Speculation and Commodity Prices

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<Abstract>

This paper attempts to identify the role of financial speculation in commodity price movements, while exploring other possible influences such as the role of spare capacity and the role of rapidly developing countries, through intensive commodity import surges. Both fundamentals and speculation appear to jointly determine crude oil prices. Speculative activity does play a supporting role in price determination but it is not the only driver. Fundamentals such as net imports, the result of consumption and production dynamics, are important in price determination. Attempts at investigating the role of spare capacity, however, found that capacity bottle neck is not an important cause of recent price movements. A production level is still primarily the most important driver on prices of wheat and is heavily reliant on weather. Speculation does not have a significant effect of prices, but position limits may disrupt hedging activity that helps stabilize wheat prices. Even though speculation have some influence on crude oil prices, setting an across the board position limit may harm the price stability in wheat markets. Market wide position limits should consider the impacts on the futures market as a whole rather than piecemeal.

Key Words: Position limits, Financial regulation, Commodity speculation, Price volatility, Hedging

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I. Introduction

Over the period from 2002 to 2008, average oil prices rose consecutively, year-on-year, for seven years. The world witnessed a series of unprecedented commodity price hikes in 2005 to 2008. Contemporarily, a myriad of commodities saw prices rise persistently and steeply, ranging from energy to metals to agricultural products. This string of events captured the attention of many. Rising energy prices affected businesses through higher operation costs and households through inflated energy bills. A volatile energy price also stifles incentive to invest in alternative, clean energy due to uncertainty of profitability, setting back efforts towards sustainable development. Input cost hikes affected specific industries that uses commodities intensively. Steeply rising food prices pushes many households in the less developed nations into poverty and starvation, and also makes food aids to them more costly and less effective. Overall, rising commodities prices also hinder the already weak global economic recovery following the 2008 global financial crisis.

Given the magnitude of the implications, many are seeking answers to persistently rising prices, and solutions to this crisis. The G20 specifically, is determined to put in place a set of policies to prevent re-occurrences of price hikes. Focus on the futures market was gaining heat by the day. The recent commodities price hike coincided with major changes in the futures market. First, futures trading volume increased five-fold, suggesting explosive