



G24 Technical Group Meeting

Pretoria, 18 March 2011

Trends and volatility in commodity prices, and food security

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Main points

- Recent commodity price developments have been driven by both fundamentals and financial investment
- Financial investment in commodity markets has undergone two substantial changes in past decade
 - 2002–2008: sizeable increase in level, particularly in form of broad-based passive index investment
 - Since 2008: increasing importance of more sophisticated and narrowly targeted active investment
- Price volatility may cause incorrect decisions and makes hedging more expensive and risky
- Main policy recommendations:
 - Greater transparency across physical, futures and OTC markets
 - Tighter regulation (clearing for standardized OTC-contracts, speculative position limits, provisions regarding HFT)
 - Increased investment for sustained physical supply growth





Overview

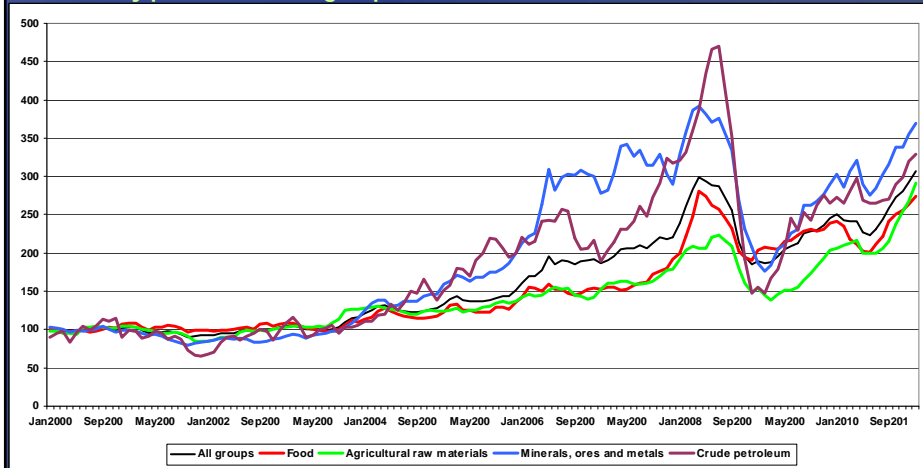
- Price trends and volatility: recent evidence and underlying factors
- Financial investment in commodities – an impact on prices?
- Why do rising prices, volatility, and financial investment matter?
- Policy measures addressing rising prices, rising price volatility, and financialization
- Conclusions

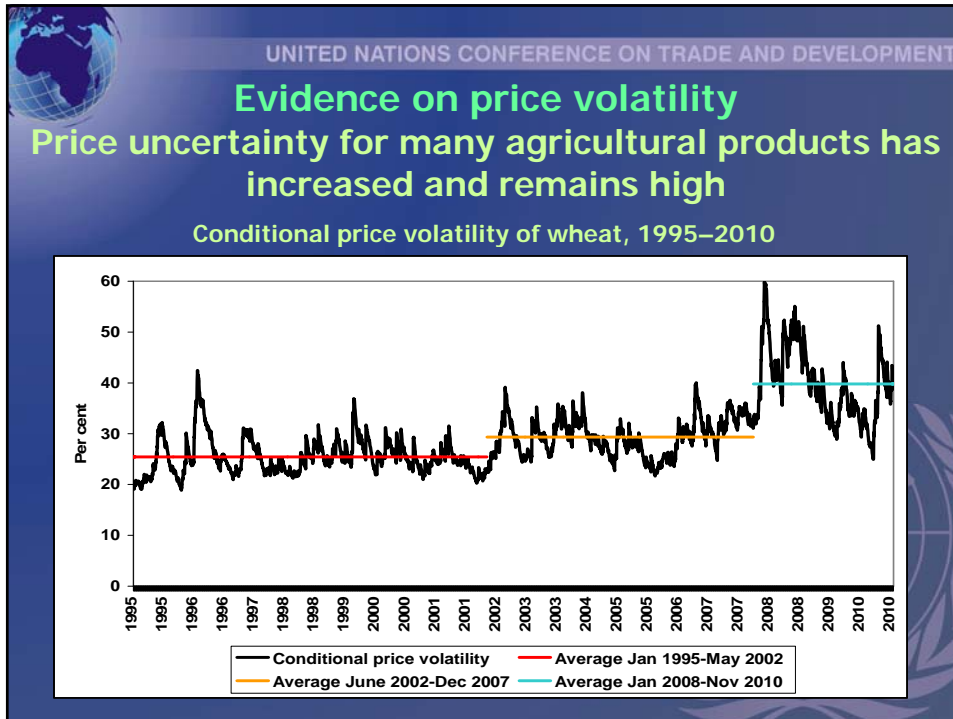


1. Evidence on price trends

Commodity prices have surged over past few months reaching (or exceeding) 2008-levels

Commodity prices, selected groups, Jan 2005–Jan 2011, index numbers. 2000=100





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- ## Factors behind recent price developments
- Is there a new commodity super cycle?
 - Depreciation of US-dollar
 - For food, low stock-to-use levels, link between energy and food prices (agricultural inputs, biofuels, financial index-based investment), as well as climatic factors and, for 2007–08 price spike, *ad hoc* policy measures
 - Role of financial investors



2. Financial investment in commodities

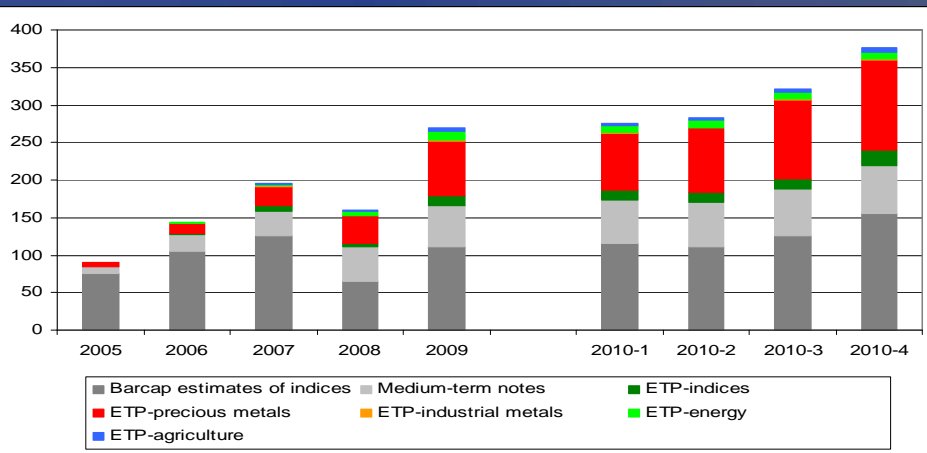
- Financialization refers to the increasing role of financial motives, markets and actors in the operation of commodity markets
- Financial investors look at commodities as an asset class (just like equities, bonds or currencies) and enter commodity markets to diversify their portfolios
- Deregulation and financial innovation have been facilitating factors

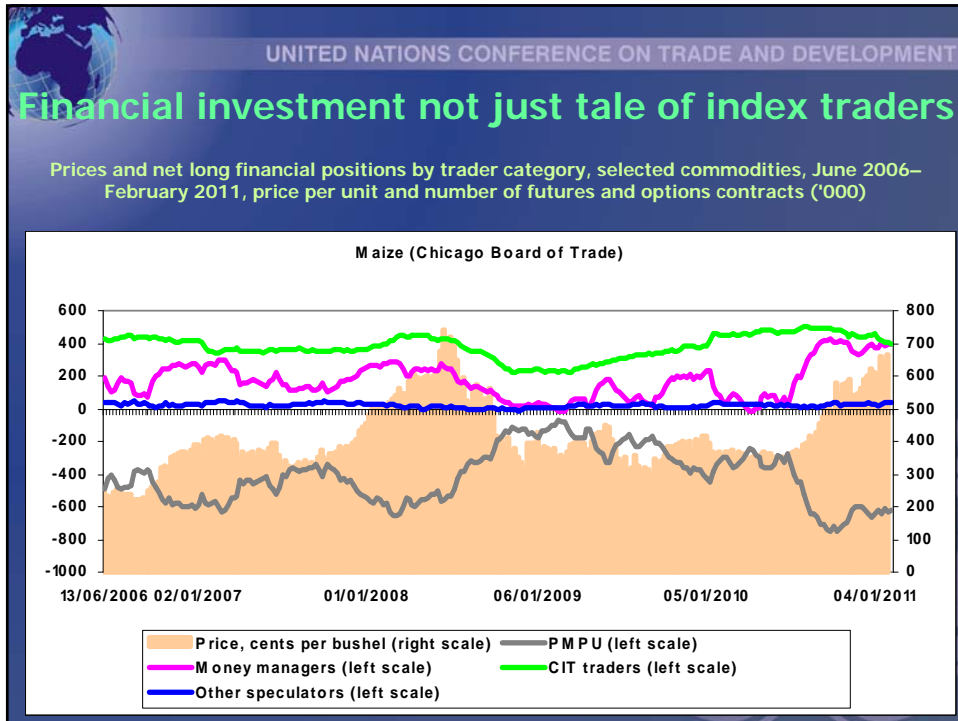


Recent evidence on financial investment

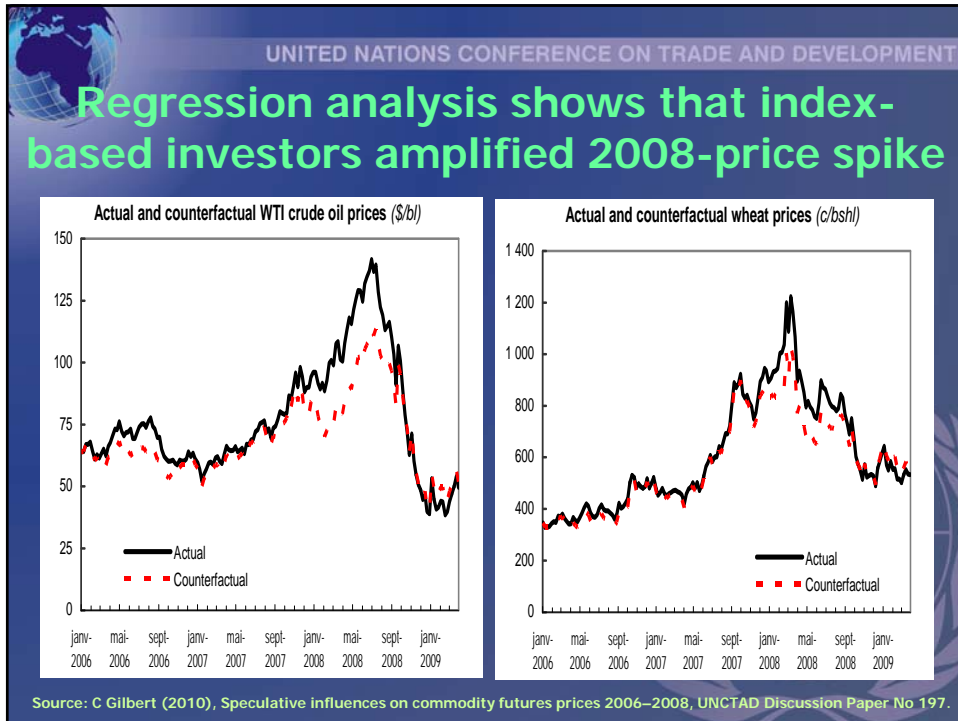
Financial investment in commodities is at historic high – and its composition has changed significantly

Commodity investment data by product, assets under management, 2005–10 (\$bn)





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- ## Financial investment – impact on prices?
- Speculators are indispensable for functioning of exchanges (risk transfer risk, price discovery)
 - Alleged 'logical inconsistencies' (Irwin/Sanders):
 - Financial traders neither hold futures contracts up to expiration and participate in the delivery process where, allegedly, price discovery takes place nor hold physical inventory
 - Krugman: where are the inventories?
 - Informed traders would do arbitrage
 - In 2007-8, commodities not included in broad-based indexes experienced similar price increases



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3. Why do rising prices, volatility, and financial investment matter?

- Key to vulnerability is net effect at both macroeconomic and microeconomic (smallholder farmers may be adversely affected by food price increases) levels
- Uncertainty (price trends disconnected from fundamentals; high volatility) adversely affects investment and may cause incorrect decisions
- Price volatility makes hedging more expensive and risky



4. Policy measures addressing rising prices and price volatility ...

- 'High prices are best cure for high prices' - incentives
- Long-term: increase in productivity, sustainability and resilience of agriculture (ODA, technology transfer, links with climate change)
- More flexible biofuel mandates (allow reduced mandated levels when rising food prices warrant)
- Review trade policies related to food security
- Food import financing facility



... and financialization

- Improve transparency on physical, futures and OTC-markets and harmonize regulation
- Debate on clearing of standardized OTC-contracts, speculative position limits, provisions for high-frequency trading, and limit misuse of information (Volcker rule)
- What can developing countries do?
 - Weather-based derivatives
 - Hedging with futures and options contracts
 - Creating their own commodity exchanges





5. Conclusions

- Commodities have acquired dual nature as physical commodities and financial assets
- Debate on price impact of financial investment remains – data problems, myriad of other influences
- Consensus that (food) stocks need to be rebuilt, supply expanded, and transparency improved for physical and paper trading
- Much of planned regulatory reform in US and EU concerns wider context of financial sector stability



Thank you !

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