The Role of Financial Markets in Determining Physical Oil Prices

What really determines the price of oil? Anthony May, assistant professor of finance at Wichita State University's W. Frank Barton School of Business, explored this topic with co-authors from the University of Oklahoma and the U.S. Energy Information Administration. The results were published in a paper titled "Factors Influencing Oil Prices: A Survey of the Current State of Knowledge in the Context of the 2007-08 Oil Price Volatility." The goal of Dr. May's research was to begin the discussion of how price formation, volatility, hedging, and speculation affect the global price of oil. This research project is an important piece of the oil price puzzle.

After reviewing nearly 200 prior research studies, Anthony and his co-authors came to some interesting and important conclusions. They determined that factors such as stagnant supply and the economic growth of China and India were contributing factors to the rise and fall of oil prices from 2007 to 2008. Two other factors, low interest rates and the weak U.S. dollar, also contributed to the oil prices during this period.

The research did not find conclusive evidence that the increase in oil derivative trading and changes in derivatives traders (swap dealers, hedge fund, and index funds) have a measurable effect on the global price of oil. The study also did not find a significant link between domestic U.S. oil futures prices and domestic U.S. spot market prices. But the authors see the need for more research in these areas to definitely rule out these factors in what really affects the price of oil.

This exhaustive study by Dr. May and his co-authors begins to explain the complexity what truly contributes to the price of oil. The complete research study can be found at the following link: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2154642.

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