UNCTAD

Multi-Year Expert Meeting on Commodities and Development 2013

Recent developments and new challenges in commodity markets, and policy options for commodity-based inclusive growth and sustainable development

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Impact of Financialization and Speculation on Prices of Commodities

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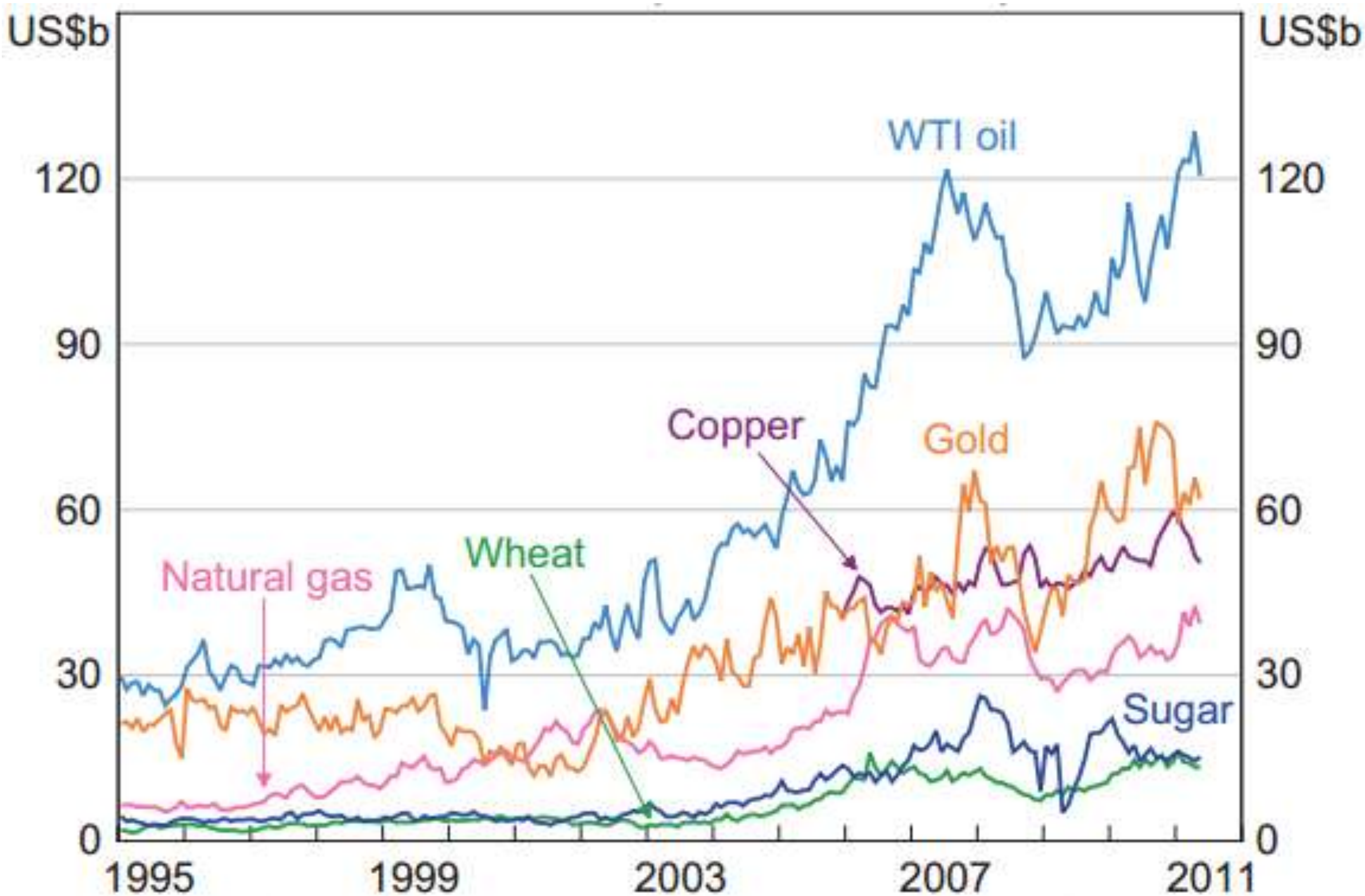
The Market Growth

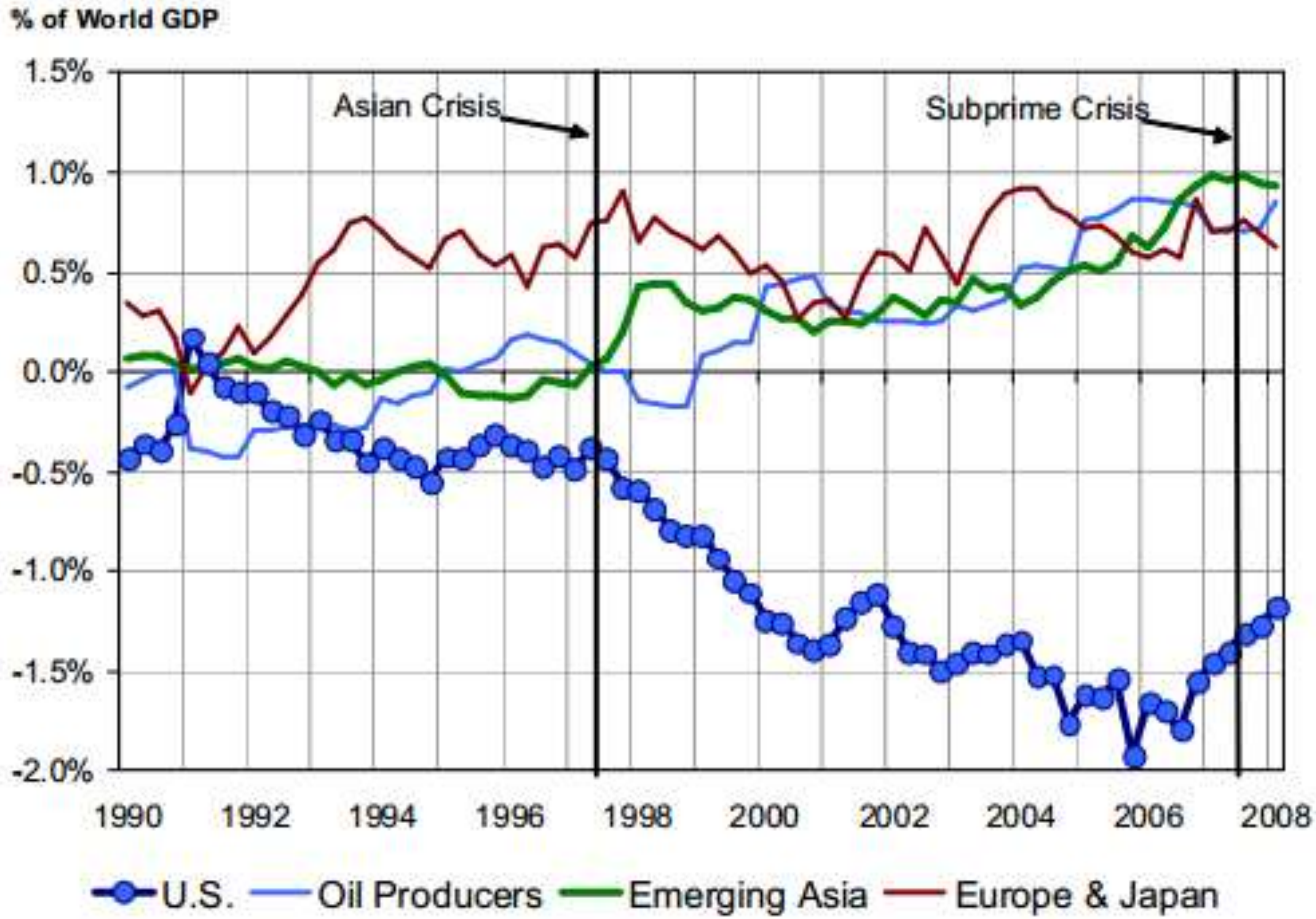


*   Open interest for the largest contract covering each commodity

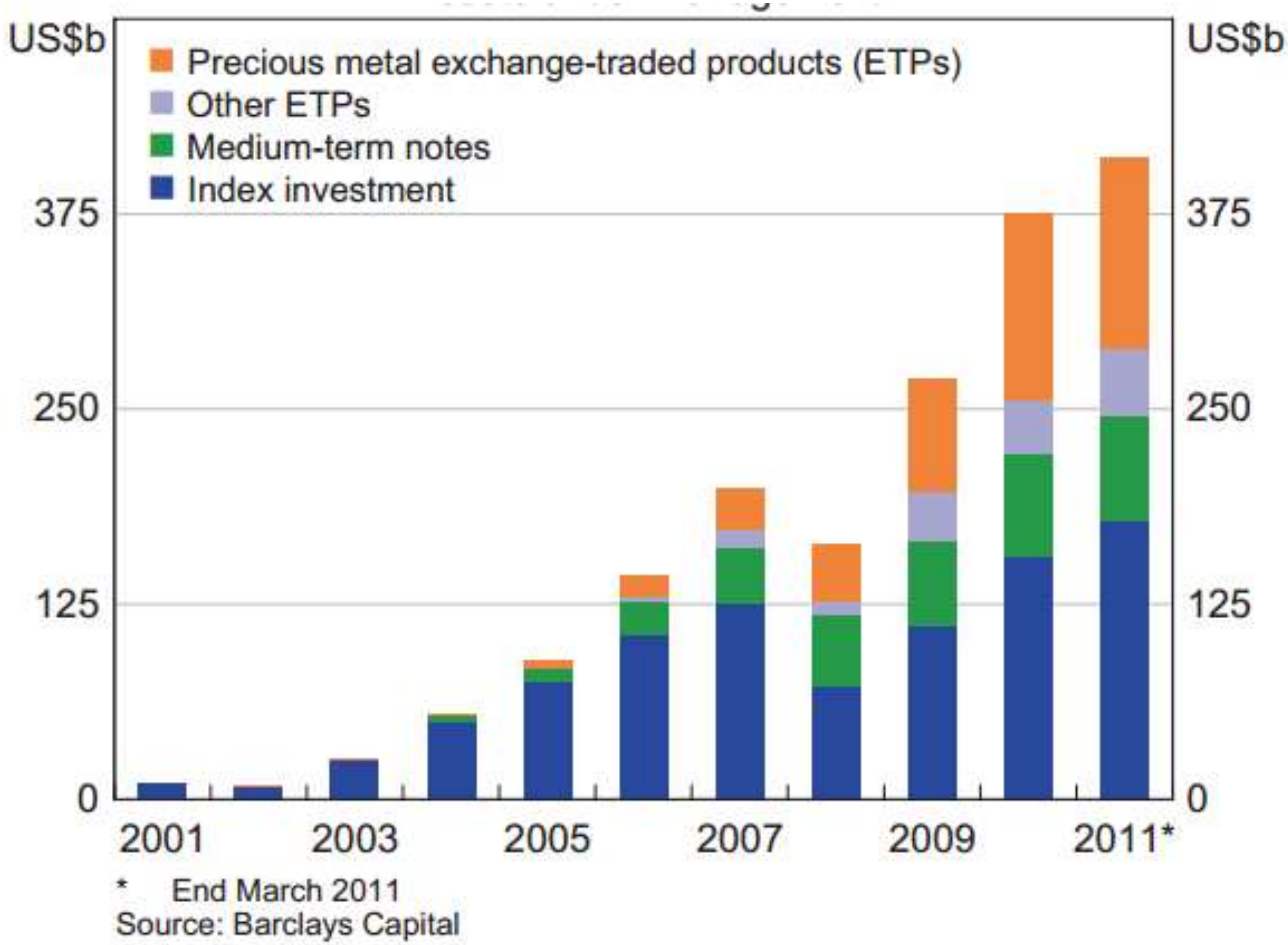
Commodities as a New Asset Class

- Prior to early 2000s, commodities were segmented from the broader financial markets and from each other.
- Motivation of portfolio diversification in a low interest rate period and collapse of the equities market in early 2000s made financial institutions invest into commodities.
- Commodity producers (mainly from emerging economy) are lack of sound and liquid financial markets. With commodity prices went up in recent years, commodity producers turned to the U.S. financial markets.
- Major financial institutions invested in commodity market through commodity futures indexes, commodity-linked notes and exchange traded products.

Commodities as a New Asset Class



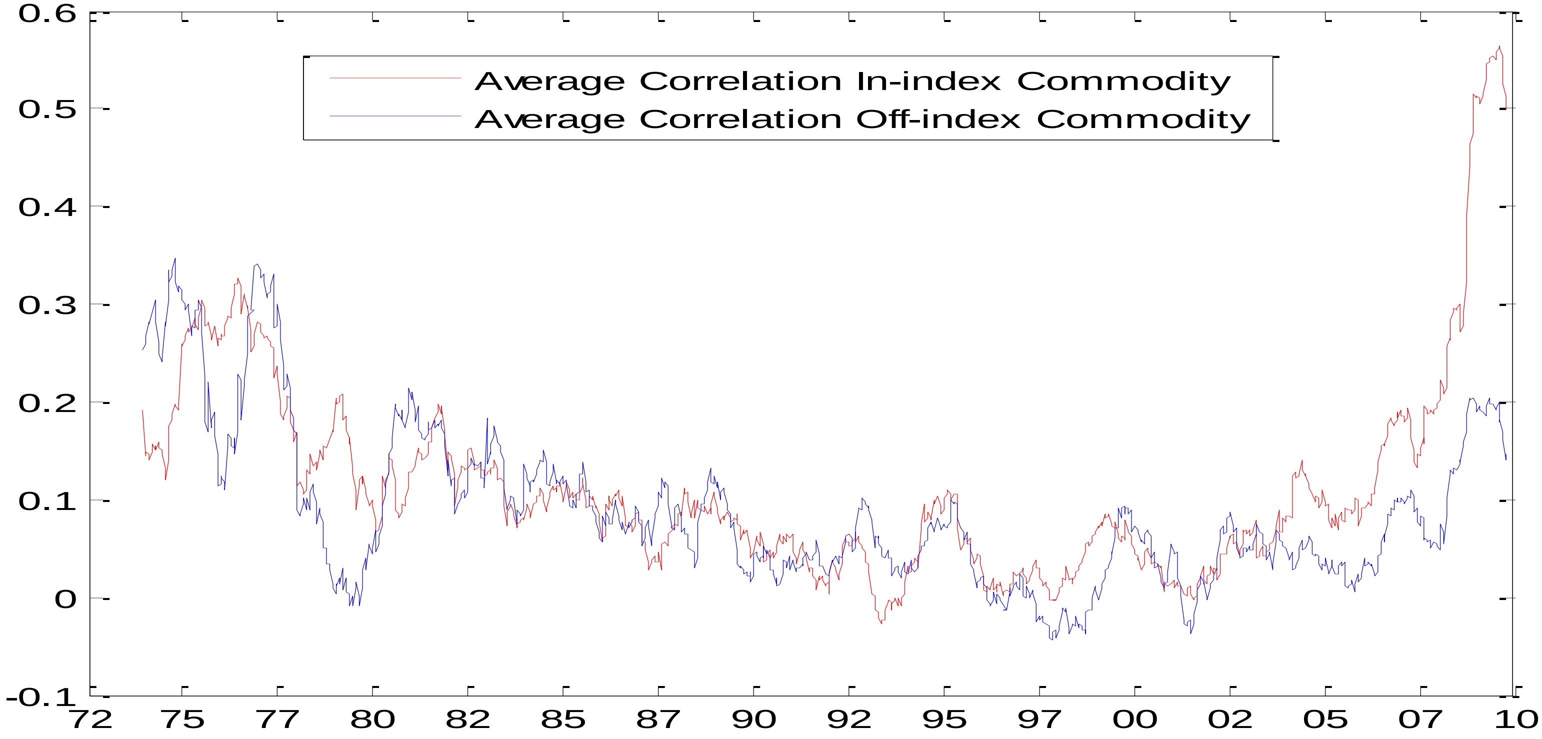
Commodities as a New Asset Class



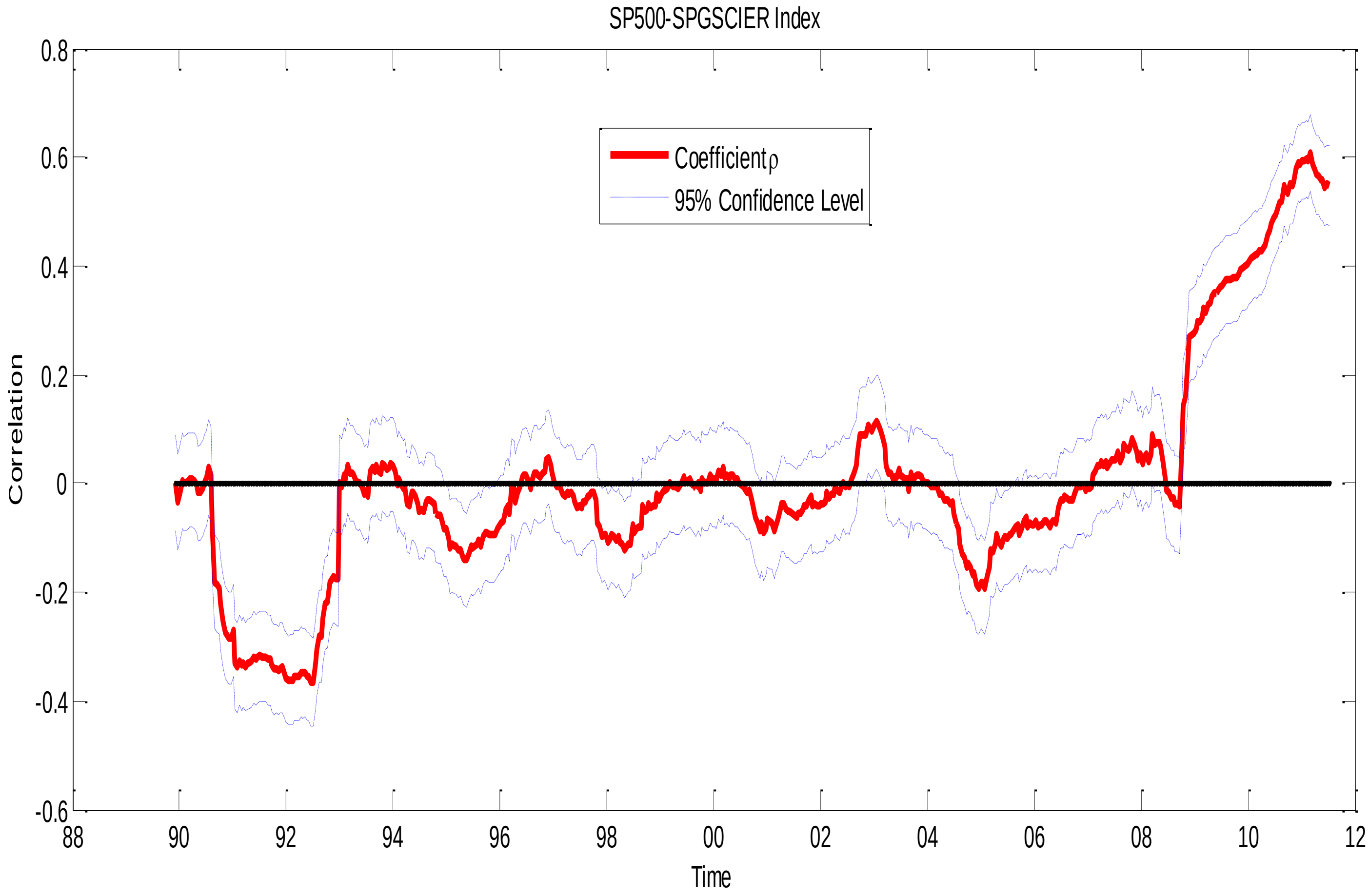
Consequence of Financialization

- Through investment from financial institutions and individuals, commodities are gradually financialized in the recent decade.
- Financialization of commodities should improve the sharing of commodity price risk.
- Correlation (co-movement) between different commodities increases.
- Correlation (co-movement) between commodities and stocks increases.
- Shocks from oil and other financial markets spillover to non-energy commodities through the financialization process.

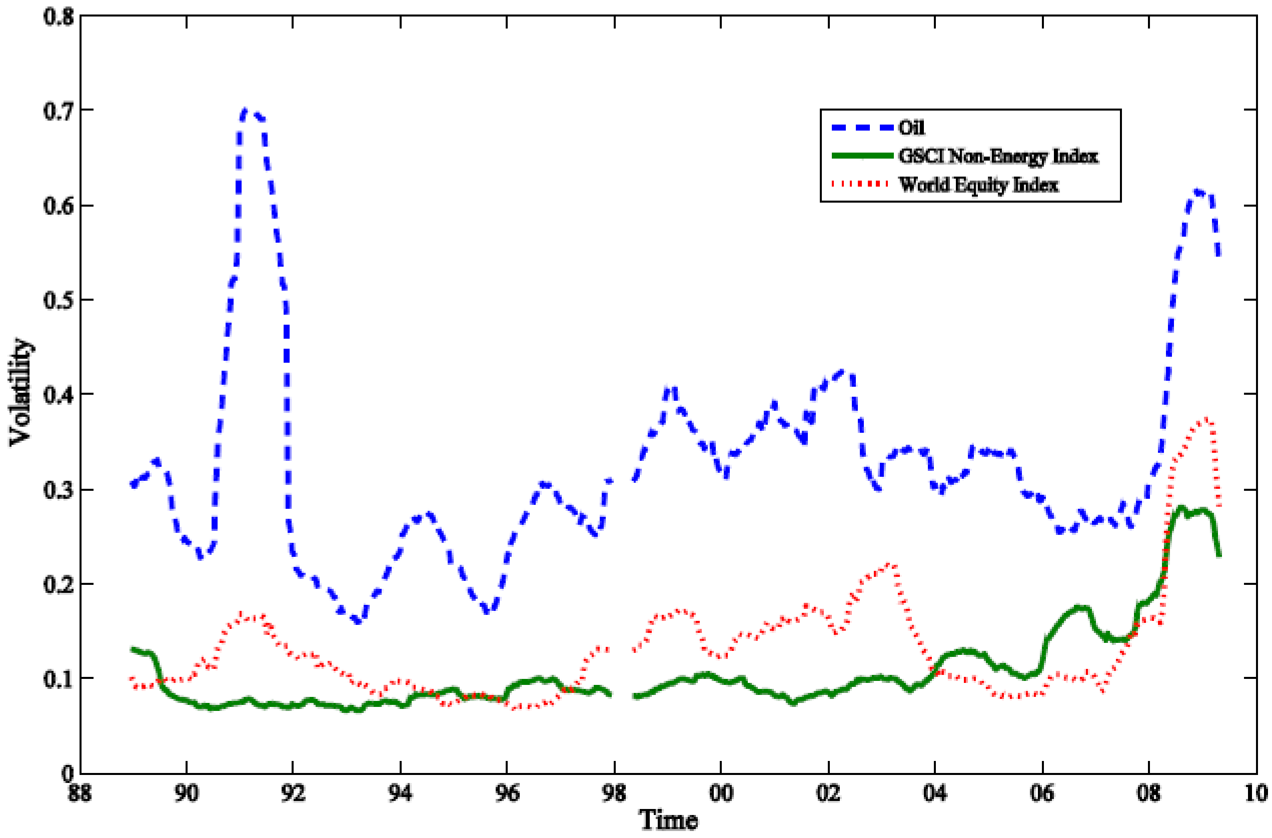
Average Commodity Return Correlation



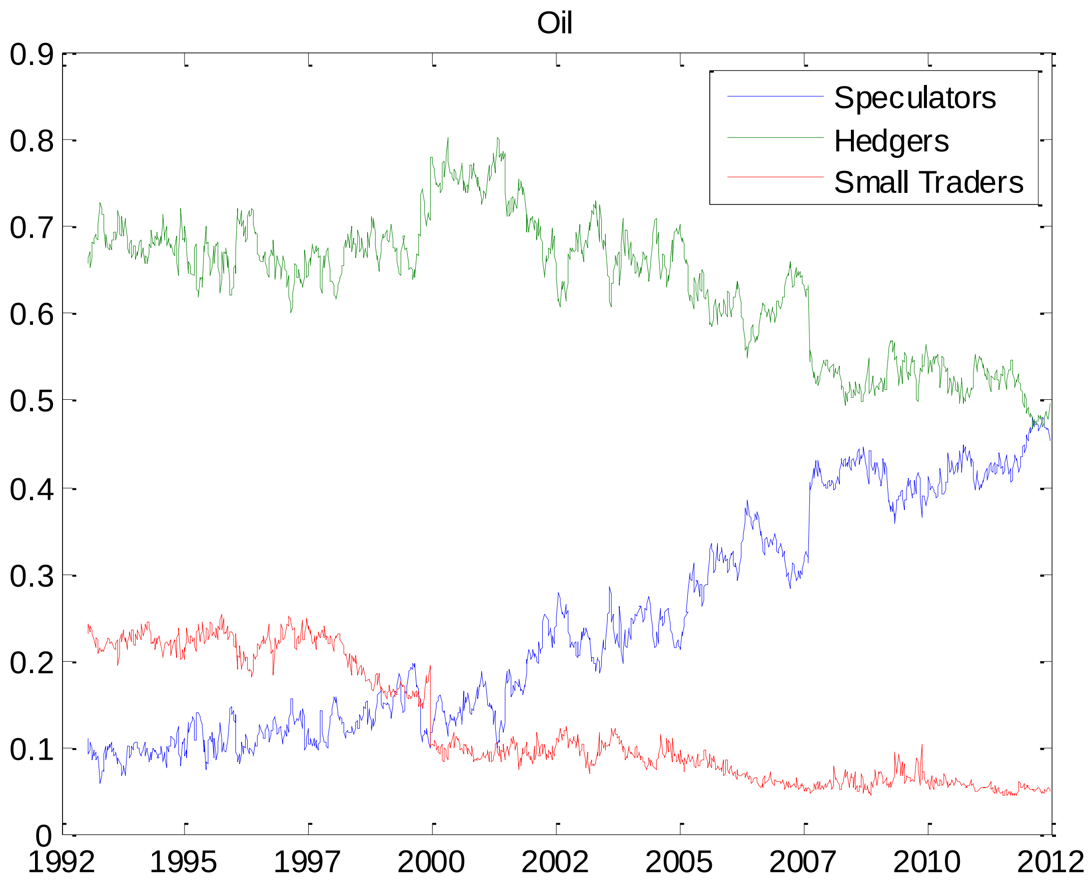
Commodity- Stocks Correlation



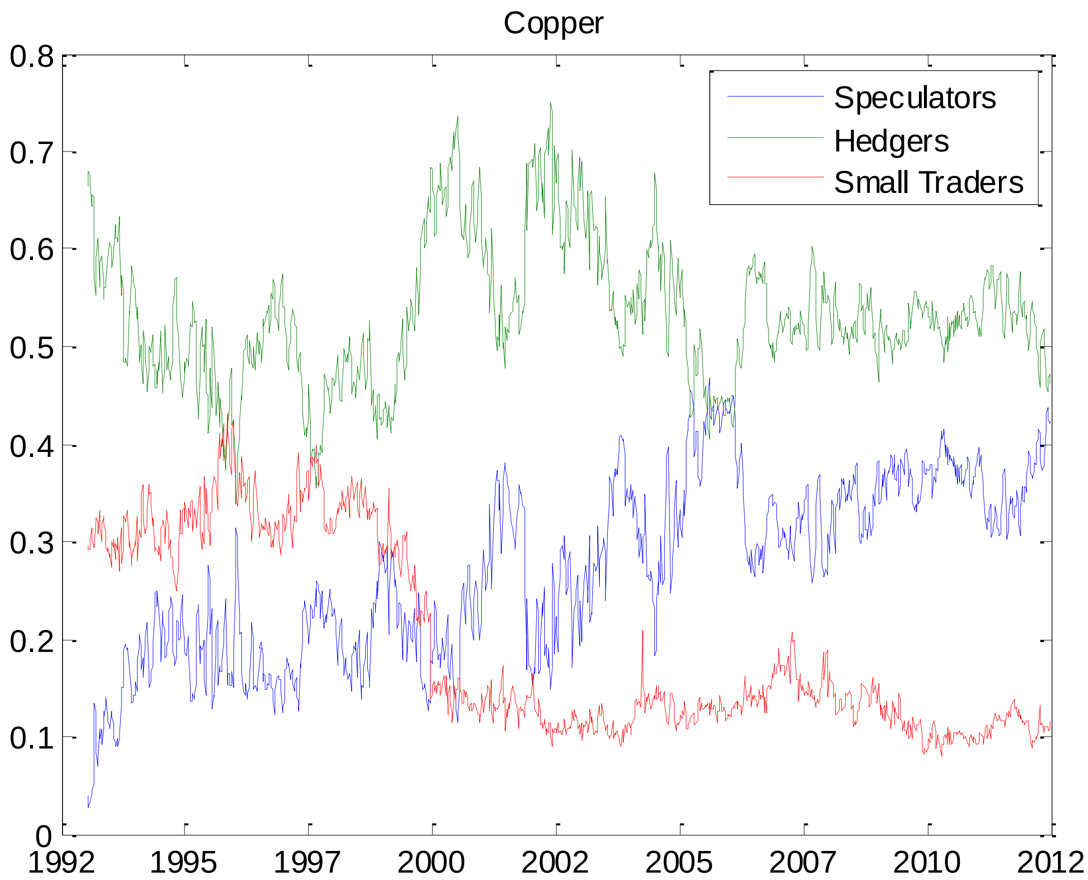
Volatility of Oil and Non-Energy Commodity Index



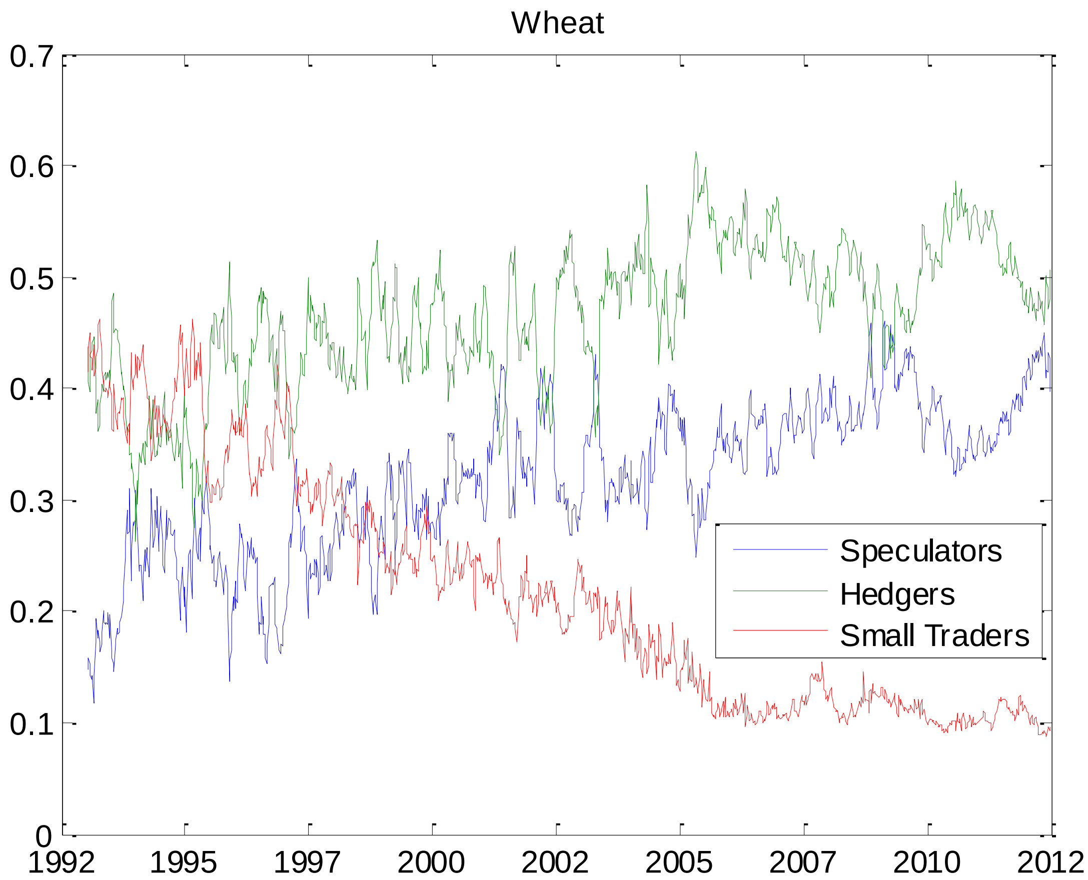
Speculators Activity-1



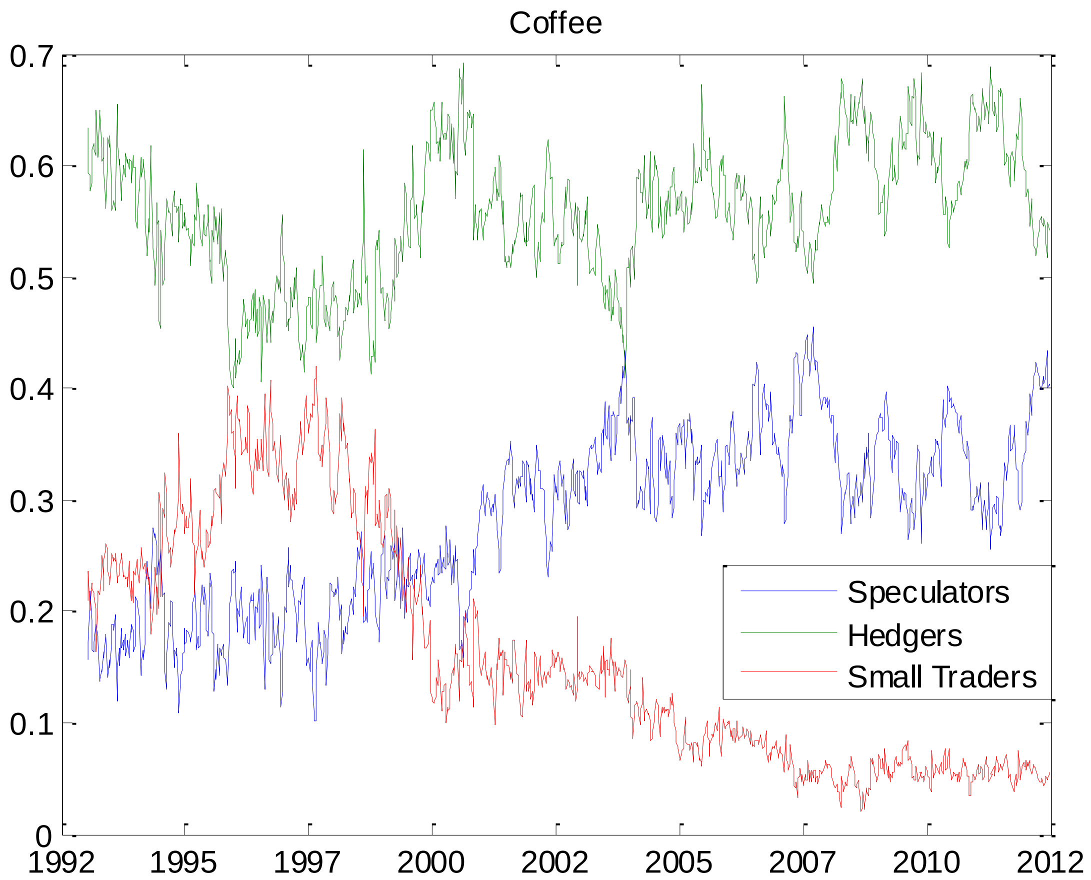
Speculators Activity-2



Speculators Activity-3



Speculators Activity-4



Behavior of Speculators and Hedgers

- Hedgers: producers, are contrarian traders.

- Speculators: institutional investors, are momentum (positive feedback) traders.

Speculation and Liquidity

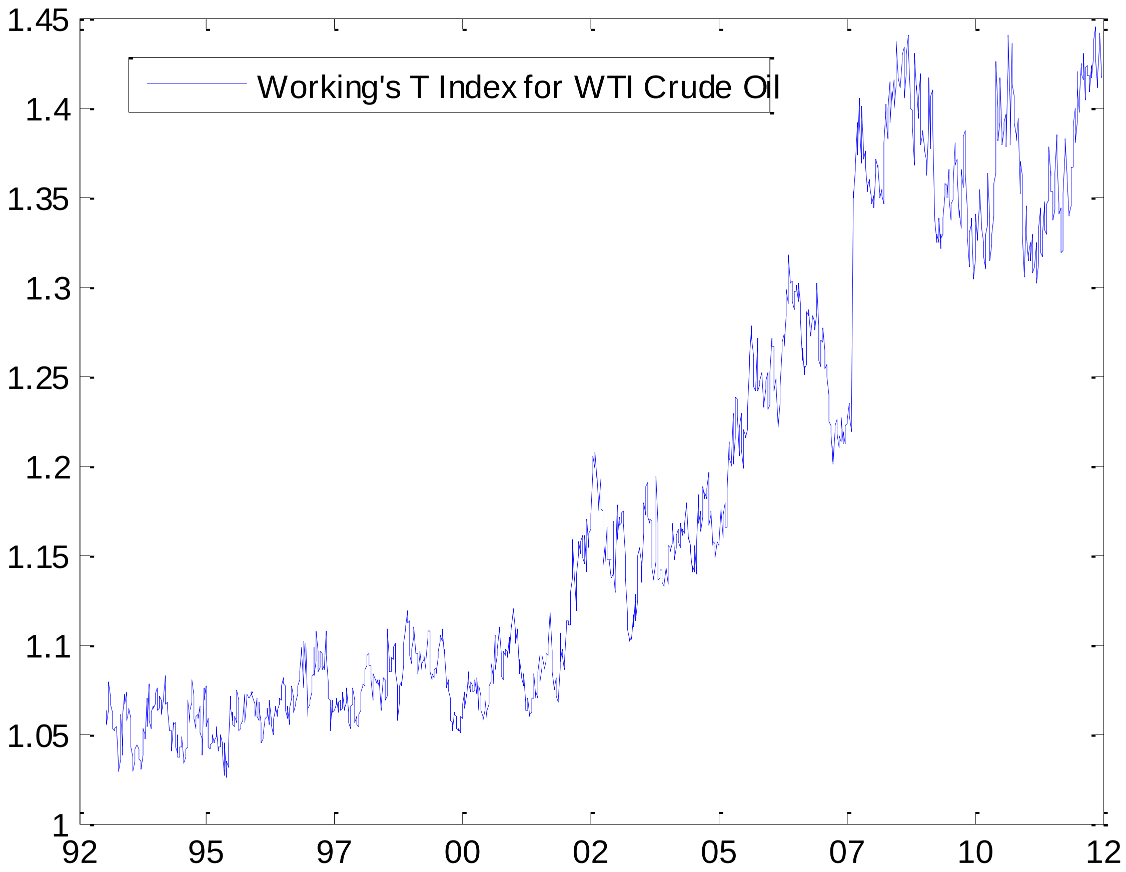
- The theory of normal backwardation:
  - Hedgers sell commodity futures to hedge their physical position, thus consume liquidity.
  - Speculators provide liquidity to the market by offsetting hedger's position, thus speculators make market liquid.

- Researchers on liquidity:
  - Contrarian traders (hedgers) provide liquidity to the market.
  - Momentum traders and institutional investors (speculators) consume liquidity.

Speculation and Liquidity

- By doing empirical test, my recent study shows:
  - Speculators consume liquidity. They might drive commodity prices off its fundamental and form bubbles. Speculators destabilize prices.
  - Hedgers provide liquidity, stabilize prices.
  - Speculators impact prices and pay liquidity premium to hedgers.
- In other markets (for example the FX market), researchers show that speculation is stabilizing at low levels and destabilizing at high levels.

- Working's T index measure whether speculation was excessive in commodity market.



Conclusion

- Speculators and index traders are mainly financial institutional investors, their risk attitude, capital constraints, leverage etc. will influence their participation in the market, and hence the market prices.
- Speculators offset trades of hedgers, but too many (large) speculators dry up the market liquidity and destabilize the prices.
- Position limit and higher margin requirement are appropriate ways to curb too much speculation.