

*The CFTC has no sound justification for its proposed energy speculative position limits.*

# No Theory? No Evidence? No Problem!

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**T**he rapid rise in commodity prices, most notably energy, in 2007–2008 sparked indignation in Congress and the public. It was widely asserted that speculation in commodity derivatives caused, or at least materially contributed to, the 100 percent rise in oil prices and the somewhat smaller, but still dramatic, rise in grain prices.

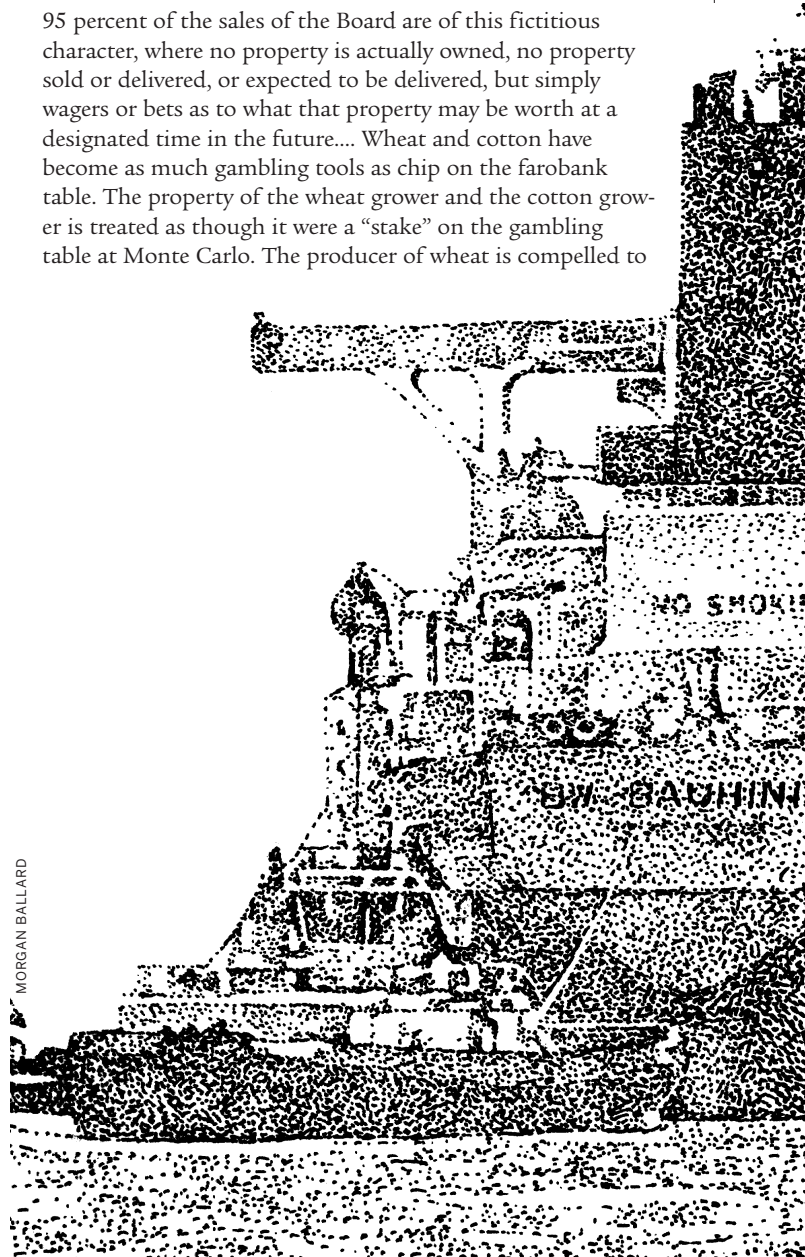
Despite the subsequent collapse in commodity prices with the onset of the financial crisis, this criticism of speculation has not disappeared. Indeed, it has led to specific regulatory and legislative proposals. Most notably, the Commodity Futures Trading Commission has issued a Notice of Proposed Rulemaking that would, if implemented, impose limits on the number of exchange-traded energy futures contracts that speculators could hold. Some commissioners have advocated that Congress give the CFTC the authority to impose similar limits on over-the-counter derivatives, and some draft legislation includes such a feature. Moreover, suspicions of speculation have influenced the various carbon cap-and-trade proposals circulating on Capitol Hill. Some of the bills (including the Waxman-Markey bill that has passed the House) would require position limits on carbon derivatives. Others, notably the Cantwell-Collins bill, would dramatically restrict the ability of some market participants to trade carbon derivatives.

This criticism of speculation in commodity derivatives, and the assertions that such speculation distorts prices, is not new. Indeed, attacks on commodity speculation are hardy perennials. In the 19th and early-20th centuries, populists and farm-state legislators routinely denounced speculation in grain, claiming that selling of futures by those who did not own the grain depressed prices. Typical of the rhetoric is this stemwinder delivered by Sen. William Washburn of Minnesota in 1892:

As near as I can learn, and from the best information I have been able to obtain on the Chicago Board of Trade, at least

95 percent of the sales of the Board are of this fictitious character, where no property is actually owned, no property sold or delivered, or expected to be delivered, but simply wagers or bets as to what that property may be worth at a designated time in the future.... Wheat and cotton have become as much gambling tools as chip on the farobank table. The property of the wheat grower and the cotton grower is treated as though it were a “stake” on the gambling table at Monte Carlo. The producer of wheat is compelled to

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see the stocks in his barn dealt with like the peas of a thimble-lerigger, or the cards of a three-card-monte man. Between the grain-producer and loaf eater, there has stepped in a “parasite” between them, robbing them both.

It is readily understood why the debates over speculation have been so enduring. One of the most important functions of markets is to discover prices; to provide a mechanism whereby information about supply and demand dispersed among millions can be aggregated. Thus, no one has the information to know what the price “should” be; if someone did, we would not need markets. But this always makes it very difficult to prove or rebut assertions that a particular market price is distorted by speculation.

So how is it possible to evaluate claims that speculation has distorted commodity prices? In this article, I take three complementary approaches: First, I examine the logical coherence of the explanations of how speculation can distort prices. Second, I review some of the specific pieces of evidence that have been advanced to support such claims. Third, I exploit the fact that since prices guide the allocation of resources, then if prices are distorted, the allocation of resources should be too. Specifically, I both examine price and quantity data from a wide variety of commodity markets to ascertain whether there are any quantity distortions (such as ballooning inventories) that speculation-induced price distortions would be expected to cause.

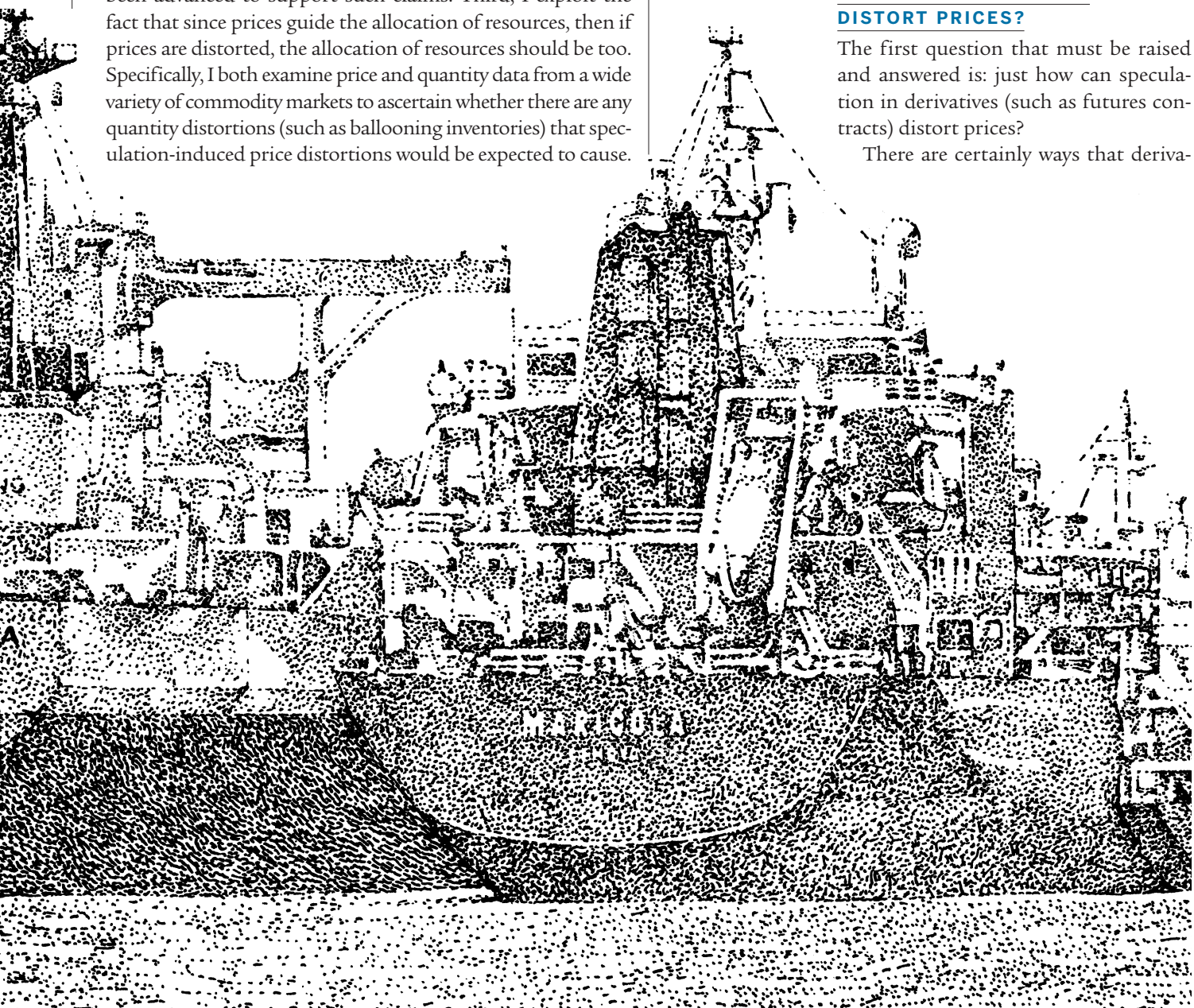
I conclude that assertions that speculation distorted prices during the years leading up to the financial crisis are logically suspect and empirically dubious. Indeed, on balance the evidence supports the view that the extraordinary commodity price movements during this time were driven by economic fundamentals.

By necessity, these findings are not dispositive. In part, this reflects the “knowledge problem” discussed above. In part, it reflects the fact that most criticisms of speculation are not formulated as formal models that generate empirically refutable hypotheses. But even though the results are not dispositive, the analysis demonstrates that the logical and empirical foundations of attacks on speculation are extremely shaky at best, and hence that policies intended to constrain speculation are likely to be destructive rather than constructive. And indeed, the CFTC’s proposed limits include several objectionable provisions that will exacerbate these negative effects.

### **HOW CAN SPECULATION DISTORT PRICES?**

The first question that must be raised and answered is: just how can speculation in derivatives (such as futures contracts) distort prices?

There are certainly ways that deriva-



tives can be utilized to distort prices. For instance, the owner of a futures position that is larger than the supply of the underlying deliverable commodity available at the competitive price can “corner” the market and drive up prices — temporarily. Such an action leaves tell-tale tracks in price data: the price of the cornered contract rises absolutely, and relative to the prices of contracts for the same commodity that expire on later dates; the price in the cornered market rises relative to prices in related markets, and then collapses after the corner ends. Moreover, this action leaves tell-tale tracks in quantity data: the artificially high price attracts additional supplies into the cornered market. However, none of these tell-tale signs were observed in markets allegedly affected by speculation in the years before the financial crisis. So, other mechanisms must be adduced to explain any connection between specu-

difficult to understand exactly how he could affect the price that a consumer pays at the pump or in the grocery.

Put differently, although the speculator may buy, he is almost invariably a seller when a commodity futures contract nears delivery. This would suggest that even if his initial purchase drove up prices, his subsequent sale would drive down prices. Absent some (unexplained) asymmetry in price response to the speculator’s purchases and sales, it is difficult to understand how his actions could affect the prices consumers pay and producers receive.

It would be gratifying if I were the first to arrive at this understanding, but that is definitely not the case. It has been around for years. Indeed, in 1901 the United States Industrial Commission made a symmetric analysis when it debunked contemporary assertions that speculative selling depressed

## Most futures speculators offset their positions prior to maturity, so it is difficult to understand how their actions could affect prices.

lative excess and price distortion.

Unfortunately, most of the criticisms of speculation posit very rudimentary causal connections. Frequently, the argument is simply: speculators bought many more futures contracts than they sold, buying drives up prices, so speculation caused prices to rise. For instance, a 2006 report of the Senate Permanent Subcommittee on Investigations asserted:

As far as the market is concerned, the demand for a barrel of oil that results from the purchase of a futures contract by a speculator is just as real as the demand for a barrel that results from the futures contract by a refiner or other user of petroleum.

The large purchases of crude oil futures by speculators have, in effect, created an additional demand for oil, driving up the price of oil for future delivery in the same manner that additional demand for contracts for the delivery of a physical barrel of oil today drives up the price for oil on the spot market.

This line of reasoning faces several serious logical difficulties. First, even if speculation caused prices to go up, that does not necessarily imply that prices were too high as a result. It is possible that speculators recognized that prices were too low (given fundamental information) and that their buying moved prices to the right level.

Second, and perhaps more importantly, this simple story ignores some basic facts about the way that most speculators trade. Most speculators using futures offset their positions prior to maturity, and hence never make or take delivery of the actual commodity. For instance, a speculator who buys July crude oil futures in January typically sells his contract prior to July. Thus, this speculator never directly affects production or consumption of the physical commodity, so it is

grain prices:

As we have attempted to show, it is a mistake to represent speculation in futures as an organized attempt to depress prices to the producers.

First. Because every short seller must become a buyer before he carries out his contract.

Second. Because, so far as spot prices are concerned, the short seller appears as a buyer not a seller, and therefore, against his own will is instrumental in raising prices.

Other traders speculate using contracts that do not even permit the buyer (seller) to take (or make) delivery of the underlying commodity. Such “cash-settled” contracts are purely financial instruments with a payoff that is derived from the price from some other market (which in energy is typically a delivery-settled futures contract). The mechanism whereby buying or selling such an instrument can influence the price of a physical commodity is typically not identified rigorously by critics of speculation.

In sum, those claiming that speculation using derivatives distorts prices of physical commodities have not specified a plausible mechanism by which it can cause prices to diverge from fundamentals. Speculators typically exit the market before the time that consumers actually purchase, and do not participate in the spot market for the physical commodity, which means that they cannot directly influence supply or demand. Moreover, as I discuss in more detail below, to the extent that speculators do influence supply and demand for the physical commodity, it will affect consumption, production, and inventories. Hence, it is possible to examine quantity data to determine whether such effects exist. Further, indi-



rect channels of speculative influence also have implications for quantity data that can be tested.

### **THE EMPIRICAL BASIS FOR CLAIMS THAT SPECULATION DISTORTS PRICES**

If explanations of how speculation has affected prices lack logical coherence, what can be said of the empirical evidence advanced in support of such claims? It too is lacking.

One of the most common sources of data used to analyze the impact of speculation is the Commitment of Traders (COT) reports produced weekly by the CFTC. For each futures contract traded in the United States, these reports disclose the difference between the number of futures contracts bought and the number of futures contracts sold by different categories of traders. The two most important categories are “commercial” and “noncommercial” traders. Commercial traders include those like oil refiners or natural gas producers that consume, produce, or merchandise physical commodities. Noncommercial traders are those who do not handle physical commodities in the ordinary course of business.

These categories do not correspond exactly to “hedger” (a firm that uses derivatives to reduce price risks) and “speculator.” Some commercial firms engage in speculation. Some noncommercial firms (notably, large financial institutions) use futures to manage price risks, some of which they might have taken on by offering over-the-counter contracts used as a hedge by those actually handling physical commodities. Moreover, since the COT reports measure only futures market and futures option market positions, they do not measure activity in the over-the-counter markets. This means that they give an incomplete picture of hedging and speculative activity in the derivatives markets.

Despite these defects (and others), the COT reports are widely used to measure speculative activity in the market. In particular, the net position of noncommercial is widely followed as a measure of speculative participation in the markets. When noncommercial are “net long” — they have bought more futures than they have sold — it is widely believed that speculators are net buyers.

Some commentators on commodity markets have asserted that there was an increase in speculator net purchasing in energy markets during the time of the price spike, and this buying caused, or at least exacerbated, the spike. For instance, a study by Kenneth Medlock and Amy Meyers Jaffee of the Baker Institute at Rice University stated:

Generally, movements in price over the last few years have coincided with trends in open interest by noncommercial traders. We can see that during periods where speculators have been net short, prices typically declined, even if only slightly. When speculators are net long, the general shift in the market has been upwards, in some cases to a dramatic extent. Some exceptions have occurred when speculators were generally in a net long position, but were moving to liquidate positions. In this case, such as the late spring/early summer 2008, prices responded by moving sharply lower.

A more rigorous evaluation of these data demonstrates that, even if one accepts that any correlation between specu-

lative activity and price movements means that the speculation caused the price movement, and speculation drove prices away from their appropriate levels, the noncommercial trader position data do not support claims that speculation forced commodity prices sharply higher in the period ending in the summer of 2008.

Specifically, I have estimated regressions of weekly changes in crude oil futures prices against weekly changes in noncommercial net positions over the 2001–2009 period. These regressions indicate that there is a positive association between changes in speculative positions and price changes during the entire sample. There is also a positive association in the 2006–2009 period (when speculative excess supposedly climaxed), but interestingly the magnitude of the “speculative effect” is about half as large during this subsample. Moreover, it is relatively small: in 2006–2009, a one-standard deviation move in the measure of speculation is associated with a one percent move in oil prices.

Furthermore, and most interestingly, using the estimated coefficient on speculation and the observed changes in noncommercial net positions in January 2006–July 2008 implies that, during this time, changes in net noncommercial positions can account for a 2.56 percent increase in oil prices. During this period, oil prices rose from \$63 to \$141, or more than 123 percent. Thus, even under the most charitable interpretation of the data, speculation as measured by the COT reports explains a trivial fraction of the dramatic rise in oil prices.

Nor is this unique to oil. I have performed a similar analysis for copper, which was allegedly the subject of a speculative frenzy in the mid-2000s. Again, changes in net noncommercial positions account for only a trivial fraction of the observed price movements. Indeed, at times speculators (as measured by the COT reports) were net sellers when prices were rising, meaning that under the speculative impact hypothesis they actually mitigated the price rise.

### **USING PRICE AND QUANTITY DATA TO TEST FOR SPECULATIVE IMPACT**

The foregoing demonstrates that the logical and empirical basis for many claims that speculation in derivatives distorted commodity prices is decidedly lacking. But taking the possibility of speculative distortion seriously, and considering the role of prices in resource allocation, it is possible to devise more reliable tests for the existence of speculative impact. In particular, it is advisable to take seriously the possibility that the increasing integration of financial and commodity markets that has occurred in recent years has affected commodity price behavior. It is widely stated that commodities are a new “asset class,” which suggests that if assets like stocks and real estate are subject to speculative bubbles, commodities may be as well.

These contentions raise the question of whether commodities are, in fact, best viewed as assets. To the extent that they are storable, commodities can serve as a store of value like a stock or a bond, and hence they bear some similarities to conventional assets. But it is important to recognize that commodities also differ from most assets in crucial ways that may make them less susceptible to bubbles, and make it

possible to identify whether prices have in fact diverged from fundamentals, as would occur in a bubble.

Specifically, unlike conventional assets, commodities are consumed continuously, and some are produced continuously. Whereas a dot-com stock, for example, is a claim on future (and perhaps distant future, and certainly highly conjectural) cash flows, a commodity is consumed continuously in the here and now. Prices are signals that guide the allocation of resources. If price signals are distorted by a speculative bubble, for instance, the allocation of goods will be distorted too. Therefore, a speculative bubble that distorts prices must distort consumption and production decisions. This means that to detect speculative price distortions, it is informative to examine quantities. This is feasible in commodities; it is far less so in financial assets.

Inasmuch as the change in inventories of a commodity necessarily equals the difference between the change in its production and the change in its consumption, a speculative price distortion should lead to distortions in inventories. In particular, a speculative distortion that increases prices should lead to an increase in inventories occurring at the same time as the price increase. Moreover, if speculators are driving the price, then they must have the highest willingness to pay, and they will bid away the commodity from consumers. Thus, speculators should end up holding the increased physical inventories.

Some examples help to illustrate this point. First, consider the case of the Hunt Brothers, who speculated extensively in silver in 1979–1980. During this episode, both prices and inventories of silver rose together. Large quantities of silver coins were refined to produce bullion that could be delivered in the futures market. Most notably, the Hunts ended up taking ownership of huge quantities of physical silver; their holdings went from under 50 million ounces to over 200 million ounces.

Next, consider the case of a speculative “corner” that artificially inflates a commodity price. The 1923 decision in *Chicago Board of Trade v. Olson*, written by Chief Justice William Howard Taft, decided the constitutionality of the first federal regulation of commodities trading. Taft’s writing gives an illustration of the kinds of quantity distortions that occur:

Mr. Julius H. Barnes, in his evidence before the Federal Trade Commission in October 1922, describes the effect upon interstate commerce of a “deal” in May 1922 wheat on the Chicago Board of Trade, when the price of futures rose rapidly. Large operators collected cash wheat all over the country and headed it for Chicago for delivery at the attractive prices. This took wheat away from all the other wheat centers of the country, where it normally would have remained for consumption, and accumulated it in almost unsalable quantity in Chicago, greatly disturbing the normal and useful flow of wheat in its ordinary and proper distribution and precipitating a crash in prices.

Last, consider the effects of government price support programs that, as a matter of policy, cause prices to rise above their competitive level. When the government supported milk prices, for instance, it had to buy large quantities

of cheese, butter, and dry milk, which it put into storage, leading to accumulations of huge stocks, as discussed in this Associated Press news story from 1982:

Current stocks of dairy products — cheese, butter and dry milk — would fill a train stretching from New York to Washington.

As of April 30, 1982, the Commodity Credit Corporation had 411.7 million pounds of butter in storage, 550.5 million pounds of cheese and 917.7 million pounds of nonfat dry milk. The annual storage cost: \$46.6 million.

Governmental warehouses across the nation are overflowing. Nonfat dry milk fills 180 huge warehouses. Another 127 are full of butter and 171 are overflowing with cheese.

Now that is a speculative distortion — courtesy of Uncle Sam.

A rigorous model, described by Ricardo Caballero et al. in a 2008 paper, of a commodity price bubble adapted to global economic conditions in the mid-2000s makes a similar prediction: as prices bubble up, commodity inventories should rise, and inventories should plunge when the bubble bursts. This model is testable because it implies that the bubble began when the financial crisis first began in July 2007: in the model, a collapse in one asset market leads investors seeking quality assets to buy commodities. This drives up commodity prices and leads to an accumulation of commodity inventories that investors hold as assets

Let us first look at oil. From July 2007 to July 2008, oil prices rose over 100 percent. But contrary to the speculative bubble stories, oil inventories did not rise commensurately. Indeed, they fell. As oil prices rose with the onset of the financial crisis in July 2007, U.S. oil inventories fell 18 percent by the end of 2007. Inventories rose slightly until April, and then fell again as prices reached over \$140 a barrel. Contrary to the bubble story, moreover, as prices collapsed as the crisis accelerated, oil inventories exploded, rising by May 2009 to 28 percent above their July 2008 levels.

The contrast to the Hunts is quite telling. Then, prices and inventories rose together, and the Hunts ended up owning huge quantities of the physical commodity. In oil, inventories fell while prices rose, and then rose while prices fell, and there is no evidence that speculators accumulated physical supplies. Thus, contrary to the characterization by one ubiquitous speculation gadfly that today’s commodity speculators are “accidental Hunt Brothers,” the evidence demonstrates clearly that they are demonstrably different. Indeed, the behavior is more consistent with fundamentals-based explanations.

Allegations of a commodity price bubble have not been limited to the oil markets, and derivatives trading has increased in volume across most major markets. Moreover, the Caballero et al. bubble model implies that other potentially asset-like commodities should have bubbled at the same time as oil. Thus, it is illuminating to examine other commodity markets.

Such an examination produces several findings at odds with the speculation explanation. Specifically:

- Industrial metals (which are cheaply storable and are arguably more potentially asset-like than oil) did not

uniformly experience dramatic price increases; some experienced substantial price decreases subsequent to July 2007. Moreover, for the major industrial metals, inventories and prices tended to move in the opposite direction. This is contrary to the implications of the speculation arguments.

- Many commodities, notably agricultural commodities, that have many disadvantages as a store of value rose dramatically beginning in the mid-summer of 2007.
- Some commodities that positively cannot be assets, notably shipping services, also experienced large price increases during the period of the oil and agricultural commodity boom.

The prices and inventories of six industrial metals (aluminum, copper, lead, nickel, tin, and zinc) did not behave as predicted by the speculative/bubble story. First, metals prices generally did not rise along with other commodity prices. The prices of lead, zinc, and nickel actually declined more than 40 percent from July 2007 to July 2008. Aluminum and copper prices rose, but only moderately – about 10 percent. Only tin rose substantially in price (over 70 percent), but tin inventories fell over 56 percent. Second, stocks rose for those metals that fell in price, remained approximately constant for copper, and rose slightly for aluminum. With the (mild) exception of aluminum, these price-inventory co-movements are more reflective of fundamentals and inconsistent with a bubble. Third, contrary to the bubble story, metals inventories increased dramatically when prices plunged as the financial crisis reached its apex. Fourth, I have examined copper in greater detail, and found that a fundamentals-based model explains well the movements of prices and inventories over this period.

Now consider the behavior of grain prices. Grain has serious disadvantages, as compared to metals for instance, as an asset used as a store of value. In particular, spot grain prices typically fall as the new harvest increases supplies, thereby exposing those holding inventory over this time to a capital loss. Grain prices rallied strongly in 2007–2008, rising approximately 70 percent (averaged across major grains) from July 2007 to July 2008. This corresponds in time to the rally in oil prices and the lack of a major increase in metals prices. Since energy and metals are plausibly more asset-like than grain, it is difficult to attribute all of these disparate price movements to an increase in demand for commodities as assets, either as a replacement for those undermined by the financial crisis, or any other reason.

Finally, consider the behavior of the price of shipping services during 2007–2009. It is essential to note that shipping services cannot be an asset. They cannot even be stored: one cannot increase the amount of space aboard a freighter next month by not using it today. The Baltic Dry Freight Index (a measure of shipping rates for goods like grain and coal) rose 75 percent between July and October 2007; it then declined back to its June level, but by June 2008 it was 83 percent higher than it had been in June 2007. The Baltic Dirty Tanker Index (a measure of crude oil shipping rates) rose 122 percent between July and December 2007, slipped back to its June level, but then took

off again, reaching 123 percent of its June 2007 value by July 2008. Since shipping services are not assets, the prices of these services cannot be asset bubbles, and conventional speculation stories cannot explain these price movements, which corresponded quite closely to spikes in grain and oil prices.

In sum, evidence on prices and stocks from oil and metals markets is not consistent with speculative bubble stories. Nor can such stories explain skyrocketing grain prices during the 2007–2008 period. They absolutely cannot explain the dramatic increase in the price of shipping services, which clearly are not an asset. Thus, taken as a whole, the evidence from the commodity markets broadly does not support claims that speculation distorted the prices of these commodities, individually or collectively.

So what can account for these remarkable movements? Again, the knowledge problem inevitably prevents a definitive determination, but one plausible explanation is that a dramatic demand increase occurring at a time when commodity supplies were generally tight was the overriding factor; the burgeoning Chinese demand for commodities was a major contributor to this increase in worldwide demand. The rise in shipping prices strongly indicates an increase in the demand for commodities, since such an increase in demand would also tend to increase the demand for shipping of dry and dirty cargoes. In addition, market-specific factors, such as the effect of European regulations requiring the use of low-sulfur diesel fuel (that increased demand for light, sweet crude oil at a time when supply disruptions in Nigeria reduced its supply) affected prices in individual markets.

The collapse in prices in 2008 reflected the effects of the financial crisis and severe worldwide recession. Similarly, the recovery of prices in 2009–2010 is best explained as the result of China's extraordinary stimulus program and its effect on Chinese commodity imports.

#### **THE ADVERSE CONSEQUENCES OF THE PROPOSED CFTC POSITION LIMITS**

Debates over the effects of speculation have been intense and enduring. It is impossible to test definitively claims that speculation (particularly speculation in derivatives markets) has distorted prices. But it is possible to evaluate the logical rigor of these claims, the empirical evidence advanced to support them, and more exacting empirical tests based on an understanding that speculatively caused price distortions should be associated with distortions in quantities. On each score, the assertion that the movements in commodity prices in the 2000s were driven by speculation instead of fundamentals does not stand up. The commonly advanced causal connection is implausible, the direct evidence of a relationship between speculative activity and price movements is weak at best, and the co-movements of prices with inventories and the pattern of price movements across a wide range of commodities are not consistent with claims that there was a commodity price bubble.

Nonetheless, widespread calls to regulate speculation in commodity markets have been heard in the United States and Europe particularly. In response to these calls, the CFTC has proposed to impose limits on the speculative positions that



market participants can hold.

Interestingly, in making its proposal, the CFTC pointedly did not provide any finding that speculation *had* distorted prices, and specifically disclaimed its obligation to do so; a disclaimer that opponents argue lacks any statutory basis. Moreover, the United Kingdom's Financial Services Authority stated in 2009 that it has not observed evidence supporting the view that speculation has distorted commodity prices, and has consequently demurred from setting position limits.

The case for position limits therefore lacks a logical or empirical basis. As a result, such limits are highly unlikely to lead to more efficient pricing in commodity markets. Indeed, they are likely to have the opposite effect. Limits on speculation constrain the derivative markets' most important functions: risk transfer and price discovery. These markets serve to transfer risk to those who can bear it at the lowest cost — speculators, almost by definition. Constraining the ability of the most efficient risk bearers to perform this vital function will impair the markets as a risk management tool. This will distort important prices — the prices of risk. Moreover, constraining speculation will reduce market liquidity, resulting in choppier and more volatile markets. Furthermore, to the extent that speculators are informed, limits on their participation will impede price discovery in commodity markets.

The details of the CFTC limits will also have deleterious effects. In particular, the commission's Notice on Proposed Rulemaking contains so-called "crowding out" provisions that mean that hedgers who receive an exemption from the position limit can hold no speculative positions at all. It also limits the futures position that dealers in over-the-counter (OTC) commodity swaps can hold to double the speculative limit.

These provisions are unprecedented and harmful. Many OTC swap dealers enter into contracts that other market participants (such as gas producers or airlines) use to hedge their commodity price risk exposures. Other OTC contracts are used to permit investors (such as pension funds) to diversify into commodities, thereby improving the risk-return profiles of their portfolios. The dealers use futures positions to hedge the risks assumed by offering these contracts. By limiting dealers' ability to hedge, the proposed limits would raise the costs they incur to provide hedges and investments to other market participants. This would impair the functioning of the OTC markets as a risk transfer mechanism. (It must be said that, given the animus of certain CFTC commissioners to the OTC markets, they may consider this a feature rather than a bug.)

The "crowding-out" provisions presume that there is a clear line between firms that hedge and those that speculate — or that there should be one. It has long been known, however, that such a line does not exist. Nor is there reason for one to exist. Modern commodity firms utilize positions in physical and derivatives markets to create portfolios to achieve specific risk-reward objectives. Moreover, many firms utilize the information that they gain through their constant involvement in the market to make decisions that can be considered speculative. Furthermore, when evaluated from a portfolio perspective (which is the correct way to measure risk), it is

quite difficult to identify any particular trade as a hedge or a speculation.

The conceptual basis for the crowding out feature is extremely weak. Commissioner Bart Chilton has rationalized it thus:

"There should be zero patience for trading on your own book, if you have an exemption," Chilton told Reuters, defending the new proposal as a safeguard against the impact of large traders roiling markets by making risky bets for their own accounts.

"Perhaps, if our proposal goes into effect, some will have to choose a business model," he said. "Are they a speculator, a swaps dealer or a hedger? Part of the problem we have had over the years is that some wanted to be everything to everybody."

Commissioner Chilton presumes to substitute his judgment about the optimal combination of economic activities within a firm for that made by market participants who put their own capital (financial and human) at risk, and who hence have a strong incentive to make those judgments correctly. Moreover, there is a strong reason to believe (based on informational considerations alone) that there can be economies of scope across different kinds of trading activities; the fact that some firms survive and prosper by engaging in multiple activities in the highly competitive commodity markets bolsters this conclusion. Thus, the proposed limits reflect not only a conceptually and empirically unsupported view on speculation, but also reveal a breathtaking presumptuousness about the way that commodity firms should do business.

In sum, there is no compelling theoretical or empirical case for limits on speculative derivatives positions. Indeed, there is not even a less-than-compelling case. Moreover, the particular limits that the CFTC has proposed are especially pernicious because they are more intrusive and constraining than more traditional limits (that do not include crowding-out provisions or constraints on swap dealers who are hedging legitimate risk exposures). As a result, if implemented, the proposed position limits will impair the proper functioning of the commodity markets and produce no offsetting benefit. **R**

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