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FINANCIALISATION OF COMMODITY MARKETS: BOON OR BANE?

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An influx of investment money into commodity futures can distort the broader economic picture, but it can also help commodity producers hedge price risks

From 2000 to 2005, corn futures on the Chicago Board of Trade (CBOT) fluctuated between US\$2 to US\$3 per bushel (for each lot of 5000 bushels), and only occasionally dipping below or rising above that range. At the end of 2006, it climbed towards US\$4, and was on its way to setting what was then an all-time high for nearby contracts i.e. contracts with the closest settlement date, at US\$7.625 on June 27, 2008 for the July 2008 contract.

Barely more than a year later in August 2009, corn futures were trading at barely over US\$3. This boom-and-bust cycle happened to almost every other commodity, which led to hedge fund manager Michael Masters's testimony before the Commodities Futures Trading Commission that institutional investment capital flowing into the commodity futures market had caused a bubble to form.

"Whether there was a bubble is a tricky question," says **Wei Xiong**, Professor of Economics at Princeton University. "To argue that there is a bubble, you need to prove that prices are too high relative to fundamentals. However, the fundamental value of a commodity is very hard to define due to the difficulty of measuring supply and demand. In the end, this debate ended up going nowhere."

He added, "Financial capital affects markets in more subtle and nuanced ways. When we think of financial market trading, there are many important basic issues. One of them is information discovery."

The long and short of it

Xiong, who was the speaker at the recent Wilmar International Professorship in Commodities Business public lecture, "*The Financialization of Commodity Markets*", describes how commodity prices are often barometers for gauging the strength of the global economy. In his research, Xiong found that when commodity futures in the U.S. go up, stock prices in East Asian countries that are net importers of commodities – China, South Korea, Japan etc. – counterintuitively go up.

“Despite the price of commodities rising and these countries having to pay more for them, their stock prices go up as well; it’s curious,” Xiong muses. “In effect, these countries view the rising commodity futures prices as a signal of economic strength in the global economy. In this light, if the capital inflow affects the commodity prices, an immediate consequence is that it will affect the information system which is very important for the economy as well as the commodity market itself.

“When people think the global economy is strong, the demand for commodities will be higher despite the cost being higher. It would be simple-minded to think that as commodity prices go up, demand should go down. That’s why I argue that the financialisation can affect the commodity markets through this information channel.”

Despite this seemingly negative characteristic, Xiong also pointed out the necessity of and motivation for creating commodity futures i.e. farmers hedging to protect the value of their crops. “The large inflow of investment capital helps hedging because the investment capital typically comes to the ‘long’ side (buying the underlying asset in the future), which is the opposite of where the farmers do their hedging. In that sense, they meet each other’s needs.”

"If hedgers just want to hedge the price risks of those crops in the field, their position doesn't have to change that much (but) farmers and producers trade a lot more than the anticipated output fluctuations."

To illustrate this relationship, imagine a farmer in April who expects in July a harvest of one lot of corn i.e. 5,000 bushels. The cash price of a bushel of corn in April is US\$4.00, so the farmer hedges by selling one lot of September futures contract at US\$4.50 (the farmer is selling, so he is on the “short” side, and therefore he is “short hedging”).

When he harvests the corn in July, prices had dropped to \$3.75. He buys a futures contract for one bushel of corn for September delivery i.e. closing his futures position, at \$4.20. The 30-cent gain (US\$4.50 – US\$4.20) from short hedging more than offset the 25-cent fall in corn prices from April to July; he makes 5 cents more per bushel, which translates to US\$250 per lot.

Traders and hedgers: Sharing risk

Without investment capital taking up long positions, the farmer would have lost money. However, farmers are not just hedging against possible price falls. Xiong says farmers are also trading and even speculating.

“If you look at the trading of the hedgers, their needs are easy to measure. The output of a certain crop – wheat or soybeans, for example – has a fixed season. The output itself doesn’t fluctuate that much – once the seeds are planted in the field, the output is relatively stable.

“If hedgers just want to hedge the price risks of those crops in the field, their position doesn’t have to change that much. On the other hand, if you look at the data, you’ll realise that these farmers and producers trade a lot more than the anticipated output fluctuations.”

So does the financialisation of the commodity markets help in risk-sharing? Xiong explains how financial traders tend to be momentum traders who buy when prices rise, and sell when prices fall, while hedgers/farmers are the exact opposite. But when price momentum starts to build, things can go awry as they did when commodity prices collapsed in 2008.

“The open interest of commodity futures contracts also collapsed, shrinking by half in many markets,” recalls Xiong, referring to open positions in the futures market. “This reduction in traders’ positions is curious because a financial crisis shouldn’t affect the crops in the field. In

that sense, the hedging needs of the farmers did not change because of what happened on Wall Street, but on the other hand, their hedging positions shrank by half.”

He adds, “I think financial traders suffered largely because of their overall risk exposure to the financial markets, causing great distress to their overall portfolios. As a result, they might have been forced to reduce their positions in commodity futures, and as a result the hedgers on the short side had to accommodate the needs of financial traders to reduce their long positions.”

Overall, the financialisation of commodity markets do help in risk-sharing, but it also increases the risk of a bubble forming.