

The Commodity Price Roller Coaster

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For most of the past year, as global prices in oil and other commodity markets zoomed to stratospheric levels, we were told that it had nothing to do with speculation. Eminent economists joined bankers, financial market consultants and even policy makers, in emphasising that these price rises were all about “fundamentals” that reflected real changes in demand and supply, rather than the market-influencing actions of a bunch of large players with enough financial clout and a desire to profit from changing prices.

In the case of oil, the arguments ranged from “peak oil”, which pointed to the eventual (and imminent) problem of world oil consumption exceeding supply and known reserves, at one extreme, to the perfidious actions of the OPEC cartel in restricting supply so as to push up prices, at the other extreme. In between were other arguments such as the easing of monetary policy in the largest economy, the United States; the weakening US dollar, which caused oil prices to rise since oil trade is largely denominated in dollars; and rapid economic growth worldwide, but especially in China and India, which have apparently become “gas guzzlers”.

These arguments did seem slightly strange, especially as global oil prices more than doubled when total world oil demand had scarcely changed in the past two years, and if anything fell to some extent, and global oil supply increased slightly. Even so, the combination of voices providing so many reasons for oil prices to increase did cause many of us to suspend disbelief and accept that there were real economic changes that justified the continued rise. In turn, governments, especially in developing countries, saw fit to pass on the oil increases to consumers because the dramatic oil price rise was seen to be permanent. This has played a significant role in creating the inflationary pressures that are now plaguing these same governments.

Similarly, the dramatic rise in food and other primary commodity prices was also traced to real economic causes and processes, such that talk of the global food crisis became commonplace. In the case of food grain and similar commodities, there is certainly a large element of truth in this argument, as rising costs of cultivation (partly affected by high oil prices), inadequate policy support for agriculture resulting in falling yields, acreage diversion

to produce bio-fuels and reduced government grain stockpiles, all meant that there were imbalances that could explain some of the price rise. But even for food grains, the very rapid rise in prices over just a few months was hard to explain without bringing in some role of speculation.

And as all these commodity prices just kept rising, we were also told that this meant good times for the direct producers, not only oil exporting countries but small farmers producing food grains that were now highly valued internationally.

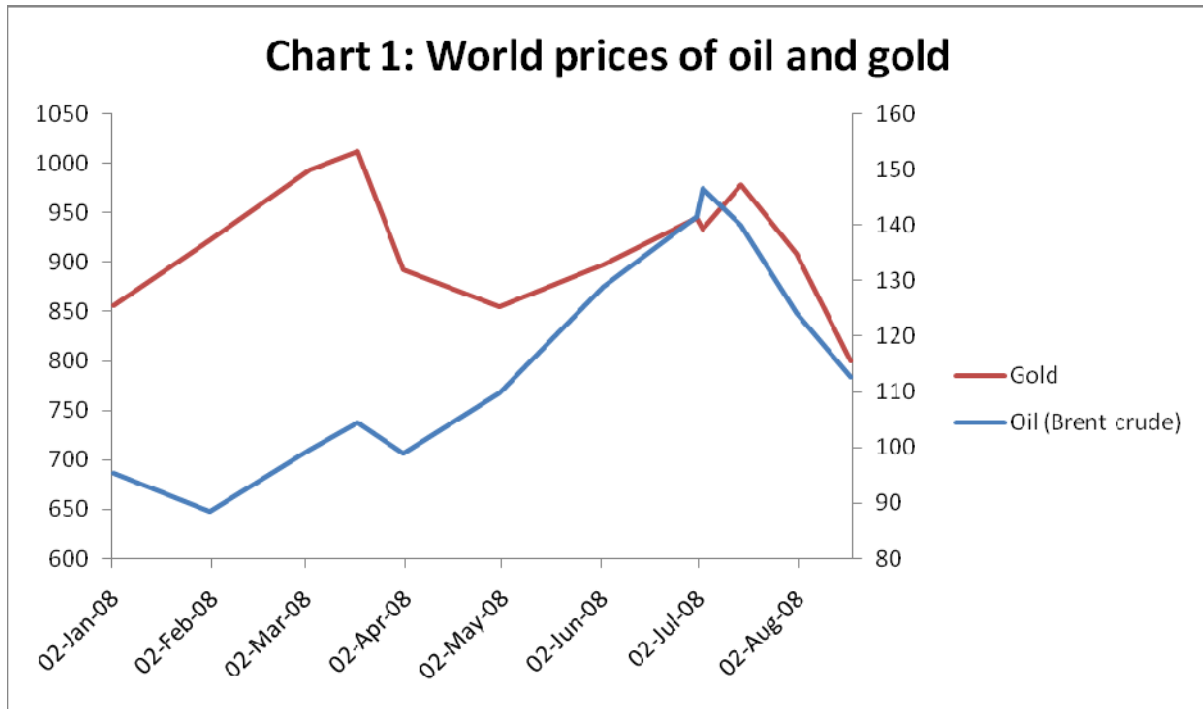
It is true that, despite this apparent consensus, as the prices continued to explode, there were growing murmurs of dissent coming from various quarters, including even the US Congress which actually had a set of hearings devoted to examining the role of speculation in commodity prices. Once again the arguments against such a possibility were many and diverse. It was pointed out that there is no “hard evidence” that speculators are responsible for high prices. In the case of oil, it was argued that there was no evidence of “hoarding” oil supplies, or growing inventories of crude, which would be expected if oil prices were actually above the real market clearing level.

In any case, the most common argument in favour of allowing continued speculation was simply that the economics of speculation require such activities to be stabilising, rather than destabilising, if they are to be profitable. The vital function of speculators is to predict future market patterns and thereby reduce the intensity and volatility of change. Because speculators are supposed to buy when prices are low and sell when prices are high, they thereby serve to make prices *less* volatile rather than more so. Futures markets in commodities play a similar role: they allow both producers and consumers (say farmers and food purchasers in the case of food grain) to hedge against future price changes and therefore allow them to get on with their real work instead of worrying about possible price changes.

According to this perception, therefore, the presence of speculation has a positive effect on the markets, cannot be blamed for rising prices, and certainly should not be curbed in any way. Taken to its logical conclusion, this argument also suggests that the price rises we witnessed especially at the start of the current year are inevitable, reflect economic fundamentals and must be adjusted to by governments and societies.

But this apparently plausible argument dissolves completely in the face of the more recent trends in prices. Indeed, what has been most marked about this year is not the

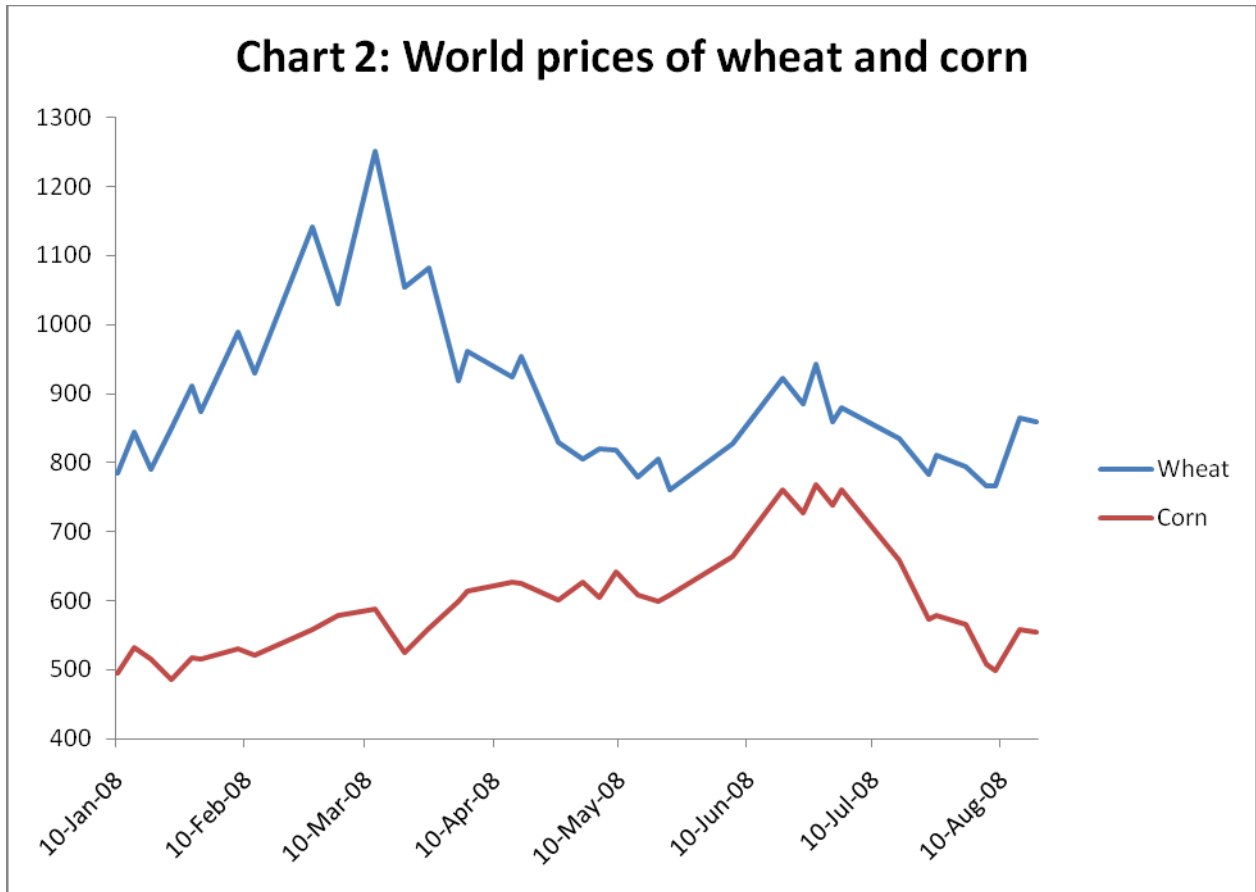
continuous rise of major commodity prices, but their sheer volatility. Chart 1 indicates global price movements in oil (Light Brent Crude, in terms of US dollars per barrel) and in the commodity that as traditionally been seen as the “safe haven” – gold (in terms of US dollars per ounce).



So far in 2008, oil prices increased by 66 per cent in the period between 2 February and 2 July, and then fell by more than 20 per cent from that peak over just six weeks until 18 August. On that date, oil prices were only 18 per cent higher than they were at the start of the year. Such volatility cannot be explained by any “fundamentals”.

Gold prices have largely tracked oil prices in the past few months, suggesting that gold has not been treated as an alternative investment but has been subject to similar kinds of market movements as oil.

This conclusion emerges even more sharply for food grains. Chart 2 shows global prices of two of the major food grains traded globally, wheat and corn, which are also commodities that have been increasingly subject to trade in the commodity futures exchanges. Other agricultural commodities, such as soyabean and rice, show similar recent trends in prices.



For these agricultural commodities, the price volatility has evidently been even more extreme. Wheat prices increased by 46 per cent in the short period between 10 January and 26 February, fell by as much by 19 May, increased again but to a lesser extent (by only 21 per cent) until a minor peak in early June, and then have been falling again over August, albeit with fluctuations. Corn prices followed a similar pattern, but with a sharper fall of more than 30 per cent between mid-July and early August.

Such wild swings in prices cannot be explained by seasonal supply and demand factors or any other “real economy” tendencies. Instead, they are clearly the result of speculative activity in these markets. So the argument that speculation has not affected prices of these commodities simply cannot be sustained.

But then what explains all this speculation? And what form does it take? Why is it not stabilising, as predicted by so many economic theories? The answer must relate such market involvement with broader tendencies in both patterns of government regulation in financial markets and other changes in finance, such as the continuing credit crisis in the US.

As the global financial system became fragile with the continuing implosion of the US housing finance market, large investors, especially institutional investors such as hedge funds and pension funds and even banks, searched for other avenues of investment to make up their losses and find new sources of profit. Commodity speculation increasingly emerged as an important area for such financial investment.

The United States became a major arena for such speculation, not only because of the size of its own crisis-ridden credit system, but because of deregulation at the turn of this century that made it possible for more players to enter into commodity trading. While commodity futures contracts existed before, they were traded only on regulated exchanges under the control of the Commodity Futures Trading Commission (CFTC), which required traders to disclose their holdings of each commodity and stick to specified position limits, so as to prevent market manipulation. In 2000, the Commodity Futures Modernization Act effectively deregulated commodity trading in the United States, by exempting over-the-counter (OTC) commodity trading (outside of regulated exchanges) from CFTC oversight. Soon after this, several unregulated commodity exchanges opened. These allowed any and all investors, including hedge funds, pension funds and investment banks, to trade commodity futures contracts without any position limits, disclosure requirements, or regulatory oversight.

The value of such unregulated trading, at around \$9 trillion at the end of last year, is estimated to be more than twice the value of the commodity contracts on the regulated exchanges. Unlike producers and consumers who would use such markets for hedging purposes, financial firms and other speculators enter the market in order to profit from short-term changes in price, and are therefore interested in volatility.

Commodity funds, that purchase and sell commodity futures contracts, have become increasingly popular investment vehicles. Typically, these are “index investors”, who focus on returns from changes in the index of a commodity, by periodically rolling over commodity futures contracts prior to their maturity date and reinvesting the proceeds in new contracts. A well-known hedge fund manager, Michael Masters, testified to the US Congress that even on the regulated exchanges in the United States, such index investors owned approximately 35 per cent of all corn futures contracts, 42 per cent of all soybean contracts, and 64 per cent of all wheat contracts in April 2008. This excludes all the ownership through OTC contracts, which are bound to be even larger.

A similar process is under way in the oil market. Recently the US Commodity Futures Trading Commission revised the estimated proportion of oil futures and options held by speculators from 38 per cent to 48 per cent. So the dominant players in these major commodity markets are those who benefit from volatility and sharp swings, rather than those interested in simple hedging against the future.

This makes it much easier to understand why primary commodity prices have been so volatile over the past six months. Such volatility is terrible for those actually engaged in producing and consuming these goods, and transfers income to financial and speculative players. Clearly, things cannot improve until more regulation is brought into financial markets.