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The "Break Glass" Moment: Secretary Yellen Should Use the ESF to Insure and Accelerate Commodity Production

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Introduction

Commodity supply shocks and a Fed-induced tightening of financial conditions threaten an incredibly promising domestic business cycle expansion and an otherwise fragile global economy. Balance of payments crises are spreading due to weighty import bills. An appreciating dollar and increased costs of financial intermediation are likely to prolong the effects of these shocks or destroy local supply-side responses. The Fed's commitment to the price stability side is intended to cool the demand side of the economy but will likely entail some collateral consequences on the supply side. Accordingly, the **Department of Treasury should be making use of the Exchange Stabilization Fund (ESF) to target accelerated supply-side responses and insure critical producers against downside risks.**

In the absence of a serious ESF response to address the root causes of inflation, **unilateral reliance on the Fed to effectively offset supply shocks will increase the risk of a global recession.** The Fed's ability to impact inflation and employment derives from its ability to tighten financial conditions and lower asset prices. But without an assist, the Fed's tightening will reduce employment and stifle investment at a time when the global economy needs investment in non-discretionary commodities more than ever. The Fed's tightening can have demand-side effects on inflation, but it will likely come with supply-side effects including limiting capital expenditures, increasing intermediation costs, and weaker inventory replenishment. At a time when supply-side responsiveness is most critical, the Exchange Stabilization Fund is ideally suited to mitigate these collateral consequences.

Secretary Yellen should announce the establishment of a Supply Insurance and Acceleration Program (SIAP) using the Exchange Stabilization Fund. This program could help reduce fears of commodity-linked exchange rate crises, and demonstrate to market participants and private actors that localized supply and investment deficiencies will be filled. With a mix of tools at its discretion, including the sale of put options (price insurance) and loan guarantee fees, the Exchange Stabilization Fund can overcome virtually any private hurdle rate (the rate of return that firms require in order to justify investing in a given project) while providing much-needed certainty in this historically uncertain time.

This is the Moment for the ESF

The ESF is uniquely matched to today's complex of historic risks. It provides (1) broad authority; (2) a highly discretionary and versatile toolkit; and (3) enough capital to deploy that the action will have a considerable impact on the markets in question.

Authority

The ESF provides broad authority to act in moments like these. The key paragraph establishing the bounds of action states the following:

> "***Consistent with the obligations of the Government in the International Monetary Fund on orderly exchange arrangements and a stable system of exchange rates,*** *the Secretary or an agency designated by the Secretary, with the approval of the President,* ***may deal in gold, foreign exchange, and other instruments of credit and securities the Secretary considers necessary****. However, a loan or credit to a foreign entity or government of a foreign country may be made for more than 6 months in any 12-month period only if the President gives Congress a written statement that unique or emergency circumstances require the loan or credit be for more than 6 months.*

Though the scope of Treasury's authority has never been litigated, a textual analysis evinces a strong argument that Congress intended to give the Secretary of Treasury wide latitude to determine when and how to use the fund (for a deeper analysis, please see our companion research report: Discretion is the Point: The Misunderstood Legal Bounds of the ESF).

The economic case for the use of this authority today is clear. The ESF has been utilized in similar moments in the past, most notably in 2008 and at the onset of the COVID-19 pandemic in 2020 (and prior to passage of the CARES Act). Multiple commodity shocks are threatening the stability of the international exchange rate system, stoking disastrous balance of payments crises across emerging markets alongside widespread recession. The costs of price-inelastic necessities like oil and food are skyrocketing, and new production requires time we don't have and investments that private actors are rationally holding back on due to a range of uncertainties.

Oil and Commodities

Though investment in crude supply is increasing, the slow climb is insufficient against current consumption patterns. While the historic SPR release temporarily relieved pressure, low inventories in a tight market will continue to drive prices up. Absent a recession, oil could reach $150 or higher. This hurts consumers at the pump, but at those prices, energy costs will stoke passthrough effects to other consumer prices, effectively increasing the prices of a wide array of goods which require oil or its refined products as an input.

Given the high cost of hedging, producers are increasingly preferring to sell constrained production at historically high spot prices, rather than scale up investment and hedge some of the price risk associated with increased future production. Their incentives could change if they have the option to sell back to the Strategic Petroleum Reserve (SPR) in the event prices fall, while still selling at spot prices when prices are high. The Treasury is authorized to utilize the ESF to sell put options (a form of price insurance) to private actors, and can then coordinate with the Department of Energy, which, under its SPR authorities, can take delivery via the Strategic Petroleum Reserve in the event that oil prices fall sufficiently. **The coupling of this type of optionality with affordable financing can overcome virtually any investment hurdle rate**. The Treasury could provide that leverage through loans or, more appropriately, loan guarantees.

The challenges associated with funding oil investment apply to other commodities where prices are volatile and investment activity is super-cyclical. Hurdle rates are exceptionally high because of the risk of a commodity glut—whether induced by a recession, OPEC, or state actors intentionally pursuing oversupplied markets. Whether energy commodities, agricultural products and inputs, or the host of metallic and mineral inputs highly relevant to the energy transition, cyclicality is virtually a given. The more commoditized, the more cyclical. The greater the cyclicality, the greater the reluctance to invest for a given price and the more unreliable the price mechanism is for unilaterally catalyzing future investment and production.

Russia and Ukraine are prominent suppliers of several of these commodities and their scarcity can have knock-on effects, from electricity outages to global hunger, from fragile automobile and housing supply chains to the critical lack of transportation fuel. Poorer countries will face high import bills that their foreign exchange reserves likely will not be able to cover. Absent a fundamental change, we are likely to see increasingly frequent exchange rate depreciations and devaluations over the rest of the calendar year.

Exchange Rate Crises

Commodity price increases can be incredibly harmful to emerging markets that import food and fuel. These crises cause sharp economic pain that often leads to severe social and political unrest. In just the past month, oil and food price surges have led to exchange rate crises in Lebanon, Laos, Sri Lanka, and Pakistan. The surging price of wheat, which may not yet fully reflect the considerable supply effects from the Russian invasion of Ukraine, puts nations like Egypt, Turkey, Tunisia, Ghana, and Kenya at even greater risk.

There is little that can be done to immediately alleviate commodity price pressures. The strongest way to act is to find any and every possible way to increase production. A program oriented to offer price insurance would help push the production frontier outward–and give markets confidence that the supply shortages will not persist long-term. Commodity price surges are at the root of much of the economic pain we're experiencing now. When coupled with affordable and available leverage, offering price insurance to commodity producers would help stabilize markets and provide an effective incentive for accelerated investment and production.

A Discretionary and Versatile Toolkit

The ESF statute allows the Secretary of Treasury to deal in "instruments of credits and securities" that she considers necessary. Beyond a minor constraint on loans or credits to foreign entities and countries, there is little limit on the variety of transactions and agreement types available.

Ideally, the Secretary would announce the Supply Insurance and Acceleration Program, with the express purpose of offering purchase guarantees and financing to facilitate the production of key commodities including, but not limited to, oil, natural gas, wheat, fertilizer inputs (e.g. potash), palladium, and copper. Support stemming from this program could be directly tied to firms' committing to expanded capital plans, providing a credible signal to market participants that support would result in a net increase in investment and production.

Take oil production as an example. The program could offer financing (through loans, loan guarantees, or other financing backstops) to oil producers who commit to expanding their rig count beyond their existing plans. Although the DoE is about to engage in rulemaking to enable forward and option contracts, the Treasury has the authority to engage in such contracts immediately, and likely at larger scale than the DoE could in the short-term. It could sell put options to producers, with the intent to store the oil at the SPR (which is explicitly allowed by SPR regulation). The same structure should work across a range of commodities: **commit to new investment and additional production, and the**

program will guarantee a floor price and provide the leverage.

Domestic production should be prioritized, but the program can also enhance the potential to boost production outside the United States too, where geological considerations might be relatively attractive and exchange rate risks can be more effectively mitigated. Egypt is incredibly vulnerable at the moment because of its dependence on wheat imports (it was the largest importer of wheat in the world in 2020)—but it is also the fifth largest exporter of nitrogenous fertilizers. Price insurance for future production of fertilizers would offer certainty for at least some incoming hard currency—helping stabilize the foreign exchange reserves while alleviating a key global commodity challenge.

The program should also support commodity price stabilization through demand reduction and by increasing production of substitutes. Even as fossil fuels are a cyclical and geopolitically-sensitive commodity, so too are the inputs for their key substitutes. Where appropriate for addressing root causes of balance of payment crises, key commodities like copper, lithium, or other critical minerals may justify price and loan guarantees given that they too are vulnerable to the same “supercycle” dynamics that plague oil prices and investment.

Of course, there are risks and imperfections in the efficacy of such a facility. New bottlenecks will emerge, or could be hindered by lack of sufficient storage capacity. **A complementary effort here should involve the development of storage and maintenance capacity for all commodities the Treasury might be contractually obligated to take delivery of—in the event that supply overshoots and prices fall sufficiently.** But because many of the production contracts will be over a longer time horizon, the Administration has time to figure out that challenge so long as it seeks an appropriation from Congress expeditiously. Where possible, the facility could deploy resources to alleviate intermediate supply challenges like insufficient refining capacity. At least for this very moment, the Treasury can send a clear signal to markets and producers directly backed by considerable resources.

Deployment at The Necessary Scale

Today’s challenges require a response large enough to make an impact. When the run on money market funds threatened the global response, Treasury responded by offering the entirety of the balance in the ESF, $50 billion. The ESF is currently valued at $221bn. Secretary Yellen should offer at least half of its asset balance to the commodity facility. The fund’s ability to engage in creative security structures, and to issue loan guarantees, offer the ability to stretch that balance even further (for reference, in 2008, the $50bn from the ESF was used to cover a $3.5 trillion dollar money market fund industry).

Conclusion

On September 16, 2008, "as the money market fund complex unraveled," a small group of Treasury and Federal Reserve officials gathered to craft a solution. Just three days later, before most of the details had been sorted out or even discussed, Secretary Paulson announced the creation of a guarantee program for money market funds. Ten days later, the program was up and running. It took just two weeks for money market funds to stabilize (they even began to grow).

We are at a similar inflection point today. The confluence of several economic challenges, from painful inflation, to balance of payments crises in emerging markets, to tighter financing conditions, can all be directly linked to the surging prices of major commodities. Now is the time to spur as much investment and production as possible. Secretary Yellen should announce a Supply Insurance and Acceleration Program.

What we're suggesting is not a cure-all for every economic problem. Commodity production is complex, and there is no way to increase production by simply turning a single dial. Investment takes time to come to fruition, and can be hindered by other challenges like appropriate weather or inputs (food production is hindered by the fertilizer shortages, which are in turn exacerbated by shortages in potash and natural gas). It will not be easy, but like most economic crises, we should heed the call of President Roosevelt, and engage in bold, persistent experimentation.