I respectfully submit the following comment as required to the above named Commodity Futures Trading Commission’s (CFTC) report. I sent CFTC a copy of the paper that gives credence to this response shortly before a meeting that culminated in their report.

In order to buttress the comment and make it more appreciated, I refer to a paper we published in May 2008 titled “Import Response and Inflationary Pressures in the New Economy: The Quantity Theory of Money Revisited” (Ajuzie et al., 2008). The paper primarily investigated the response of inflation or general price level to goods and services (G&S) imported into the U.S. The finding was that importation of goods and services significantly reduces inflationary pressures. As many have stated before, the reason is that the G&S come from places with lower opportunity cost of production. As a result, they can afford to sell to us at lower prices than the same G&S produced domestically. The competition forces our producers to reduce their prices. The overall impact is a reduction in general price level.

When oil speculation became an issue and there were debates as to whether or not it plays any role in energy price increases, we decided to include oil speculation as a variable in the same formulation or equation used in the import paper. The variable used is the spot oil price (STP) at the Mercantile Exchange (Ajuzie et al, 2009). It was astonishing to find that imports of goods and services (IMP), though still negative, was highly statistically insignificant in its ability to reduce or dampen inflationary pressures. Oil speculation was found to statistically and significantly increase inflationary pressures. We also found that the price of crude oil, which was one of the variables in the model, is a derived price. It is derived from speculative prices of oil at the Exchange. The price of crude oil had an insignificant effect on speculative oil prices and on other economic variables.

The data used in the study included the highest STP of $147.45 reached in mid-July 2008. The inflationary pressure it created in the economy led to energy price increases, the inability of many businesses to sustain the increases in costs and the failure of many of them, such as the airline industry and small businesses. Oil speculation was not the only culprit in the present economic crisis, but it played a significant role.
As the stimulus money was being handed out in 2009, oil speculation again started to drive up prices at the pumps, thus negating the effect of the stimulus money. It was like giving with one hand and taking it back with the other. Gas pump prices increase or decrease based on oil speculation and not on crude oil prices at points of production. The reason oil speculation is such a problem is because oil is the main, if not the only, commodity that has the ability to spread its price effects throughout the economy at the same time, leading to general price increases, especially the price of energy.

We found that oil speculative prices are not driven by actual crude oil demand and supply. For example, people may predict that a particular event in Saudi Arabia would cause oil shortage. Without waiting to see if this would really happen, speculators start bidding up the spot oil price at the Exchange. If the predicted event fails to occur, STP does not fall at the same rate as it rose. Meanwhile, crude oil producers would react to the speculative oil price increases by raising crude oil prices to capture the new prices at the Exchange. If this argument were not true, can anyone tell us why the price of oil keeps rising when demand decreased in the U.S. since last year, 2009? Another reason for the decrease in demand is that poor economic conditions reduced people’s decision for extensive trips in their gas guzzling cars. The reduction in demand for oil was even felt in China, which has been blamed for demand and price increases since 2006.

Chris Khan, Associated Press (AP) Energy Writer, NY, (Khan, 2010) states, “Retail gas prices likely bottomed out last week, and they're again headed to above $3 a gallon this summer, experts said Monday.

Although pump prices typically rise this time of year as refineries switch to a more expensive grade of gas, the increase likely will frustrate many motorists. Prices are climbing even after millions of Americans received pink slips and kept their cars in the driveway.”

"If you look at demand, it's just abysmal," said Fred Rozell, retail pricing director at Oil Price Information Service.

In his editorial, Khan quotes Rozell, “What's pushing prices higher isn't American consumption. It's the crude oil that's used to make motor fuel. Crude is an international commodity that's become ever more expensive as demand grows in China. As crude increases, so does gas.”

Continuing in his editorial, Khan writes, “On Monday, retail gas prices rose for the fifth straight day, adding less than a penny overnight to a new national average of $2.648 a gallon, according to AAA, Wright Express and Oil Price Information Service.

A gallon of regular unleaded is still cheaper than it was a month ago. It's also 73.1 cents more expensive than the same time last year.
Rozell said motorists shouldn't expect a return of the price spikes of 2008, when gasoline jumped above $4 a gallon in some parts of the country. Americans simply aren't burning enough fuel to push prices that high.

"I'll be surprised if it got over $3.25," Rozell said.

Gasoline futures also jumped Monday to the highest price in more than a month as investors looked ahead to the summer driving season. Prices also were propped up by a festering refinery strike in France, where workers angry about the uncertain future of a Total SA plant have shut down over half of the country's refining capacity.

The standoff already has led to gasoline shortages in parts of the country, and it appears to be spreading. Refinery workers at Exxon Mobil Corp.-owned Esso France are expected to join the walk out Tuesday, and workers at British-owned chemical company INEOS also plan to strike.”

These comments above go to confirm the findings and assumption in our paper of how speculators are lured into bidding higher the STP even when there is no pressing need for such increases. How can prices keep rising after Rozell stated that demand is “just abysmal” and in the middle of one of the worst snow storms that brought most transportation to a halt? Is it not increases in demand without reciprocal increases in supply that drive up prices? How is that age-old economics law different when it comes to energy prices? We have come to believe that the enticement to quick economic gain from oil speculation is so much that it blinds us to its overall detrimental economic impact.

The middle and lower classes of this nation make up the major consumer spending hub that spurs production and economic growth. The higher the percentage of their income is spent on gas, the less they have to purchase G&S. As less G&S are purchased, less output is produced, leading to stagnating employment and the jobless recovery we are experiencing in this recovering economy even as the stimulus money is spent to create jobs.

What is scary is the fact that this oil speculatory behavior is occurring throughout the world, from New York to Hong Kong and places in between. Does anyone doubt then why the downturn has a universal effect?

Who gains and who loses? This question is outside the scope of our study. The reader can make up his/her mind and urge policy makers to adopt initiatives that will help to reduce energy prices and spur growth by directing consumer spending toward goods and services. The recipe for correction is to take oil off speculation or put a stringent limit on it. If the price of energy has such immediate ripple effect globally, why speculate on it? Is it not intuitively obvious that, again, oil speculation pushes up its price, albeit the price of energy, because it does not depend on demand and supply but mostly on stories told to create anxiety among speculators, leading them to bid up prices, which are later adjusted to by producers? It seems hard to believe that the inordinate ambition of speculators to spike the price of energy, especially oil, will bring the world economy to its knees. The U.S. and the world have to take action to avoid a looming
financial catastrophe in the future. It will be worse than the Great Recession the world is slowly emanating from.

Reference


Submitted By:

Emmanuel I.S. Ajuzie, Ph.D.
Associate Professor
Economist, Cooperative Research and Extension
219 Allen Hall
Lincoln University of Missouri
820 Chestnut Street, P.O. Box 29
Jefferson City, MO 65102
Tel: 573.681.5635
Fax: 573.681.5546
E-mail: ajuziee@lincolnu.edu