



3

Global Closure, Crises and Financial Markets: A Commentary

W. Travis Selmier II and Chang Hoon Oh

Introduction

In the paper titled “Speculation in international crises: report from the Gulf”, Weiner (2005) analyzes oil futures trading on the New York Mercantile Exchange [NYMEX] during the Gulf Crisis (1990–1991) to address several issues critical to financial trading, national security policy, and the impacts of crises. Splitting price movements of futures contracts into Day (trading occurring when NYMEX is open) and Night (contract price changes which occur between market close and the following day’s opening price), the author searches to identify the causes of market volatility rather than merely symptoms of volatility. The paper essentially

W. T. Selmier II (✉)
Indiana University, Bloomington, IN, USA
e-mail: wselmier@indiana.edu

C. H. Oh
University of Kansas School of Business, Lawrence, KS, USA
e-mail: changhoon_oh@ku.edu

questions whether trading and speculation cause greater market volatility. He argues that politics and market fundamentals are more impactful progenitors of market volatility rather than speculation *per se*. Herein, we argue that changes in technologies and markets since the [first] Gulf Crisis have perhaps strengthened his conclusion, but with an important twist. While there are deeper institutional frameworks, more access to markets, and stronger corporate risk management, speculative behavior and variety of risks have also increased in financial trading and international business.

Weiner (2005, 577) notes four reasons why “[t]he Gulf Crisis is a natural experiment for scrutinizing trading and volatility”, namely (1) there is a clear link between political conflict and international markets; (2) the global impact on the oil market wherein defined, direct results are evident; (3) the Crisis’ beginning and end are clearly defined temporally; and (4) both the Crisis and the futures market [NYMEX] are geographically distinct. We concur with these ideas, but we also feel Weiner undersells his “natural experiment.” Some market participants were familiar – in some cases extremely adept – at dealing with crises and understood how those crises affected oil markets at that time. Given a long history of wars and conflict (in the Middle East and elsewhere), some oil MNEs were already quite experienced in risk management, in some cases even profiting from crises. Their strong institutional memories had already been established with a product that has always been political. Hence, a fifth reason why the Gulf Crisis may be a useful natural experiment to scrutinize market volatility is that the oil MNEs – which were active traders of both physical (oil and its downstream products) and futures – could count among their numbers true exemplars of what has become known as “non-market strategy” in the decades following the Gulf Crisis. Oil MNEs were early employers of technology and non-market strategies to manage political and business risk.¹

¹Yergin (1992: 129–133) provides a fascinating vignette into how oil MNEs weighed market and non-market strategies in the aftermath of the revolutionary Baku oil riots in 1905. Yergin argues this was “the first time... a violent upheaval had interrupted the flow of oil, threatening to make a vast investment worthless.” Paris-based Rothschilds decided to lower their Russia-concentrated oil interests; whereas Royal Dutch/Shell, seeking to diversify supplies, paid in stock for the Baku assets. The Rothschilds became the largest shareholders of both Shell and Royal Dutch stock, considerably diversifying away from Russian oil assets into a global oil company, while Royal Dutch/Shell diver-

In another paper published during the Gulf Crisis, Weiner (1991) made a fascinating, controversial claim that the “world oil market is by no means unified. Almost half of the region-pairs (11 out of 23) are in different geographic markets more than half the time” ([based on price fluctuation analytics) (1991: 105). As strong proponents of regionalization we recognize this, but add an important caveat, which constitutes a sixth reason underpinning his “natural experiment”: The oil market may not be (or have been then) “one great pool”, but oil MNEs arbitrated around these region-pairs. Oil MNEs recognized the idea of “global closure” (a term coined in 1904 by British Member of Parliament and geographer Halford Mackinder, often called the “Father of Geopolitics”); i.e. the idea was that world transport routes were being knitted together by the coming of the railroad era which were then linking markets, people and armies globally.

The Interaction Between Technology, Traders and International Business

We take Weiner’s “natural experiment”, using three quotes from his 2005 paper, to point out that technology, traders and international business dynamically interact in sometimes cooperative, sometimes conflictual, ways. First, Weiner notes (2005: 578): “The question of the role of the trading process in market stability is an old one.” Yes indeed, this question literally goes back millennia: Cicero complained that “the credit of the Roman money market is intimately bound up with the prosperity of Asia; a disaster cannot occur there without shaking our credit to its foundations” (Frank, 1992, quoting from Teggart, 1939: 74, fn. 40). Traders conveyed the effects of Asian booms and busts to the Roman money market, causing political leaders like Cicero to express concern and occasional hostility. Osaka rice merchants in Edogawa Japan developed bonds, then a form of futures contracts in rice during the seventeenth century

sified their oil assets by adding Baku to their portfolio. Both sides weighed the political risks of the developing Russia revolutionary movements against their respective needs for oil assets, coming to this agreement in 1912.

CE, but were constantly criticized for weakening market stability; “futures trading, the market in ‘book transactions ... was said to be nothing but gambling’ by the government” (Schaede, 1989: 494). The latter nineteenth century introduction of intercontinental telegraph networks resulted in share-pricing differentials between London and New York Stock Exchanges shrinking from ten days before the Atlantic Cable was installed in 1867 to “zero days” (Hoag, 2006). To take advantage of this emergent technology, British merchant bank Samuel Montagu & Co. began siting their offices next to telegraph facilities in the 1870s (Chapman, 1984: 47). Later that decade, Chicago-traded commodity prices reacted to Indian climate disasters within hours through the transmission of the news via several intercontinental cables (Odlyzko, 2000: 96–97), leading to considerable outcry against traders from farmers and from the US government. These three examples illustrate not only the political pressures on trading mechanisms, but also that, while developments in techniques and technology – expansion of long-distance trading, financial contract sophistication, and telecommunications advances – created pressures on existing markets, the abovementioned market developments were primarily responses to demand for goods over geographic space and time.

Second, as Weiner states (2005: 577), “Speculators, particularly hedge funds, have been blamed in several crises, including the worldwide stock market crash of October 1987, the Gulf Crisis of 1990–1991, the breakdown of the European Exchange Rate Mechanism (ERM) in 1992–1993, the Tequila crisis and the Asian financial crisis of the 1990s, and the Russian crisis and collapse of LTCM of 1998.” And these were only the crises occurring just before and after the Gulf Crisis of 1990–1991. We can look back just a decade before to find a powerful source of this blame which influenced policymakers during the Gulf Crisis: the infamous Hunt Brothers’ attempt to corner the silver market in the late 1970s. Initially buying physical silver, the Brothers’ shifted to futures markets and borrowed heavily, even arranging warehouse space so that when their futures contracts expired, they could demand physical silver in payment rather than simply settle their futures contracts at expiry for the profits (Abolafia & Kilduff, 1988). Silver prices shot up in the resulting “squeeze”, affecting film producers and other MNEs dependent on silver, as well as

other commodities such as gold and platinum (Selmier, 2017: 229–231). This memory was very fresh on the minds of regulators and non-financial MNE managers during the Gulf Crisis as the Hunt Brothers were finally fined and banned from trading just at the end of 1989 (Eichenwald, 1989). In effect, the Brothers' example proved that old adage stating that one scandal cancels out a thousand good deeds, and their attempts considerably damaged speculators' reputations and set the stage for policymakers' overreactions during the Gulf Crisis, overreactions which Weiner deflates (2005: 582–583). But over the last century of financial markets, the Brothers' perfidy was a rarer occurrence. As Weiner points out, closing or severely restricting markets does not end speculation except in criminal cases such as the one illustrated by the Hunt Brothers.

Third, Weiner correctly argues that “[t]oo often, strong claims and policy proposals are made without supporting analysis”; in this case of the Gulf Crisis, governments may “influenc[e] market fundamentals, and expectations ... [through] an announcement of forthcoming strategic-reserve releases” (2005: 583). Unfortunately, policymakers sometimes panic (Weiner notes some government-tied reserves were purposefully not released, causing further panic). In 2009, economist and former Bundesbank Director Beatrice Weder di Mauro (2009) pointed out another relevant policy-linked problem when she summed up post-Global Financial Crises challenges facing policymakers: “As soon as crisis strikes, the optimal choice for policymakers differs from the pre-announced policy, the authorities will usually offer support. The banks anticipate this behaviour and run even more risks as a result.” Either closing down the market, or offering too much unquestioned support, signals a lack of balance. Weiner (2005) and Weder di Mauro (2009) acknowledge additional problems without explicitly stating them. One is that policymaking almost never exists in a *tabula rasa* form; already codified, policy *changes* must often be made rather than policy newly written. Another problem is that a complex pastiche of policymakers interacts with policymaking, which clutters, complicates, and even confuses responses. In contrast, the corporate form was created, in part, to form a more hierarchical, in many cases, command economy nature with defined boundaries. A third problem is that technology may move faster within markets rather than within governments. This is particularly so with

financial markets. In 2009, technology consultancy Gartner Group pointed out that financial firms spend more globally on technology than any other institutional grouping – 20% more than industrial firms, and 60% more than all governments at that time (Economist, 2009). This leads to considerable information asymmetry across and even within industries.

Oil MNEs – The Winners of the Gulf Crisis?

When engaging in policy analyses, analytics must include estimations of who benefits and who is harmed *ceteris paribus*. Analytics requires information, but information is only one necessary condition. In Weiner's *problematique*, oil MNEs were among the biggest winners of this Gulf Crisis. Adrian Throop of the Federal Reserve Bank of San Francisco (1991) estimated that American oil companies garnered *additional* overseas profits of \$8 and \$9 billion in the 4th quarter of 1990 and 1st quarter of 1991 respectively, which he attributes to the oil price increase caused by the Gulf Crisis. Since the Gulf Crisis, the boundaries between non-financial MNEs with oil operations and financial firms have become blurred. Hache and Lantz (2013), Zhang (2012) and others point out the increase in non-commercial trading volume in the “noughties” from perhaps 20% of trading volume to more than 60%. Goldman Sachs, for instance, now trades in both physical and futures, having arranged considerable storage facilities. Natural resource MNEs such as Glencore and Trafigura engage in so much financial trading that they have been compared to large financial firms through engendering systemic risk. Trafigura commissioned Craig Pirrong (2015), a prominent natural resources economist specializing in hedging strategies, to argue they were not “too big to fail.”

We differ in part with Weiner's assertion “Daytime (i.e., when the exchange is open) price fluctuations during the Gulf Crisis can be associated primarily with the trading process, and overnight fluctuations with news” (580). The operative word is “primarily”. No doubt if a reaction to the Crisis were forthcoming, it would have been led by the US, so news was also created during the trading day. Attributing the “gapping” that

occurred – where future contract trading begins with a gap between opening and previous day's close – to “news” is not inaccurate, though. Oil companies could and did trade both physical and derivatives, as they had done for decades; physical traded 24/7 during the Crisis. But NYMEX was the only game in town for those who could not trade physical. SIMEX (Singapore International Monetary Exchange) began trading oil futures during October 1989, while TOCOM (Tokyo Commodity Exchange) did not begin trading similar contracts until September 10, 2001. To critics who might argue that Weiner (2005) ignored SIMEX, volumes were so low that Victor Yu, in the energy group of Refco (then perhaps the world's largest risk management consultancy), said during the Crisis that “SIMEX is kind of a joke, the IPE [SIMEX oil futures] just doesn't have the liquidity that you really need” (see Beveridge, 1991).

Is Weiner's 2005 Paper Dated?

We, with an obvious bent toward economic history, are not unbiased judges. The readers will have to decide, and they will need to consider how technology developments in international business, trading and risk management dynamically change over time. America's Strategic Petroleum Reserve was established after the oil crises in 1973–1974. NYMEX' decision to extend oil futures' trading hours began during the Crisis. Glance back up at the times when SIMEX and TOCOM introduced oil futures – a few months before the Gulf Crisis, and the day before 9/11, respectively. Global closure, we argue, is an ongoing, dynamic process, but it is processed in fits and starts. International strategic management inherently accepts this; notably, Oh and Oetzel pointed out (2017) that MNEs develop institutional memories through experiential learning to manage risk but much of that learning results from experiencing, and overcoming, events such as crises, conflicts and disasters. Passing through trying periods catalyzes institutional changes, and the above-mentioned blurring of lines between financial and non-financial firms in resource markets underscore this.

In conclusion, we note that Weiner's (2005) analytics show us four important, and timeless lessons: (1) crises, which are inevitable and

repetitive, may occur without adequate risk-management tools; (2) blame may be apportioned without fundamental analysis, which likely leads to (3) incomplete, inadequate and often off-target policy responses, all of which implicitly require (4) well-structured non-market strategies which consider both potential crises and inherent asymmetric information sets.

References

- Abolafia, M. F., & Kilduff, M. (1988). Enacting market crisis: The social construction of a speculative bubble. *Administrative Science Quarterly*, 33(2), 177–193.
- Beveridge, D. (1991, November 7). Oil market seeks round-the-clock trading. *AP News*. Downloaded November 17, 2020 @ <https://apnews.com/article/79d83de27260365a253a6d64f3d6d950>
- Chapman, S. D. (1984). *The rise of merchant banking*. George Allen & Unwin.
- Economist*. (2009, December 3). Banks and information technology: Silo but deadly.
- Eichenwald, K. (1989, December 21). 2 hunts fined and banned from trades. *The New York Times*.
- Frank, A. G. (1992). *The centrality of Central Asia*. VU University Press.
- Hache, E., & Lantz, F. (2013). Speculative trading and oil price dynamic: A study of the WTI market. *Energy Economics*, 36, 334–340.
- Hoag, C. (2006). The Atlantic telegraph cable and capital market information flows. *Journal of Economic History*, 66(2), 342–353.
- Mackinder, H. J. (1904). The geographical pivot of history. *The Geographical Journal*, 23(4), 421–437.
- Odlyzko, A. (2000, June 16). *The history of communications and its implications for the Internet*. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=235284
- Oh, C. H., & Oetzel, J. (2017). Once bitten twice shy? Experience managing violent conflict risk and MNC subsidiary-level investment and expansion. *Strategic Management Journal*, 38(3), 714–731.
- Pirrong, C. (2015). *NOT TOO BIG TO FAIL: Systemic risk, regulation, and the economics of commodity trading firms*. Trafigura. Downloaded June 1, 2016, at <http://www.trafigura.com/media/2366/trafigura-pirrong-not-too-big-to-fail-systemic-risk-white-paper.pdf>

- Schaede, U. (1989). Forwards and futures in Tokugawa-period Japan: A new perspective on the Dōjima rice market. *Journal of Banking & Finance*, 13(4–5), 487–513.
- Selmier, W. T. (2017). An institutional perspective on governance, power, and politics of financial risk. *Business and Politics*, 19(2), 215–240.
- Throop, A. W. (1991, September 13). The Gulf war and the U.S. economy. *FRBSF Weekly Letter*, pp. 91–31.
- Weder di Mauro, B. (2009, October 1). The dog that didn't bark. *The Economist*. <http://www.economist.com/node/14539774>
- Weiner, R. J. (1991). Is the world oil market “One Great Pool”? *The Energy Journal*, 12(3), 95–107.
- Weiner, R. J. (2005). Speculation in international crises: Report from the Gulf. *Journal of International Business Studies*, 36, 576–587.
- Yergin, D. (1992). *The prize: The epic quest for oil, money, and power*. Simon & Schuster.
- Zhang, Y. J. (2012). Speculative trading and WTI crude oil futures price movement: An empirical analysis. *Applied Energy*, 107, 394–402.