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Banking Cartel That Steers Oil Market

Valentin KATASONOV

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The start of the new year was accompanied by a record drop in indexes and prices in financial and commodity markets. The oil market also set new records. Between July 2014 and the end of 2015, the price of this energy resource dropped by 70 %. It looked like it had bottomed out, but then last week oil prices dropped more than 10% – the worst start to a new year in recorded history. More and more traders are inclined to think that prices could fall below $30 a barrel.

According to the aggregate Bloomberg World Oil & Gas Index, in the first week of the new year the world’s 60 largest oil companies lost about $100 billion due to falling prices.

A lively discussion of the causes of the unprecedented fall in prices for this black gold has long been underway. Fewer and fewer still believe that such a decline is the result of «natural» changes in the market.

Often the actions of Saudi Arabia are cited as a reason for the nosedive in prices on the global market. And it's true that that country has unilaterally (without other OPEC members' agreement) boosted its oil production and begun dumping oil in an attempt to dominate the world market for black gold. This could account for a drop of a few dollars per barrel in global prices, but the fact is that the total decline is now about $100 (measured from its peak in 2008). And if calculations are based on the average price in 2014, which was almost $100 (for Brent crude), that comes out to a drop-off of almost $70/barrel since the beginning of 2016. It would take a concerted effort by all the major oil-producing countries in the world to shake up the market that much.

There is hardly a serious expert today who considers OPEC – the organization known as the oil cartel – to be a significant factor. Naturally there are suspicions that the oil market is being manipulated. Stockpiling is a traditional method for manipulating any market. Hoards of black gold, labeled as strategic reserves, are being amassed by many countries, especially the United States. Selling off a stockpile can force prices down. And the US has sold part of its reserves before, but the effect of such sales is very short-lived and impacts prices by no more than a few dollars per barrel.

In the last days of 2015, the media published a string of reports blaming the banking cartel for the dramatic fluctuations in the oil market. One of the first was an article by the American financial consultant Michael McDonald, claiming it is not OPEC that steers the market for black gold, but that it is controlled by the banking cartel, which uses energy-related loans made to companies in the oil industry and other energy sectors as a tool. According to McDonald, total outstanding loans to the US energy sector (the oil and gas industry) amount to $4 trillion. And

US banks currently hold only about 45% of all US loans to energy companies, while another 30% are held by foreign banks, and 25% by non-bank entities like hedge funds.

McDonald's first conclusion seems reasonable: it's true that OPEC has not controlled the oil market for a long time. And it's even fair to say that banks operating as a cartel have begun to steer the market. But his third conclusion – his claim that energy loans are being used as a tool for directing the market – is questionable.

McDonald himself cites data that cast doubt upon his own conclusion. The author states that loans to the energy sector make up only 3% of the total US loan market. That's not enough to prompt major changes in the market for oil and other energy resources. Obviously Wall Street banks do not view the energy industry as their top priority when setting their lending policies. Hypothetically, bank loans could be a means for pursuing a long-term structural policy. Some experts hint at precisely that, claiming that the drop in oil prices is «real and long-term». But such opinions have to be backed up with statistics showing investment in the development of alternative energy that are edging out traditional oil, but there is no such evidence. Banks, at least, in recent years have not noticeably increased their lending for green-energy projects.

This suggests that the fall in prices for black gold results from price manipulation. Bank loans cannot be used as an instrument of such manipulation. Loans of course have an impact on prices, but a loan's effect cannot be seen until several years have passed. However, prices react to manipulation immediately, or within a few weeks at most. McDonald claims that in the past year banks have cut back on their financing of the oil industry and are likely to continue to do so in 2016. But one could expect that that will have the opposite effect, resulting in higher prices for black gold, since credit restrictions will reduce the supply of oil.

The manipulators of the oil market are the largest banks. They do this by using oil futures contracts and other derivatives tied to oil. It seems counterintuitive, but daily prices (for spot trades) are set by the prices for future deliveries (in a year's time, for example).

And futures prices are the result of what are called «expectations». «Expectations», in turn, are created by the rating agencies, the community of experts, and the mass media. All of these are under the control of the largest banks. Banks simply place an order for the «needed» expectations.

Since the late 1970s a robust market has been growing for «paper oil», i.e., a market for futures contracts that do not culminate in a physical shipment of oil. This is a game of chance for speculators, which causes a great deal of suffering for anyone in the business of producing, refining, or using oil or oil products in the real economy. Currently the market for «paper oil» sees ten times the number of transactions as the market for physical oil. The trading volume for oil futures contracts on the two major exchanges – New York's NYMEX and London's ICE – is already more than 10 times higher than annual global oil consumption.

All the derivatives markets are controlled by banks, chiefly Wall Street banks, as well as some of the largest banks in the City of London and continental Europe. The market for «paper oil» is no exception. According to some estimates, 95% of the global market for oil derivatives is controlled by US banks.

The biggest dealers in oil derivatives are Goldman Sachs, J.P. Morgan Chase, and other banking giants that use oil futures, first of all to profit from fluctuations in oil prices, and second – in order to ensure their own role as financial intermediaries. What's more, the bank's clients include both players in the market for physical oil – oil companies, refineries, airlines, etc. – as well as financial players such as hedge funds. In order to increase the commercial impact of their monopoly of the «paper oil» market, many giant banks also trade in physical oil (it is obvious that these banks have an advantage over players on the so-called free market when it comes to arranging prices for black gold). In 2003, the US Federal Reserve decided to allow banks to act as commodity traders, and J.P. Morgan, Morgan Stanley, Barclays, Goldman Sachs, Citigroup, and a number of other major banks eagerly leapt into trading physical oil.

The financial crisis of 2007-2009 was triggered largely by the fact that derivatives markets emerged in which US banking giants could run wild and which was outside the control of financial regulators. The US Federal Reserve, the US Securities and Exchange Commission, the US Department of Justice, and European financial regulators have all tried to bring some sense of order to the derivatives markets. In 2010, the US passed the Dodd-Frank Act, which sketched out a plan for tighter regulations on the financial market, but that act is only a framework. Its practical application would require a great many more specific laws and statutory instruments.

For several years the US has been investigating the activities of Wall Street banks and the largest European banks before and during the crisis of 2007-2009. In particular, ties have been identified linking bank transactions on the oil futures markets with their transactions involving physical oil. In 2012, an investigation was launched into actions taken by Goldman Sachs, Morgan Stanley, and J.P. Morgan to manipulate commodity prices (including oil), and legitimate charges were brought against those banks in 2014.

Most of the major banks are staying in the financial derivatives markets for now. This includes the oil futures market. Therefore we must be prepared for the oil «market» to continue to perform all kinds of circus stunts.

In conclusion, it should be noted that the banks that are manipulating the prices of black gold truly are operating as a cartel. However, this is not a specialized cartel, with activity limited to a single product market. This is a global cartel, bearing the official title of «the US Federal Reserve System». With access to a printing press to manufacture global legal tender (dollars), the regional Federal Reserve banks effectively control all of the financial and most of the commodity markets.