

Are Oil Futures Markets Being Manipulated?

Jerry Taylor and Peter Van Doren, 05.18.11, 12:00 PM EDT

Obama's newly formed Financial Fraud Enforcement Task Force is an exercise in futility.

A few weeks ago President Barack Obama announced the creation of a Financial Fraud Enforcement Task Force, a working group under the Department of Justice that will be charged with rooting out manipulation in oil futures markets (a job, by the way, that's long been the charge of the U.S. Commodity Futures Trading Commission, but no matter). At a town hall meeting in Reno, Nev., [the president promised](#) that "We are going to make sure that no one is taking advantage of the American people for their own short-term gain." We'll save the working group some time; there is nothing untoward going on.

First some basics. All futures contracts involve two parties: one who thinks future prices will be higher (a buyer who takes the "long" position) and another who thinks future prices will be lower (the seller, who takes the "short" position). The daily future price for a commodity is that price which exactly balances the number of longs and shorts so that each pair can sign a contract.

It is the imbalance of longs and shorts that changes daily futures prices. If ten participants think the future price will increase (relative to the previous settlement price) for every one participant who thinks the future price will decrease, then the price of the futures contract has to rise until there are equal numbers of longs and shorts.

Thus large changes in futures prices result from large imbalances in the number of participants who believe future prices will go one way rather than the other. Prices change until there are an equal number of participants on both sides of the bet. Exactly half the participants make money and the other half lose, regardless of whether subsequent actual prices go up or down.

If large changes in futures prices arise from a large collective imbalance of participant beliefs, what is the origin of the imbalance in beliefs? There are two possibilities. In the first, the participants determine their beliefs independently and seek to act on them independently. The result sometimes just happens to be a collective imbalance necessitating a price change to equate the number of longs and shorts. In the second, participants collude to create the imbalance.

Much commentary on oil markets since 2000 has focused on the development of financial products that allowed ordinary investors to invest in commodities prices. In particular, attention has been focused on the influx on long positions held by large investors who are passively buying futures contracts for crude oil for delivery no more than a few months out and then rolling those contracts into new contracts as the old ones are settled and cashed-out. Their investments are primarily through commodity funds heavily weighted toward crude oil, the two most important of which are marketed by **Goldman Sachs** ([GS - news - people](#)) (the GSCI) and JPMorgan (the DJ-**UBS** ([UBS - news - people](#))). These are not the scalpers (who hold futures contracts for no more than a few seconds to a few minutes) or day traders (who open and close contracts within the same trading day) that make up the bulk of the speculator population. It's hard to imagine these passive investors conspiring to rig anything.

One would think, given all the political caterwauling, that the longs were making a killing in oil futures markets. Economist Philip Verleger, however, calculates that average monthly returns for the Goldman Sachs commodity fund (that largest of such funds) were only 0.5% from 2000 through May 2009. Consistent bets for higher oil prices in futures markets have not been particularly lucrative.

If an imbalance in beliefs and the resulting large change in prices were the result of collusion, why is it occurring only in one direction? Wouldn't it make sense for the speculators to collude to short oil, drive prices down, and make the same amount of money as they're allegedly making at present but without all the governmental investigations and threats of new regulation that inevitably follow when futures prices go up?

Regardless, futures markets don't operate in a vacuum. Eventually, futures prices have to reconcile with "market fundamentals" (the term of art for the real supply and demand for crude in physical markets). If futures prices rise even though no underlying shortage exists to justify higher future prices, the shorts (along with everyone else) will be offered a golden opportunity to buy oil in spot markets (so-called because oil can be bought "on the spot"), put it into storage, and sell that crude forward into the futures market--at the inflated, "manipulated" price--and realize a very real and totally risk-free profit. Because our economy is full of people who are smart enough--and motivated enough--to know a risk-free profit opportunity when they see one, any significant divergence between spot and futures price will trigger so much of this sort of thing that futures prices will fall (more futures are being sold into the market, and futures prices--like the price of

everything else--is established by the supply of and demand for futures) and spot prices will rise (because of the reduced supply from oil being placed in storage) eliminating the difference between the futures and spot price.

It is this arbitrage (the making of risk-free profits) between futures and spot markets through changes in inventory that provides the only plausible mechanism by which bets about the future price of oil have any impact on the actual price of oil. It has happened before, but we see no evidence (yet) that unusual inventory buildup is happening now. In fact, gasoline inventories have been declining all spring and are [below last year's levels](#).

So we wish the president well in this political snipe hunt. Don't hold your breath waiting for the hunters to return with a trophy.

Jerry Taylor and Peter Van Doren are senior fellows at the Cato Institute.