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Greedy Speculators?

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Are you aware that without speculators, most food and physical products would cost a whole lot more? Many members of Congress have been looking for the villain who is causing gasoline prices to soar (they seem to be mirror-less). A large number, mostly, but not exclusively, Democrats, have decided that speculators, or at least "greedy speculators," are the villains.

Many members of Congress make up "solutions" to things they do not understand and cause problems where there are none or make real problems worse, which explains the current run-up in gasoline prices. There are "futures" markets in most basic agricultural, metals and energy products. In a futures market, it is possible to buy or sell things for delivery at some specified date in the future. The reason the futures markets developed formally a couple of hundred years ago, and are so important to the world economy, is that they enable producers and consumers to offset the risk of price changes to those willing to take the risks.

Assume you are a farmer and estimate that you can produce corn this year for $5 a bushel, and at the moment corn is selling for $7 a bushel. At $2 a bushel profit, corn is the most lucrative crop you can produce, so you plan to expand your corn plantings. You rightly fear that other farmers will also plant more corn. But this additional corn could cause the price to drop, especially if Congress sensibly reduces the foolish, corn-based ethanol mandate it passed. If the price falls to $3 a bushel, you will go bankrupt.

Fortunately, futures markets exist, which enable farmers to sell a portion of their crop for future delivery (e.g., September, when the crop is in) at today's high prices. This will protect them from a large drop in prices - known as "going short." The other side of the bet might be made by breakfast cereal companies who fear that if corn prices continue to rise, they will not be able to pass the price increase to their consumers, so they want to protect themselves by locking in the current price of corn - known as "going long." Both the farmer and the cereal companies are "hedging their bets" about the future price of corn. There are many corn market speculators who provide liquidity to the market and fill the void if the numbers of short and long hedgers do not match up.

The same principles hold for oil. If you are a small oil producer and know that if you drill an expensive but possibly low-producing well, oil will have to sell for more than $60 a barrel for it to be profitable. Thus, if you can sell some of your future expected oil production at a price higher than $60 in the oil futures market, it will likely be profitable and, hence, you are willing to take the risk of the costly investment in expanded production.

On the other side, assume you are the manager of your city's municipal bus system. You must provide the city council with an estimate of what your diesel fuel costs will be next year so it can properly allocate the city budget. If there is an unexpected price rise in diesel fuel, you will not have enough for all of your buses and will have to curtail bus service. This will anger the citizens, the council members, and also may cost you your job. Fortunately, you can "go long" on the diesel oil futures market, safeguarding the city in case of a price rise of diesel fuel, protecting your job and the bus-riding citizens.

As with the corn example, oil speculators, some of whom have "gone long" and some of whom have "gone short," provide the necessary liquidity and mismatch between the various hedgers.

The current political charge is, "the speculators are driving up the price of oil." But think about it for a moment. If the price of oil is being driven above the market clearing price where supply equals demand, demand will fall and the speculators will be stuck holding huge, unintended stocks of oil. Holding oil in tanks and ships is costly, and speculators will not incur these costs for long, so the price will drop. Some in Congress want to curtail the activities of the speculators by increasing regulation. This will only drive more of the energy markets to other countries, thereby hurting the U.S., and will do nothing to reduce the price of oil.

The price of oil is higher than it would be in a totally free, private global market, because other countries' state oil companies own 88 percent of the proven reserves and many of them are part of the OPEC cartel. Much of the oil that could be produced in the U.S. and elsewhere by private parties has been made off-limits by governments. Speculators are not the problem; they are part of the solution, by reducing the risk for producers, refiners and other oil market participants. This risk reduction results in more production of oil, other fuel, food and metals where futures markets exist.

The next time you hear a politician ignorantly rant about greedy speculators and business people, tell him or her to go home and read a good, basic economics textbook.

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