Excessive Speculation in Commodities Markets: The Basics

- **There are two kinds of market: capital markets, and non-capital markets.** Stocks and bonds fall under the first category, commodities under the second.

	Capital Markets	Non-Capital Markets
Examples	Stocks, bonds, etc.	Commodities, etc.
Key Features	Provide cash flows. Not good for consumption: you can't eat a bond.	No cash flows – ultimately only good for consumption.
Purpose	Channel savings into investment; manage financial risk.	Allocate natural resources like food and energy; manage natural risk (climate, crop yield, etc.)
Role of Speculation	Market is 100% "speculation". However, cash flows make capital assets legitimate investments.	Some speculation is needed to provide liquidity, but not too much. Any "investment" is purely speculative, because there are no cash flows on consumables.

- **All non-capital markets, including commodity markets, require some speculation to function well.** A small amount of speculation provides "liquidity". With zero speculation, producer X only has one option: trade with consumer Y. But sometimes, he cannot find such a consumer. With some speculation, he now has another possibility: trade with speculator Z.

- **When there is already enough speculation, adding more does not increase liquidity.** In fact, it can have the opposite effect, as speculators compete with end-users for scarce resources.

- **When speculation becomes excessive, it begins to dominate the price formation process (aka "price discovery).** If no limits are placed, speculative buying and selling can crowd out supply and demand in the market. For example, at the peak of the oil bubble in 2008, oil speculators held futures contracts equivalent to several years' worth of actual oil usage. The same is true for agricultural commodities: if speculators are doing all the buying, they effectively set the price of food.

- **Excessive speculation is different from manipulation.** However, excessive speculation can help facilitate manipulation. The more speculation is present in a market, the easier it becomes to manipulate that market. This contradicts the conventional academic theory of efficient markets, which claims that the more speculation present, the harder it is to manipulate prices.

- **The most damaging form of speculation is index speculation.** This is where a large institution like a pension fund simply buys a whole basket of commodities and holds it for the long term. It is a form of hoarding. Generally, these funds are not interested in supply and demand conditions. They care only about portfolio diversification, or other financial considerations. With excessive index speculation, commodities markets become financialized, meaning their prices are set by financial concerns, rather than supply and demand. Index speculators have a lot of capital, so they can push prices way up as they enter the market, and then crash them down again when they exit. This is precisely what happened in 2008. The price of food and energy skyrocketed because pension funds allocated investment capital into commodity indexes. Then, when they reduced their allocations in mid-2008, prices crashed back down.

How Speculation Affects Commodities Markets:

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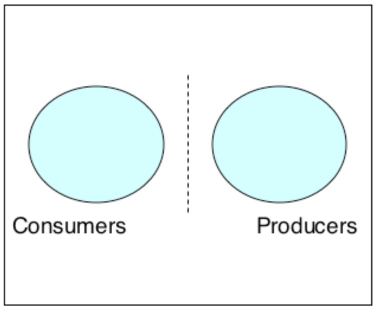
With zero speculation, markets lack liquidity



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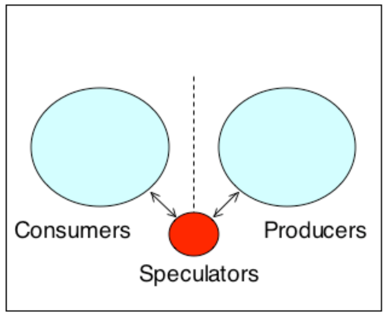
The introduction of speculation adds liquidity



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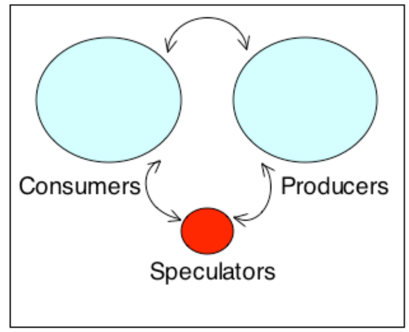
A healthy balance of end-users and speculators



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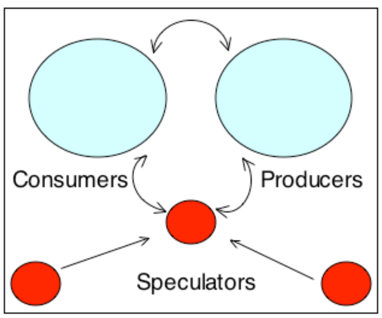
The presence of speculators attracts more speculators



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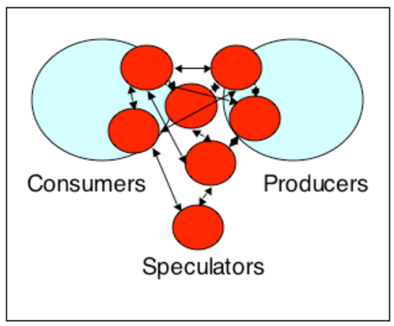
Excessive speculation can come to dominate the market



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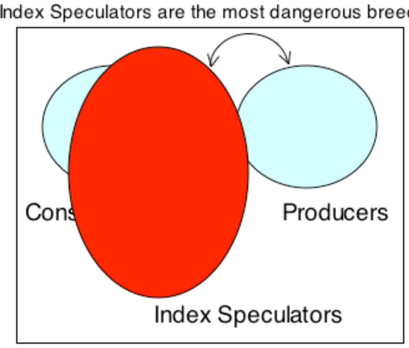
Index Speculators are the most dangerous breed



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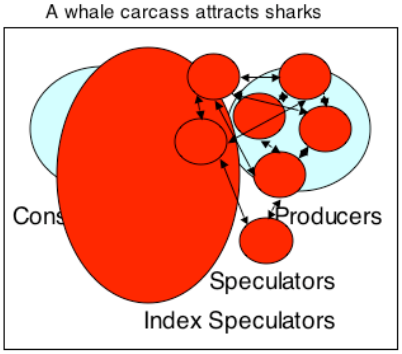
A whale carcass attracts sharks



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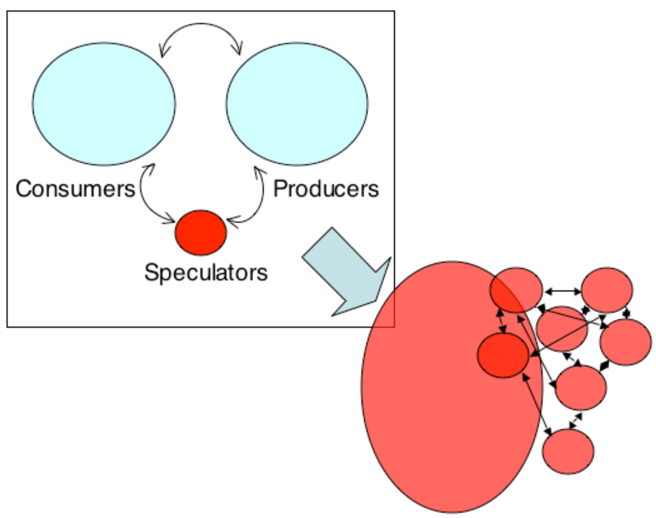
Solution: take out all Index Speculators, and limit others



Recommended Further Reading:

http://www.bettermarkets.com/papers/OECD2010.pdf Better Markets response to OECD study
http://www.wdm.org.uk/food-speculation World Development Movement campaign
http://stopgamblingonhunger.com/ Maryknoll website on food speculation
http://www.accidentalhuntbrothers.com Blog on commodities speculation run by Adam White CFA
http://www.bettermarkets.com/papers/Anthropic Longer theoretical piece on how markets function
http://www.bettermarkets.com/papers/Balanced Longer theoretical piece on the social role of markets

Look forward to the launch of http://www.bettermarkets.com in September!