# Study: Oil speculators dominate open interest in oil futures

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A new policy paper by Rice University's Baker Institute for Public Policy shows a clear increase in the size and influence of noncommercial traders, or "speculators," in the oil futures market since regulations were eased by the Commodities Futures Modernization Act of 2000. Speculators now constitute about 50 percent of those holding outstanding positions in the U.S. oil futures market, compared with only about 20 percent prior to 2002. The report also finds that the correlation between oil and the dollar has strengthened significantly over the past several years.

The coauthors of "Who is in the Oil Futures Market and How Has It Changed?"-- Kenneth Medlock and Amy Myers Jaffe -- advocate that the government should revise its policies to reverse these trends. Kenneth Medlock is an energy fellow at the Baker Institute and adjunct professor of economics. Amy Myers Jaffe is a fellow in energy studies at the Baker Institute and associate director of the Rice Energy Program.

Using data from the Commodity Futures Trading Commission (CFTC), the authors state that the previous claims by the commission that speculation wasn't influencing oil futures markets were based on inappropriate analysis. The authors present new evidence that speculative trading is playing an increasingly important role in the oil market.

They note that while the question of what has produced sharp swings in oil prices since 2005 is a complex one that requires further and deeper

study, there are "inescapable facts" that need to be part of the debate about regulating the activities of institutions betting on movements in oil price purely for financial gain. Specifically, speculators, which the CFTC designates as any reportable trader who is not using futures contracts to hedge, have increased their footprint in the marketplace dramatically since the late 1990s.

Hedgers are typically producers and consumers of the physical commodity who use futures markets to offset price risk. By contrast, speculators seek profits by taking market positions to gain from changes in the commodity price, but are not involved in the physical receipt/delivery of the commodity.

"To protect the U.S. economy and American consumers, there needs to be greater market oversight," Medlock said. "The tremendous increase in the market presence of speculators by fifteenfold speaks for itself."

As noted in a 2007 U.S. Government Accountability Office report, the Commodities Futures Modernization Act made it easier for financial players to obviate speculative limits and made it more difficult for the CFTC to regulate oil futures markets. Changes at the London International Petroleum Exchange, which is now the Intercontinental Commodities Exchange, regarding U.S. delivery-based contracts also created problems with monitoring and limiting speculative activity because these contracts were outside the jurisdiction of the CFTC.

While there were short windows of time before 2001 when the oil price and value of the dollar were correlated more strongly, a dramatic sustained period of high correlation emerged during the 2000s, according to the Baker Institute study. Given this new strong correlation, the authors note, the threat to the U.S. economic health and national security is that the dollar risks getting caught in a vicious cycle where continually rising oil prices feed the U.S. trade deficit, leading to

increased U.S. indebtedness and thereby an even weaker dollar, which further drives oil prices higher.

The authors conclude that new policies are needed. When oil prices started rising in 2007-08 from $65 per barrel to $125, governments around the world, including the United States, engaged in building strategic stockpiles. This policy signaled to oil-markets participants and the Organization of the Petroleum Exporting Countries that governments would not use strategic petroleum stocks to ease prices under any circumstances except major wartime supply shortfalls. This allowed speculators to confidently expand their exposure in oil market futures exchanges without fear of repercussions and revenue losses from a surprise release of U.S. or International Energy Agency strategic oil stocks. "We need to re-evaluate our policies for how we utilize strategic oil stocks in light of the oil/dollar linkages," said Jaffe. "Clearly, our government needs to fashion a better response."

More information: To read the complete study, go to www.bakerinstitute.org/oil-futures-speculation .

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