

# SAFER

**ECONOMISTS' COMMITTEE FOR STABLE,  
ACCOUNTABLE, FAIR AND EFFICIENT FINANCIAL REFORM**

A PROJECT OF THE POLITICAL ECONOMY RESEARCH INSTITUTE ■ UNIVERSITY OF MASSACHUSETTS, AMHERST

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**RE: Regulation of Commodities Futures Markets in the Reconciliation of the Financial Reform Bill**

Dear Members of the Reconciliation Committee conference:

As you are well aware, in the momentous work ahead of you in reconciling the House and Senate versions of the Financial Reform Bill, probably the most contentious issue outstanding will be how to regulate the markets for derivatives. The undersigned members of the Economists' Committee for Stable, Accountable, Fair and Efficient Financial Reform (SAFER) want to express our strong support for comprehensive derivatives regulation, including: Section 716 of the Senate bill, separating swaps desks from bank holding companies (with significant penalties for rule violations); strong anti-manipulation authority; strict position limits on commodity derivatives; and no systemically significant exceptions for particular industries and activities. In other words, we support a tight version of the Senate bill, which goes further than the House bill to promote stable derivatives markets that can effectively promote the well-being of consumers, farmers and other producers in the U.S. and throughout the globe.

Financial market derivatives include many of the esoteric Wall Street inventions that led to the near collapse of the U.S. and global financial system in 2008-09, including subprime mortgage-backed securities and credit default swaps. Other types of derivatives include what had once been plain-vanilla options and future contracts for commodities such as oil and food, which farmers and others have long relied on to help maintain stability in their business operations and plan for the future. But deregulation that began in 2000 with the so-called "Enron loophole" encouraged hyper-speculative activities by market players who had no interest in the underlying physical commodities being traded. This produced severe price swings for both oil and food in 2008-09 that destabilized business and household budgets in the U.S. and throughout the world. This experience led Gary Gensler, the Chair of the Commodities Future Trading Commission (CFTC) to observe at his February 25, 2009 Senate confirmation hearing that "I believe that increased speculation in energy and agricultural products has hurt farmers and consumers." The huge run up in food prices in mid-2008 also created a worldwide food emergency, causing about 130 million people in the developing world to face malnourishment as a result, according to a study by the United Nations Food and Agriculture Organization.

Of course, the first issue at hand for your Committee must be: what regulations of the derivative markets are needed to prevent a repeat of the 2008-09 financial market disaster? But we believe that your Committee also needs to give careful attention to the question of how to return the commodities futures market to its proper role of promoting price stability for consumers, farmers, and other producers.

The version of the bill that passed in the Senate goes further than the House bill in reaching this goal. The Senate bill would require most standard derivatives to be traded on regulated exchanges, as opposed to unregulated, freewheeling over-the-counter (OTC) markets. It also imposes capital reserve requirements and business conduct rules on the most highly speculative derivatives, such as credit default swaps, and, in Section 716, prohibits banks that benefit from government deposit insurance, subsidies and bailouts from operating as swap dealers altogether. The House version contains comparable measures, but also includes a longer list of exceptions, including no prohibition on subsidies and bailouts for swap dealing banks.

The Senate bill is also stronger in a host of other areas. For example, the Senate bill narrows major loopholes in the House bill that exempt foreign exchange derivatives. The CFTC estimates that 90 percent of the derivatives market would be covered under the Senate version of the bill but only 60 percent under the House bill. Other provisions in the Senate bill that are stronger than in the House include: stronger fiduciary duty on swap dealers dealing with government entities and pension funds, stronger whistleblower protections, and provisions allowing regulators to prosecute persons who knowingly or with reckless disregard use false or misleading information to affect the price of any commodity such as food or oil.

The Senate version itself may also include major loopholes, especially, as Senator Cantwell of Washington has emphasized, the possibility that credit default and other swap market traders would face no punishment if they ignore the requirement that their deals be conducted in a transparent way through an organized clearinghouse. Such loopholes need to be closed in the reconciliation conference.

We know from recent experience that the U.S. government is capable of establishing and implementing largely effective regulation of the commodities futures market. Until 2000, the regulations guiding the CFTC—including oversight of clearinghouses, significant capital requirements for the clearinghouses, margin requirements for traders, and limits on the total amount of trading that any market participant could control—were reasonably successful at restraining commodity price volatility. But 2000 brought the so-called “Enron loophole,” exempting over-the-counter energy trading undertaken on electronic exchanges from CFTC oversight and regulation. Enron quickly seized this market opportunity to create an artificial electricity shortage in California in 2000-01, which led to multiple blackouts and a state of emergency, and, finally, the collapse of Enron itself and its once-Big-Five accounting firm, Arthur Andersen.

Despite this experience, in the aftermath of the Enron debacle, the big market players subsequently exploited similar major loopholes—the “London loophole” for nominally foreign market trading and the “swap dealer loopholes,” which permitted all swap trading to move into OTC markets. The overall effect was to enable the OTC markets to flourish alongside the regulated markets. In the OTC market, a period of rising prices can much more freely feed on itself to create a bubble, since upward price momentum is not restrained by trading limits or the need to meet capital requirements or margin calls. This is the overall situation analyzed in the important 2006 Senate Staff Report, “The Role of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back on the Beat.”

By the end of 2007, the value of the unregulated commodities contracts had hit around \$9 trillion, which was estimated to be more than twice that of the contracts on regulated exchanges. The impact of deregulation on commodities prices was dramatic. A 2009 study by the United Nations Conference on Trade and Development reports that “the price boom between 2002 and mid-2008 was the most pronounced in several decades—in magnitude, duration and breadth.” Just starting from the full year of 2006, the average price of crude oil on global commodity markets rose by 71 percent by mid-2008, before collapsing by 60 percent over the next six months. Similarly, the average price of a broad basket of food products rose by 43 percent on global commodity markets, before dropping by 23 percent over the next six months. Such major price swings are continuing up to the present.

Everyone in the U.S. recalls the summer of 2008 when gas prices spiked at over \$4.00 a gallon at the pump. What brought gas prices back down quickly was the global financial collapse, leading to the severe recession, which in turn burst the global oil price bubble. If the economy does start recovering strongly out of the 2008-09 recession, and if, at that time, speculative commodity traders can still find ways to readily operate

outside of CFTC oversight, we should not be surprised to see a rapid return to gasoline prices of \$4.00 or higher at the pump.

Relative to the oil price spike, the impact of global food price volatility on U.S. consumers was less harsh. But the effects of food price volatility on U.S. farmers were severe. Of course, farmers like high food prices just as much as consumers like low prices. But wild swings in global market food prices makes it extremely difficult for farmers to manage their businesses.

Still, the most severely impacted victims of commodity price volatility are people in developing countries, where it is common for families to spend 50 percent or more of their total income on food. It is therefore no surprise that, as the U.N. study found, the 40 percent rise in average food prices in mid-2008 led to malnourishment for 130 million people. This food price spike also generated food riots and political instability in 33 developing countries at that time. Low-income people in developing countries have been further hammered by the fact that, even with global food prices falling sharply from their mid-2008 peak, they are still today, on average, about 20 percent higher than they were in 2006.

We should recognize that reinstating a viable set of regulations will not, by itself, ensure stable commodity futures markets. Even if an effective regulatory regime does emerge now from your reconciliation conference, these laws still must also be enforced. This means that the CFTC must be adequately staffed. Moreover, the staffers must be people committed to enforcing the letter and spirit of the new system. But the first step to reviving safe and stable commodities futures markets—that is, to bringing cops back on the beat in these crucial markets—will be to pass a legally tight version of the Senate’s Financial Reform bill.

Sincerely,

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