Intervention in a Stagflationary World

By Hilda Ochoa-Brillembourg, CFA

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The time has come for governments to consider intervening in the oil futures markets to reduce the effect of speculative demand, which may be exacerbating the rise in oil and other commodity prices.

Whether we like it or not, from time to time governments are forced to intervene in markets first and answer questions later. The U.S. government has intervened in the capital markets over the last 12 months by allowing non-bank financial intermediaries access to the Fed discount window, and by backing unwanted paper in the Bear Sterns portfolio to facilitate its purchase by J.P. Morgan, and, more recently, the US Treasury and Federal Reserve have announced plans to increase the Treasury line of credit for Freddie Mac and Fannie Mae and, if necessary, even buy their equities. These interventions have been predicated on the need to prevent a financial crisis that would have instantly destroyed carefully woven and well developed financial networks along with the global trust in the U.S. and other financial systems.

All interventions come at a price. The least visible and most lasting impact of interventions is "moral hazard," the term used to describe excessive risk taking on the part of economic actors with the expectation that the government will bail them out if things go wrong. That is why many economists and cautious investors dislike market interventions of any kind.

Coordinated Sales of Oil Futures: An Effective Circuit Breaker

The apparent imbalances in commodity markets, exacerbated by increased portfolio demands, stem from and contribute at the margin to increased uncertainties about future inflation. While no one can precisely determine the role speculative demand for oil futures has on real commodity supply and demand conditions, there is an easy, relatively costless way to find out and put an end to disruptive behavior if any is involved.

Feverish speculation in oil futures can be curtailed in the short run by a coordinated and determined sale of oil futures contracts, which would bring the leveraged speculators to their knees. A well coordinated short sale in the oil futures markets would certainly remove the appetite for financial profits from momentum traders, who have had the upper hand over value-oriented traders anticipating price reversals.

Despite talk in Congress about banning pension funds from investing in commodity futures, investment restriction is never a good idea. It leads to suboptimal portfolio allocations, reduced transparency and market liquidity. If the government needs to intervene, it should use the markets to do so and not create permanent regulatory hurdles that make capital markets less transparent and more segmented.

When you see extraordinary price momentum outside market equilibrium — when prices fluctuate within one standard deviation of a trending average — it is either a structural change in supply-demand conditions leading to a new long term mean, or indication supply and demand are price inelastic, as is clearly the case in the oil markets. But both conditions may be present. In the case of oil, intervention will be one way of finding out, and it will buy some time for supply and demand to catch up with one another if we are moving to a new and much higher price permanently (which by the way I do not believe).

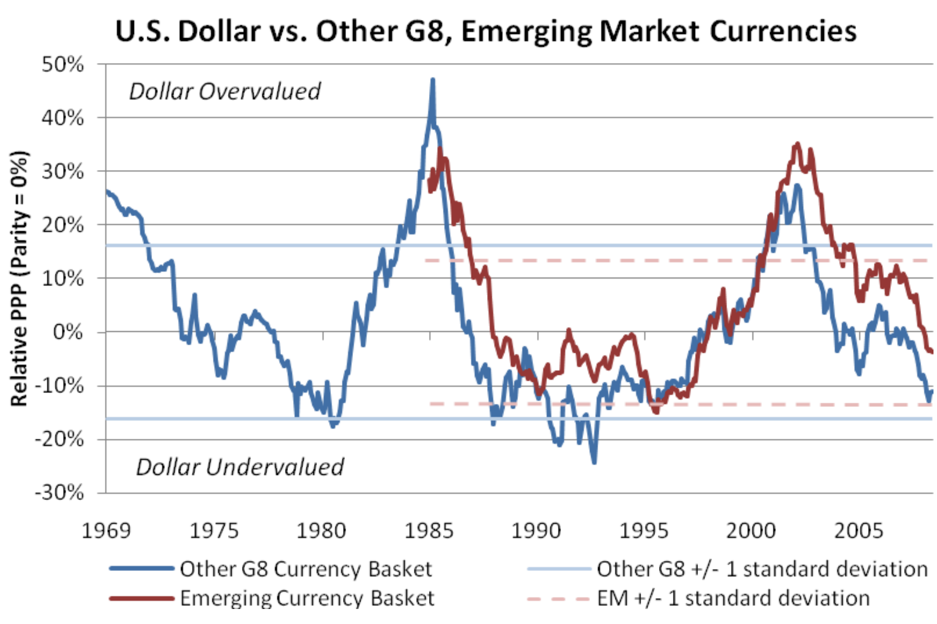
Why Oil and not Currencies?

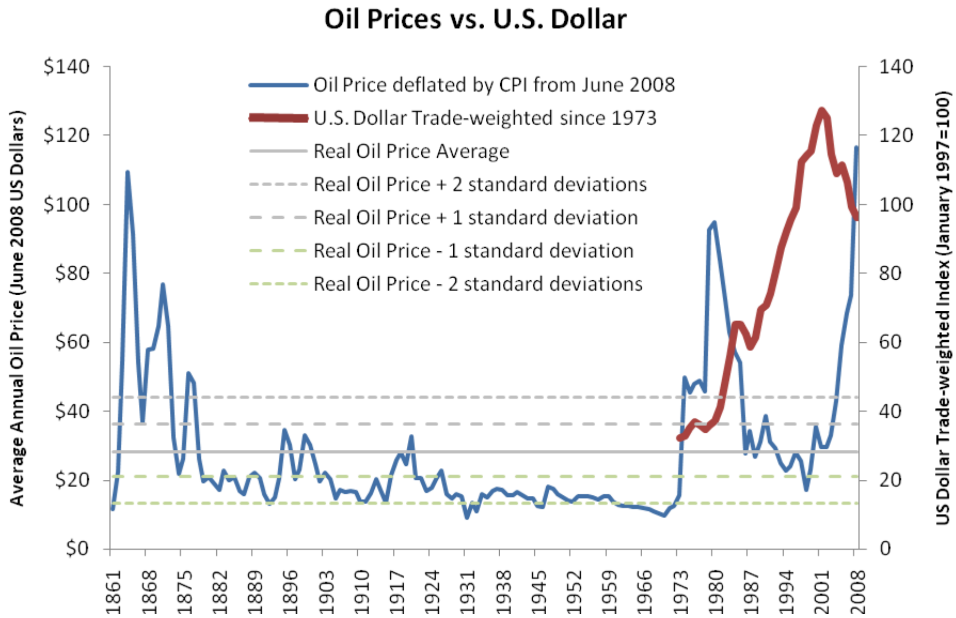
As the dollar declined, investors began allocating to passive commodities futures as an alternative to low-yielding dollar, euro, pound sterling, and yen deposits. Thanks to a consistent rise in the prices of oil and other commodities over the past two years — spurred by increased demand from emerging economies, decreased production from Venezuela and Iraq, and just-in-time sales practices in Saudi Arabia — oil and other commodities became many investors' currency hedge by other means. Commodities have been, in effect, a currency (or currency hedge) that keeps appreciating at 2% to 5% per month for the last 24 months. The temptation to join the stampeding herd has been overwhelming. It is no surprise that pension fund and other institutional investments in commodity futures have increased to $240 billion in the first quarter of this year from $175 billion last year, with more than half that amount dedicated to oil futures in particular.

Intervention in the oil futures markets would be a new kind of currency intervention, and one that would end very quickly the speculative tone of the oil futures markets.

When currency parities "overshoot" manageable bounds, government intervention in the currency markets has been used to cool off speculative trading when parities are out of normal ranges and threaten the workings of the real economy, since exchange rates are an important price mechanism to help bring balance in global trade, inflation and real growth rates. The U.S. dollar is well within typical deviations from fair value relative to a trading basket of G-8 and emerging markets currencies, but the U.S. dollar appears to be far below fair value relative to oil prices.

To break the current momentum driving oil futures markets, with its attendant influence on in- and above-ground inventories, all we need is a concerted intervention in these markets by the G-8 countries, Saudi Arabia and China. It might even be a very profitable move for the group of countries that intervene. An intervention of this nature, if a necessary transitory and emergency measure, would need to be followed by appropriate alternative energy policy incentives, to bring oil demand and price expectations to more sustainable levels over the long run.





Sources: British Petroleum, U.S. Federal Reserve, U.S. Bureau of Labor Statistics, U.S. Bureau of Economic Analysis, Strategic Investment Group.

Intervention Impact

The intervention would just buy time and cool markets for other constructive policies to take effect, given the inelasticity of supply and demand for oil in the short run. If there were no "speculative" component to oil futures prices, spot prices would rise to future prices and governments would have lost nothing (they have just hedged their futures sales or oil/gas tax income). In the best case scenario, the intervention would produce the necessary circuit breaker for run away speculation in the futures markets and be a profitable trade for governments at the expense of speculators. A successful short sale would likely buy six to 12 months of time for policy makers to put in place appropriate long-term oil-substitute incentive policies without the disruptive consequences on producers and consumers of continued run away commodity prices.

Restoring non-speculative supply-demand equilibrium in the oil and other commodity markets over the long run would require more than simply shorting futures. Appropriate policies that decrease uncertainty and increase the potential payout from investing in alternative, sustainable energy resources (new exploration, nuclear, solar, etc.) are also needed. Restoring equilibrium will also require continued countercyclical fiscal, monetary and trade policies, as well as retirement and health savings and immigration reforms, and additional new forms of monetary and capital market intervention.