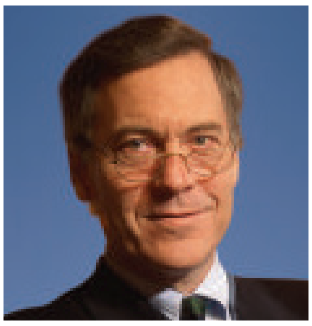

COMMODITY SNATCHERS

SCARY RICE AND OIL PRICES HAVE SENT POLITICIANS TO their bag of tricks. Not surprisingly, they have pulled out one that has been a staple since the Middle Ages: blame the speculators and hoarders. But the politicos should be pointing fingers at themselves. Governments around the world buy and store commodities, especially rice and oil, with justifications stressing the value of everything and the cost of nothing. A notable proponent of commodity buffer stocks was John Maynard Keynes. As Keynes put it in 1942: "One of the greatest evils in international trade before the war was the wide and rapid fluctuations in the world prices of primary products." He recommended that governments use buffer stocks to smooth out price fluctuations by purchasing commodities when prices were thought to be low and selling them when prices were thought to be high.

Not surprisingly, this buffer-stock variant of "Father knows best" has not worked. For one thing, it assumes that government bureaucrats possess the same knowledge of market fundamentals and face the same incentives as well-financed, farsighted private traders. It also assumes that politics will not raise its ugly head. Both of these heroic assumptions are not met in the real world. Government buffer-stock schemes are rife with politics, and instead of generating profits from buying low and selling high, they tend to generate losses.

Rice is one of the most government-controlled commodities in the world. There are subsidies for rice producers and consumers. There are tariffs, quotas and, yes, buffer-stock programs. In consequence, the world's rice markets are fragmented and only 6% to 7% of world production is traded internationally.

Over the past year rice prices have more than doubled. Not because of private speculation and hoarding but because of government speculation and hoarding. As the price of rice began to climb, governments invoked their concerns for food security and increased their hoarding propensities. Exporting countries imposed restrictions to keep rice at home, while some of the largest rice importers signaled that they intended to significantly increase their buffer stocks. This proved to be a deadly supply-demand cocktail that set off panic buying, a price surge and food riots.

But this isn't the end of the rice story. Japan announced last month that it wants to export rice. The Japanese rice industry is superprotected, and the government holds huge stockpiles. Part of these stocks are accumulated because Japan agreed, as part of a World Trade Organization deal, to make regular purchases from foreign producers, mainly the U.S. To keep domestic rice prices high, the Japanese government hoards its WTO-mandated imports. Now that Japan wants to unload some of its rice, opposition is flaring up in Washington and other capitals, claiming that re-exports are not allowed under the agreement. When it comes to filling or releasing government stockpiles, politics clearly rules the roost.

The mother of all commodity hoards is the U.S. Strategic Petroleum Reserve. At its current status of 97% full, the SPR is more than twice the size of private crude oil inventories, with enough reserves to cover about 71 days of U.S. crude oil imports or 47 days of total U.S. crude oil consumption.

Rice prices have soared because of speculation and hoarding by governments, not private business.

Last month Congress voted overwhelmingly to force President Bush to stop filling the SPR just as its capacity was about to be reached. The President magnanimously complied, and Congress began to debate whether crude oil in the SPR should be released to break the back of speculators.

What should be done with the hoard of crude? It's time to remove the release rules from the grip of politics. Market-based release rules would transform the SPR into an oil bank. It would provide the country with a huge precautionary inventory of oil, generate revenue to defray some of the government's stockpiling costs, smooth out crude oil price fluctuations and push down spot prices relative to prices for oil to be delivered in the future.

How would an oil (or rice) bank work? The government would sell out-of-the-money call options on its stockpiles. It might, say, sell December 2008 oil options with a strike price of $200 a barrel. If the price surged above that level, the option buyer would exercise and take delivery of crude oil from the government's stockpile. If the price never reached $200, the option would expire worthless, and no crude oil would be released.

Let the market, not politicians, determine the flow of rice, oil and other commodities. Lower, more stable prices will ensue. F

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