



## G24 Technical Group Meeting

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# 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

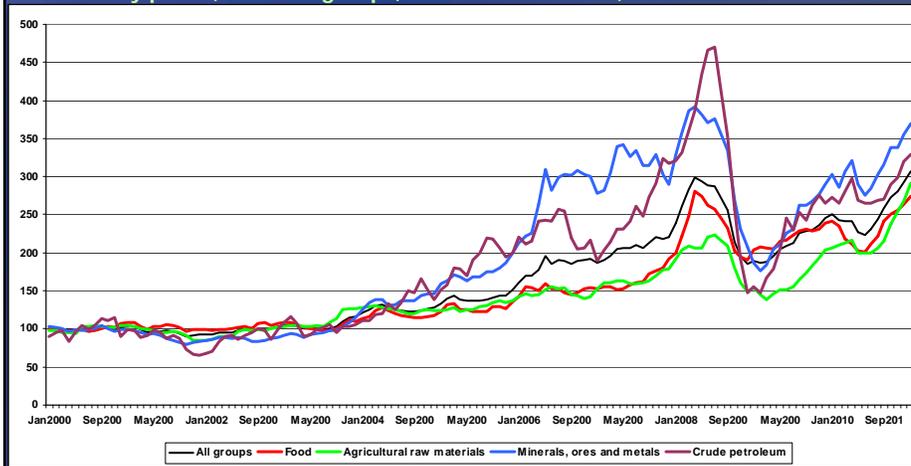
- Price trends and volatility: recent evidence and underlying factors
- Financial investment in commodities – an impact on prices?
- Why do rising prices, volatility, and financial investment matter?
- Policy measures addressing rising prices, rising price volatility, and financialization
- Conclusions



## 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 2001, index numbers. 2000=100

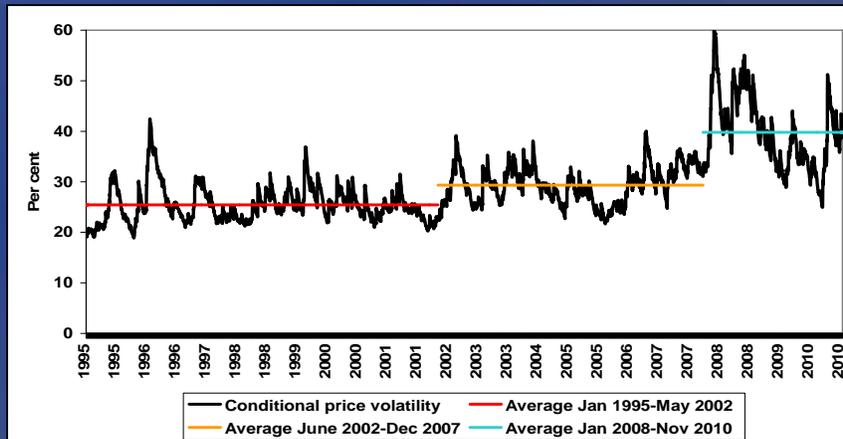




## Evidence on price volatility

### Price uncertainty for many agricultural products has increased and remains high

Conditional price volatility of wheat, 1995–2010



## 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

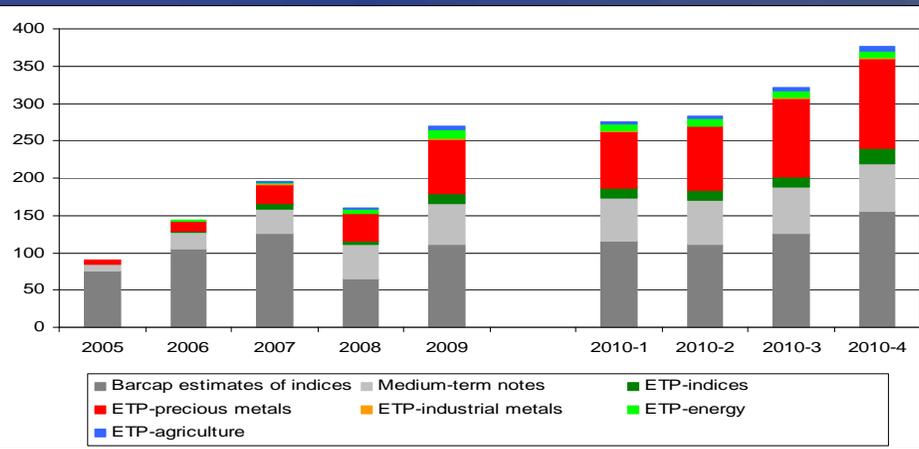
- Financialization refers to the increasing role of financial motives, markets and actors in the operation of commodity markets
- Financial investors look at commodities as an asset class (just like equities, bonds or currencies) and enter commodity markets to diversify their portfolios
- Deregulation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

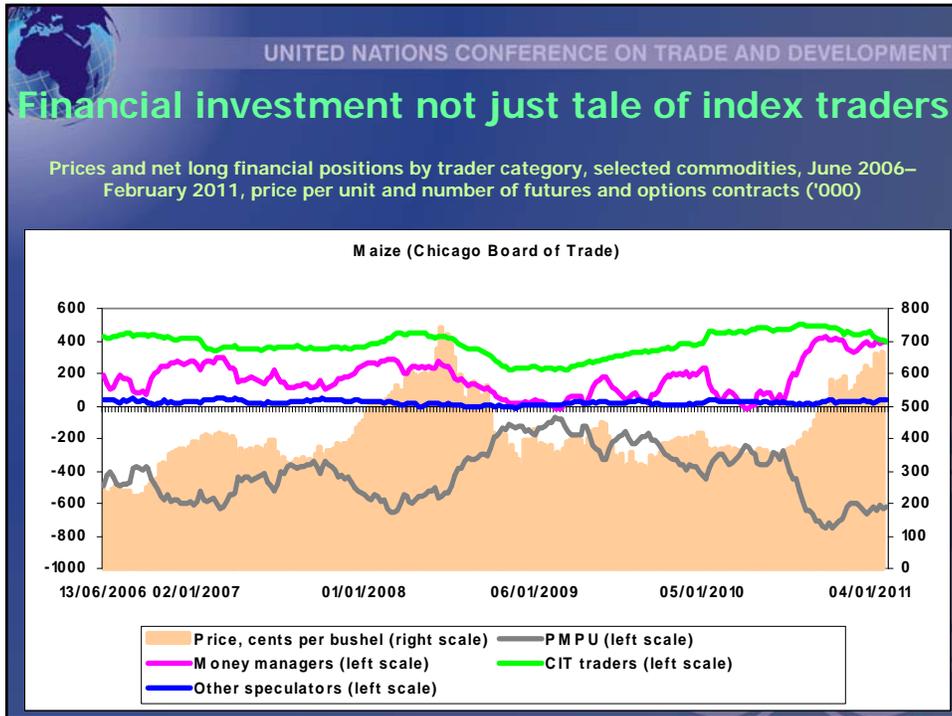


## Recent evidence on financial investment

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)

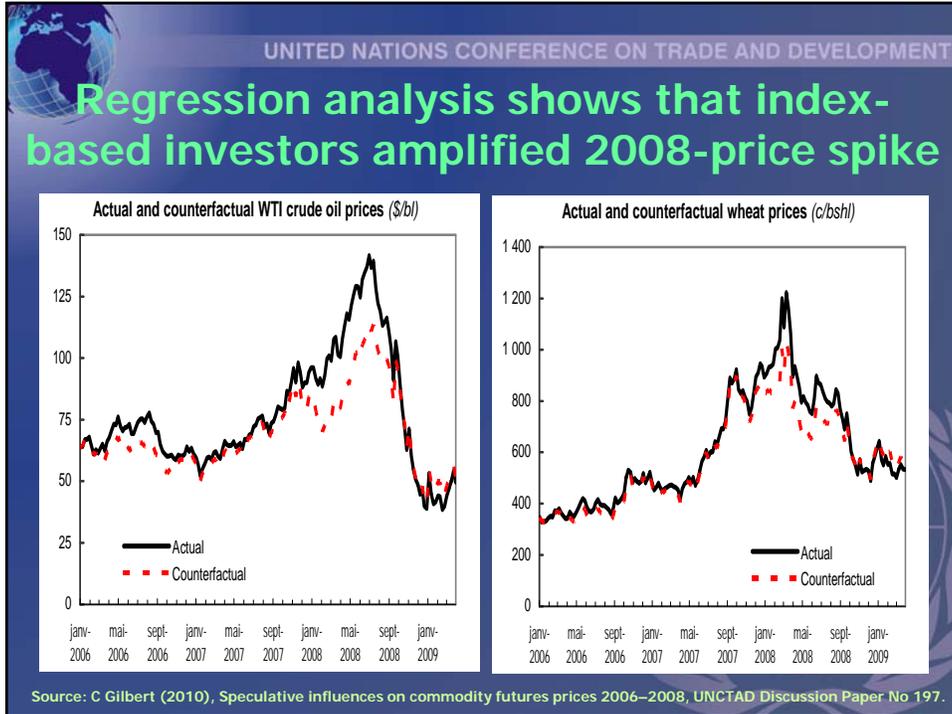




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## Financial investment – impact on prices?

- 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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