shelves. Consumers spend part of their disposable income buying high priced gas to go to work, which reduces their power to purchase goods and services and the incentive for businesses to hire workers, thus the reason for the slow pace of both economic and employment recovery. Another reason is that banks do not give loans when interest rates are low. They wait to do so when rates rise; but this is the time businesses refrain from borrowing, so we are in a quandary. As it is traditionally known from the time of Chairman Greenspan, short-term rates are raised to try and dampen inflationary pressures. Following the model described above in Ajuzie et al. (2008), there will hardly be any inflationary pressures in the foreseeable future of the U.S. economy, which means that there will not be any objective incentive to raise the short-term interest rate. Already, the long-term rate is low and possibly decreasing.

So, what do you do to stem the widening gap between the rich and the poor? Based on the findings in previous papers, this author had suggested effective scenarios which have not been heeded. Circumstances have changed and the economic fundamentals that governed economic thinking in previous years - when the U.S. was a “closed economy” - would either overstate or understate projections, leading to misapplication of monetary policies and resulting in economic uncertainties - a continuously widening gap between the poor and the rich and potential class warfare within. These may extend to the rest of the world if its greatest economy is mired in economic quagmire. How long are we going to continue the unsustainable QE? Remove it and the economy sinks.

CONCLUSION

The main purpose of this paper is to examine the findings of a paper published on July 30, 2012 by Fattouth, Kilian, and Mahadeva entitled “The Role of Oil Speculation in Oil Markets: What Have We Learned So Far?” After reviewing a lot of literature, they concluded that “the existing evidence is not supportive of an important role of speculation in driving the spot price of oil after 2003”. Unfortunately, a lot of the papers they reviewed used futures and crude oil prices in trying to determine whether or not oil speculation impacts spot oil prices. In this paper, it has been shown that using any other type of oil price, except spot oil price, to ascertain the effect of oil speculation on the spot price of oil will lead to erroneous conclusion, just as it has in Fattouth, et al.

Six years after the date they claimed that speculation stopped having effect on spot price of oil, Ajuzie et al. researched the impact of speculation on spot oil prices. The paper found that oil speculation is the main force behind the rising spot price of oil. It produces increases in general price level, especially spot price of oil. The rise in spot price of oil has a spill-over effect into other goods and services through increases in gas pump prices that affect cost of distribution, which businesses transfer to consumers after the same consumers have also paid the high gas prices. There is no wonder, then, why we are talking about a widening gap in income inequality in the society.

In order to emphasize the significance of the finding in Ajuzie et al. (2009), we refer to an earlier journal article titled “Import Response and Inflationary Pressures In The New Economy: The Quantity Theory Of Money Revisited” (Ajuzie et al., 2008). It has a long history which dates to the time of Chairman Greenspan at the Fed, of arguing about the need to observe and incorporate present economic conditions and applying them to the age-old economic definition of inflation as a monetary phenomenon. This means that inflationary pressures are triggered when excess money in the economy is pursuing fewer good and services. But, since the second half of the Clinton Administration when trade was opened up and pursued between U.S. and other nations, more goods and services have continuously been imported into the economy to offset the shortage or gap between domestic demand and supply, thus dampening or reducing incidences of inflationary pressures.

The relationship between oil speculation and this import paper is that the same model was employed to look at the effect of oil speculation a year later. The only variable added was the spot price of oil (STP). Results show that import of goods and services is significant in its impact in the reduction of the growth rate of CPI inflation or the general price level, thereby dampening the weight of inflationary pressures on economic policy formulations. The spot price of oil in the 2009 paper led to the insignificance of import of goods and services. In other words, it reduced the effect of import of goods and services in dampening inflationary pressures in the economy.

Therefore, it is not true that after 2003 oil speculation has not been driving the spot price of oil as was found in Fattouth et al. To believe that would open the door for more speculation in a commodity of vital importance in the economy worldwide. Such speculation would easily create economic upheavals, such as recession, inflation, increase in unemployment, and much disgruntled populace - conditions that are very unhealthy for national cohesion and growth.

AUTHOR INFORMATION

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