June 22, 2010

The Next Financial Crisis: Coming to Your Neighborhood Soon?

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With the financial reform bill in the U.S. Congress now heading into its final phase of debate--the Reconciliation Committee conference that will resolve differences between the versions of the bill passed by the House and Senate--probably the most contentious issue outstanding will be how to regulate the markets for derivative financial instruments. 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, that farmers and others have long relied on to help maintain stability in their business operations and plan for the future. But deregulation also converted these derivative markets for basic commodities into gambling casinos, which led to the severe price swings 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)--the federal agency charged with regulating commodities futures markets--to report in a 2009 Senate 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 additional people in the developing world to face malnourishment as a result, according to a United Nations study.

A great deal obviously rests on the outcome of the Reconciliation Committee conference’s work, which committee Chair, Representative Barney Frank of Massachusetts, would like to have openly televised over C-Span. Thus far, the debate has properly focused on the obvious first issue at hand: what regulations of the derivative markets are needed to prevent a repeat of the 2008-09 financial market disaster? But we also do need to give serious 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, as opposed to serving as yet another platform for Wall Street speculators.

The version of the bill that passed in the Senate goes much 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 prohibits banks
that benefit from government deposit insurance and bailouts from operating as swap dealers altogether. The
Senate version also establishes "position limits" on traders—how much of the overall market any one trader
can control. The House version contains many comparable measures, but also includes a longer list of
exceptions that that could easily become playthings for clever Wall Street operators.

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 ignored the requirement that their deals be conducted in a transparent way through an organized
clearinghouse. Such loopholes—or even the possibility that they are lurking amid the hundreds of pages of
legalese—need to be closed by the reconciliation conference.

Anticipating all loopholes in advance, much less closing them, is, of course, an impossible task. But we
know from recent experience that the federal government is capable of establishing and implementing
largely effective regulations of the commodities futures markets. 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.

Nevertheless, following Enron's example, the big market players subsequently took advantage of 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. remembers the summer of 2008 when gas prices spiked to 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 ever 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. (In fact, gas prices do indeed need to be significantly higher than their present average level at around $2.80 a gallon to reflect the severe environmental costs of a fossil-fuel based economy, including global climate change, with all its ramifications, and the disastrous oil spill in the Gulf of Mexico. But this price increase needs to be established carefully as one step toward creating a clean-energy economy, in which the interests of U.S. consumers are protected to the maximum extent. Rising gasoline prices under such circumstances would be completely different than experiencing another price spike due to some newly-hatched variant of the 2000 Enron loophole.)

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 was severe. Of course, farmers like high food prices just as much as consumers like low prices. But wild swings in global market food prices make it extremely difficult for farmers to manage their businesses. Consider, for example, a small U.S. farming family with an annual income of $60,000. The family is considering purchasing a new tractor for $20,000, which they could afford as long as the business continued generating an average of $60,000 in income. But if global food prices fall by 40 percent, and family income declines with it, to, say, $40,000, the funds to cover the tractor along with normal living expenses are gone.

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 additional 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.

Deregulation of derivative markets has not been the only factor creating global price volatility for commodities in recent years. The rising demand for biofuels as a substitute for carbon-emitting fossil fuels has pushed up prices for corn, sugar cane, and vegetable oil, the food products used most heavily as biofuel raw materials. Another frequently cited factor is the rising demand for commodities in China and India tied to their rapid economic growth. But this effect has been greatly overstated. In fact, food consumption in China and India has actually declined in recent years. The demand for oil has risen, but this increase has occurred steadily over several years, in step with the pace of economic growth. This is not a pattern that could itself explain wild food price swings--both increases and decreases in the range of 40-60 percent--in a matter of two years.

We should recognize that reinstating a viable set of regulations--something akin to a legally tight version of the Senate’s bill--will not, by itself, ensure stable commodity futures markets. Even if strong regulatory laws do emerge now from through the House/Senate 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 regulatory laws, rather than people serving time in government jobs before they cash in as industry lobbyists. If we have learned any lesson from the financial debacle of 2008-09, the principles guiding the writing and implementation of the final derivatives regulations should be straightforward: that the livelihoods of U.S. consumers and farmers, as well as of low-income people throughout the developing world, cannot hang on the latest contrivances of Wall Street speculators.