Financialization - one of « new twists » to commodities problematique

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Fig. 1: Non oil commodity price index in constant terms, 1960-2011 (2000 = 100)
Overview of price trends, 1960-2011

- Commodity price cycles are often asymmetric; boom periods in general being shorter than bust cycles;
- Relative commodity prices are non-stationary: is the trend deterministic or reflects structural breaks
- Mid-2008 to 2009: global financial crisis - most commodity prices plummeted as global growth slowed down & consumer demand weakened.
- But from 2010 all commodity subgroups have rebounded strongly; average prices for metals, agric. raw materials & beverages in 2011 had even surpassed the 2008 levels.
- A challenge to conventional arguments about asymmetric nature of commodity price cycles;
- “New twists” to commodity problematique?.
“New twists” to the perennial commodity problematique

- Strong growth in developing countries’ (DCs) markets, esp. BRICs, for mineral, metals & energy commodities;
- Growth in DCs markets for high value agricultural commodities through new & dynamic wholesale & retail outlets;
- Growth of biofuels & increased competition over cropland resources;
- The increasing role of TNCs in international commodities trade;
- Sanitary and Phytosanitary (SPS) and Technical Barriers to Trade (TBT) measures;
- Climate change, environmental pressures;

Financialization of commodities markets;

Financialization: what is it?

- Two main component concepts: “financialization” and “commodities price volatility”;
- Measuring price volatility is well-established; details vary among different metrics, but all define volatility as the degree with which prices differ from historical averages;
- “Financialization: a combination of two related components:
  (i) Flow of financial capital (distinct from commercial capital), into commodities futures markets – the “upstream” component?
  (ii) The effect of these financial capital flows on various aspects of commodities futures markets (price discovery, risk management & the notional link between futures prices and the supply & demand fundamentals of underlying commodity) – “downstream” component?
- Analysis of the financialization of commodities markets tends to examine topics from within one or both of the upstream and downstream components.
- Financialization means that commodities markets are increasingly beholden to the expectations of financial actors and less so to those of commercial actors.
Financialization: simplified view

- Financialization of commodities”, a process according to which a number of non-conventional actors “financial investors”, e.g., investment banks, hedge-funds or pension funds, have been investing in commodity-linked instruments;
- Note: Financial investors have been long active in commodity markets, but their investment in commodities for purposes of portfolio diversification gained considerable attention following the bursting of the equity market bubble in 2000.
- Strong and sustained increase in primary commodities prices (2002 and mid-2008) was accompanied by the growing presence of financial investors on commodities futures exchange;
- This “financialization” of commodity markets has caused concerns that most of the recent commodity price developments was driven largely by financial investors’ use of commodities as an asset class.

Financialization: some concerns

- Speculative behavior of financial investors towards commodity markets;
- Few reporting requirements in DCs aimed at regulating commodity futures plus increasing deregulation in such markets in developed countries;
- Many of the top financial investors in commodity markets are headquartered in Switzerland, where regulation on ownership information disclosure is lax;
- Trading in futures contracts involves high costs for purchasing the contracts themselves; only the largest trading companies (mostly TNCs) are able to enter the futures markets.
- DC’s export companies find themselves effectively excluded from such profit- making, as the risk-management tools available to them are very limited.
Financialization: some concerns, contd.

- Production and trade of minerals and metals dominated by big TNCs.
- A new breed of “speculators” (Pension Funds), have flooded the commodity markets. This fuelled new growth in speculation by hedge funds and investment banks;
- Financial investors cause greater uncertainty about the reliability of signals from the commodity exchanges with respect to storage and price risk management;
- Financial investors dilute the participation of commercial users (the physical market still is relatively unaffected), including those from DCs, because commodity price risk hedging has become more complex and expensive;

A positive note: the speculative money that has flown into the market place has provided liquidity and made for a deeper market with regards to, not only investment vehicles, but also for the producers and users of the commodities.

The evidence. Evolution of commodity trading on world exchanges
The evidence. Commodities as a share of global derivatives exchange trading (%)

The evidence. OTC derivatives trading of commodities.
The evidence. Explosion in turnover of futures markets

- Proportions of turnover differ by commodity. In 2009-2010, the ratio of the value of exchange-traded derivatives contracts relative to the value of its underlying physical production, was:
  - 76:1 for copper
  - 62:1 for gold
  - 10:1 for oil
  - 55:1 for sugar
  - 0.15:1 for rice

- **Note that financial capital flows only contributed to these ratios – they are not wholly responsible for them!**

- Commercial actors on commodities markets still effect the majority of the trades, but “upstream” financialization/the flood of non-commercial capital into commodities futures markets since 2003 – **this is a fact.**

The evidence. UNCTAD research

- Little consensus on the effects of financial flows on commodities prices, on value chain actors, or on the functioning of markets;
- UNCTAD: financialization has had **a damaging impact** on the price discovery and on risk management activities conducted by commercial actors on futures markets – this affects their investment decisions;
- **Portfolio investors.** Effect traced through the vector of disrupted price signals. Financial investors make their trading decisions based on **a portfolio of assets that includes commodities**, but of which the majority are stocks, bonds, currencies, etc. Expectations for commodity investments are related to the returns to be generated as part of the portfolio. They are not linked to the commercial value chain that underpins the commodity futures market.
The evidence. UNCTAD research

- Non-fundamental price signals have become more important in the last decade. Financial price signals are steadily replacing commercial ones;
- While “long” financial investors had a causal impact on agricultural commodities prices, speculators had a causal impact on the price of non-agricultural commodities.
- Whether prices rise or fall, these muddied price signals cause prices to overshoot their historical average range. Uncertainty among commercial actors, including raising the risk of a commodity price bubble;
- Commercial hedging becomes more complex and tends to exclude DCs participants, from conducting commercial risk management on the futures markets.

The evidence - Others

- Gilbert (2010): index-based investment in oil and non-ferrous commodities accounted for inflated prices by up to 15% in 2008, but limited evidence that the current price boom is a bubble;
- Irwin & Sanders (2011): No causal link between commodities index trading and futures prices and cast doubt on whether index funds drove a commodities price bubble;
- Sanders et al (2010): index fund activity in agricultural commodities markets, no material changes in measures of speculative activity by index funds leading to 2008 crisis. Speculative values remain within the average historical ranges;
- On energy markets. Buyukshin and Robe (2011). International Energy Agency (IEA) found that index funds – the largest pool of financial capital in commodities markets (which UNCTAD believe have driven agricultural commodities prices) – had little effect on price formation in energy markets, but rather that hedge fund transactions had the most important impact on energy prices;
The evidence – Others (ii)

- One commonality: the increasing synchronization of futures prices across a variety of commodities (Tang & Xiong 2010; Dwyer et al. 2011; Buyuksahin & Robe 2011; UNCTAD 2009);
- But again, even in agreement, there are disagreements:
  - UNCTAD: the synchronization of commodities prices bears negative consequences for commercial actors;
  - IEA: the increased co-movement between commodities prices is neither beneficial nor harmful to the market and its actors;
  - The Reserve Bank of Australia: synchronization of price cycles across asset classes is not uncommon – it happens when the overall economy is subjected to large shocks, such as the Great Depression;

Refocus on fundamentals

- The debate about the effects of financialization continues;
- Need to revisit other, more fundamental factors, which are important in understanding and reacting to the current commodities price boom;
- Critical Question: Are the ongoing high prices and volatility in commodities markets consistent with well-established influences, i.e. direct supply and demand influences, or recurrent indirect influences such as foreign exchange rates, increased participation of financial investors in commodities markets?
- E.g., studies about the 2008 food crisis generally attribute the price spikes and supply shortages to some combination of:
  - Adverse weather leading to lower than expected harvests
  - Low worldwide inventories of food commodities
  - Export restrictions and hoarding in producing countries
  - Increased consumption growth from developing countries
  - High oil prices creating incentives to divert corn crops from food to biofuels; and
  - Cheap money in the USA.
Some additional thoughts and conclusions.

• Does discussion on “harmful” or “excessive” speculation mean a misunderstanding of how commodities market work?
• Speculators tried to profit from the resulting price movements; perhaps in some cases, the volume of capital flows amplified some of the price movements;
• Is there sufficient evidence that speculative transactions “caused” these price movements? With the number of inflationary influences that hit the market in a short period of time, is it possible that the food crisis would have happened even if speculators had stayed out of commodities markets?
• Whatever the effect on prices, there would be negative consequences if these financial players are removed from the market – less liquidity;
• The vectors by which financialization have affected commodities markets are still being studied (but these studies may reveal that commodities price movements over the last decade were the result of a complex set of factors);

UNCTAD policy proposals

• UNCTAD 2009 - Major reason on the absence of consensus on the effects of financialization is that reporting requirements for commodities traders are minimal compared to those required on for equity, debt or currency traders;
• No comprehensive data exists to track over time the change in positions of specific categories of traders – whether they be financial or commercial - for an individual commodity;

Among UNCTAD’s policy proposals:
• Regulating more transparency through enhancing reporting requirements in commodities markets (note also G20 proposals);
• Along with the impacts of financialization on commercial actors in commodities markets, study the potential for imbalances in commodities futures markets to send wrong macroeconomic signals to monetary policy markets (UNCTAD 2011);
• G20: Enhance market transparency in agricultural commodities markets through more reliable market information systems (AMIS).
• THANK YOU FOR YOUR ATTENTION!