WSJ 9-15-08 A22

See You Later, Speculator

It was said to be the year of speculators gone wild. Seemingly everyone in Washington, including Barack Obama and John McCain, decided that oil prices were soaring because profiteers and middlemen were manipulating the futures markets. "Speculators" were spotted everywhere this side of the grassy knoll.

So much for the conspiracy theory of high oil prices.

The only problem is that there's no evidence to support the conspiracy theories—and sure enough, federal regulators dismantled this Beltway consensus late last week. In one of the broadest and most authoritative studies to date, the Commodity Futures Trading Commission has offered hard statistical data that financial trading hasn't been driving price moves. The CFTC conducted an unprecedented Wall Street data sweep and scrutinized millions of transactions worth billions of dollars between January and June of this year.

Commodity futures markets have grown fivefold by volume over the last decade, while becoming more complex. "Index traders" are one cause. These pension funds and other institutional investors don't buy options for commercial use, but rather roll them over from month to month as passive long-term investments. "Swap dealers," usually investment banks, operate off the main exchanges and sell customized futures packages to firms. These aggregations of options and derivatives are designed to match particular needs and spread risk more broadly.

Lo and behold, the CFTC found that index traders and swap dealers actually *reduced* their stake in crude oil futures as prices spiked. The number of contracts held by these investors betting that prices would increase—the net long position—fell by 11%, and more were shorting oil than going long over the six-month period. In other words, index traders and swap dealers were driving the future price of oil *down*.

Commodity index funds also have a much smaller share of the oil market than everyone thought: just 13%. Even if the figure was 70% or more, as some assumed, it wouldn't have mattered. In a futures exchange, trades are matched, so one trader's gain is another's loss. The overall volume is irrelevant.

The CFTC study is especially notable because it came in response to extraordinary political pressure. Congress held more than 40 hearings on "speculation" over the summer, and commission chief Walter Lukken was the pinata. Federal bureaucracies have been known to try to appease their Congressional funders, so the CFTC deserves special credit for debunking the speculator frenzy.

As it happens, the CFTC report arrived just as the Moe, Larry and Curley of the anti-speculation show—Senators Byron Dorgan and Maria Cantwell, and Michigan Democrat Bart Stupak—pre-emptively released their own study, by Virgin Islands fund manager Michael Masters, which purports to show "index speculators" are "now the single most dominant force in the commodities futures market." Bad political timing, folks.

Then again, the speculation furor was never about the evidence. The politicians wanted a fall guy for rising prices, since the real explanations of supply and demand and the falling dollar were partly their fault. On that point, the CFTC rightly notes that the expansion of commodities indexing can be partially explained by investors seeking to "hedge against inflation." It's not surprising that traders have been driven to commodities to protect themselves, given that the Federal Reserve, Bush Administration and Congress have all trashed the dollar.

No doubt the politicians will keep trying to shoot the price messengers, but thanks to the CFTC they look increasingly silly in doing so.