Globalization Commentaries

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Spotlight G20: New Evidence of Speculation in financialized commodities markets

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The G20 agriculture ministers dodged most of the tough issues in their meeting last month in Paris, leaving the heavy lifting on France's ambitious G20 agenda to finance ministers later this year. Among the dodged issues were agricultural price volatility and the so-called "financialization" of commodity markets. Despite a relatively ambitious set of reforms proposed by an interagency group, the agriculture ministers "action plan" took very few actions beyond pushing for better information on grain inventories, as Jennifer Clapp and Sarah Martin explained on this blog. Action was missing, too, on a more serious consideration of grain reserves to curb price volatility (see Sophia Murphy's recent post).

For their part, volatility and speculation celebrated the continued inaction by further roiling commodity markets, driving global food prices to new highs. And the debate rages on over the extent to which financialization and speculation are to blame for the spike in commodity prices. As I noted in earlier posts and subsequent comments (here and here), the disagreement is less over whether financial speculation causes volatility on commodities futures markets than it is over whether volatile futures markets drive up real commodity prices.

Fortunately, new research from UNCTAD is drawing light from the heat of the debate. The June report "Price Formation in Financialized Commodity Markets," reviews the evidence and concludes that while market fundamentals determine medium and long-run commodity prices, financial speculation can lead to significant short-term price distortions in real commodity prices.

Information, of course, is the key to effective price discovery, all the more so in today's uncertain markets. As UNCTAD explains, there is strong evidence for the rise of herd behavior among traders, who have an incentive to follow market movements rather than market fundamentals. Commodity exchanges intended to convert many independent actions in the market into dependable price discovery no longer play that role. As UNCTAD notes:

"The financialization of commodity trading has increasingly jeopardized this function of commodity exchanges. Financial investors in commodity markets base their position-taking on risk and return considerations for which information about other asset markets and the overall economy play a key role, as do financial motives more generally. Such trading behaviour, while relying on similar types of information, also anticipates the price impact of that information in similar ways. Taken together, the financialization of commodity trading poses the risk of herd behaviour and of self-fulfilling prophecy due to the pecuniary power of these market participants."

Because market fundamentals tightened during the same period that financial speculation and index funds grew so dramatically, it is difficult to discern the impact of financialization. UNCTAD cites new research that does just that, refuting the contention that financial speculation played no role in the 2007-8 price spikes. Other cited research shows that index investors contributed to price increases for crude oil, wheat and maize well beyond the levels we would have seen without the futures speculation by index funds.

Interestingly, UNCTAD offers its own new research documenting the growing and determining role of money managers, who now hold roughly the same volume of open long positions as the index funds. UNCTAD's research suggests that they are now driving the speculative price cycle, leaving commercial hedgers overwhelmingly holding short positions as they ride the financialized futures roller coaster.

UNCTAD's new report complements other new work by Chowdury on the link between speculation and food prices, and a recent article by Jayati Ghosh on speculation in petroleum markets. Meanwhile, Robert Pollin and James Heintz show in a recent study that as much as 20% of the current price of U.S. gasoline at the pump is due to speculation in oil markets.

The G20 should pay attention to the new research when it takes up the crucial questions of price volatility and financial speculation in agricultural markets. And they should adopt some of UNCTAD's recommendations, which include not only grain reserves and stronger regulation to ensure transparency (in line with Dodd-Frank), but also a financial transactions tax to curb excessive financial speculation.