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Krugman on Carbon Derivatives: A Rebuttal

By Steve Suppan

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In his eagerness to support climate and energy legislation, Paul Krugman oversimplifies and thereby distorts the opposition to the carbon derivatives provisions in the American Clean Energy and Security Act of 2009 (ACES) as "[…] basically 'Eek! Markets! Wall Street! Speculation! Bad!'" ("Is the threat of speculation a reason to shun cap and trade?" July 21, 2009). Granted it is only a blog post, and not yet a topic of his very influential and widely syndicated New York Times column; yet given his influence, even his blog merits a rebuttal.

Krugman would have us believe that trading carbon emissions permit derivatives is just like trading a wheat futures contract. Not so. Wheat futures contracts allow market participants to manage short-term (usually 90 days) price volatility, including "bets" that hope to drive down the price of wheat. How will a statutory purpose of ACES—"to reduce green house gas pollution"—be fulfilled if speculators are allowed to drive down the price of carbon below even the price of the emission permits Congress gives away to industry in ACES? The data reporting requirements for ACES indicate that "short only" bets to decrease carbon prices will be allowed.

Following what European traders have done, Wall Street will slice, dice and package the claimed dollar per ton value of carbon-reducing claims made in projects to offset increases in carbon emissions elsewhere. Offset-based carbon derivatives contracts could proliferate on nothing more than the expectation of regulatory approval of projects claiming to offset carbon emissions. As Friends of the Earth's Michelle Chan testified to the House Ways and Means Committee in March, profits could be taken on offset-based derivatives far in advance of any proof that an offset project has resulted in verifiable greenhouse gas reductions.

Wall Street forecasts at least a $2 trillion market in carbon derivatives within five years. The current estimated value of all agricultural and non-agricultural commodity derivatives traded under Commodity Futures Trading Commission authority is $4–5 trillion. If the forecast is accurate, carbon derivatives could become a major component of commodity index fund formulas. The ACES trader data reporting requirements anticipate that carbon derivatives will be bundled into commodity index funds. Depending on how traders formulate the mix of commodities in the fund formula, it is likely that carbon emissions could become the dominant "commodity" in some fund formulas, displacing oil. Agricultural commodity prices, and to a lesser extent global food security, could be vulnerable to a swing in carbon derivatives prices, as carbon dominant index funds roll over to take profits.

Krugman still believes that speculation was not a major driver of commodity price volatility in 2008; and hence believes that excessive speculation can be easily regulated for carbon derivatives. He bases the former belief on a blog by Scott Irwin at the University of Illinois at Urbana-Champaign, who dismisses a just-published U.S. Senate report on wheat speculation because it incorporates the views of market participants—and benefits too little from Irwin's own work and that of other U.S. agricultural economists. However, as Christopher Gilbert at the University of Trieste has shown on the basis of CFTC data, index funds controlled about a third of all corn futures contracts from 2006–2008. (The disparity in 2008 futures contracts held by index funds vs. commodity traders subject to CFTC contract holding limits is even more severe; e.g., 1.5 billion bushels in Chicago Board of Trade March 2008 corn contracts held by the Goldman Sachs and Morgan Stanley managed funds vs. 11 million bushels held by users and traders of that commodity.) After demonstrating how the funds could swing the price of corn, Gilbert concludes that the "fund formula is the fundamental."

In February, the U.S. House of Representatives Committee on Agriculture, convinced that excessive speculation was a major factor in commodity price volatility in 2008, passed a bill to prevent the trading practices that lead to excessive speculation. However, Wall Street has set aside hundreds of millions of dollars to finance a sotto voce lobbying campaign against this and similar bills in the Senate. As a result of this campaign, a future House and Senate compromise to reform the Commodity Exchange Act (CEA) may result in some of the financial service industry practices that have triggered the destruction of much of the global economy.

As Satyajit Das wrote in the Financial Times ("How to design derivatives that dazzle and obfuscate," July 8), "Financial products must be opaque and priced inefficiently to produce excessive profits." Although Das writes about financial derivatives, he could just as well be writing about commodity derivatives, which provided the original model for financial derivatives. If the CEA, an underlying legislative authority for ACES, allows the opacity for over-the-counter derivatives that have contributed so much to the present depredations, we could soon live in the worst of all possible carbon-derived worlds. Huge institutional investors, such as pension funds, could be plowing money into carbon derivative offsets, while ACES enriches Wall Street but fails to reduce carbon emissions.

Traditional speculators provide liquidity needed to clear trades in commodity futures markets; but their role must be tightly regulated in order that excessive liquidity not result in the extreme price volatility that has disrupted agricultural and non-agricultural commodity markets. This need for tight regulation is all the greater when it concerns the reduction of green houses gasses. The purpose of ACES should not be to "get carbon prices right" but to achieve the long-term reduction of carbon emissions of which the legion of benefits is ultimately beyond pricing. The carbon derivatives subtitles of ACES do not provide the statutory basis to achieve that purpose. We would suggest that instead of caricaturing the opposition to carbon derivatives in ACES, Krugman dedicate more time to analyzing the bill itself.

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