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Soft commodities and the global financial crisis: Implications for the economy, resources and institutions



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ABSTRACT

Over the past decade, soft commodities have been subjected to increasing speculative price fluctuations. Following the 2008 financial crisis, most studies have highlighted causal relationships between price volatility, derivative and future markets for underlying financial assets as well as agricultural and mineral commodities. This article investigates the multi-faceted effects of unrestrained financialization of the resources and goods markets and its implications for agricultural markets and soft commodities for purposes other than direct human consumption. We place a particular emphasis on the process of commodification of food and non-food crops and their use as green source of liquid fuels (i.e. soy, sugar cane, palm oil, jatropha, and canola). It is argued that speculation in financial markets has led to spillover effects across commodity and resource markets. More importantly, speculation and price volatility in the commodity markets has had a direct bearing on the resource markets and organization and appropriation of common-pool resources. The article sheds further light on the causal relationship between derivative markets, hedging techniques, financial yields and price volatility and spillover effects in the market for food and soft commodities.

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1. Introduction

Commodities markets volatility and price fluctuations have been diversely commented by market analysts, financial investors and policymakers. Most studies have placed a particular emphasis on the multiple causalities and linkages between financial and commodity markets and across the market for financial assets, futures contracts and mineral and agricultural commodities derivatives (Cartwright and Riabko, 2015; Creti et al., 2013). The analysis of price volatility and spillover effects, monetary and exchange rate transmission mechanisms, and spot and futures markets price fluctuations have shown the moving boundaries of an increasingly financially driven global market (Aboura and Chevallier, 2015; Huchet and Gueye Fam, 2016; Kocenda et al., 2011; Huchet-Bourdon, 2011; Balcombe, 2008; Gilbert and Morgan, 2010). Most studies have shed light on how price fluctuations of agricultural and mineral commodities have correlated with a wide array of economic and natural factors, supply and demand conditions, price elasticity variations, climatic and inventory change, hedging techniques in an attempt. Using the two-stage least squares method for seven agricultural commodities set as independent variables (i.e. corn, soybean, wheat, rice, sugar, coffee, and cocoa), and S&P Goldman Sachs commodity and US inflation-indexed

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bonds as explanatory variables, [Huchet and Gueye Fam \(2016, pp. 53–55\)](#) demonstrate a positive correlation between the volatility index (VIX) and selected soft commodities over the period of 1998 to 2013. Despite differences in methodological approaches, data used and study intervals; most statistical studies highlight the existence of a direct relationship between soft commodities price volatility and the futures markets index variation. Commodities hedging strategies affect the production cycle of the underlying agricultural markets causing volatility in physical markets. Having said this, market volatility raises a more fundamental question as how financial frenzy can disconnect investors from market fundamentals.

The decoupling between market fundamentals and expectations has characterized the real and monetary spheres of the economy. Financialization and its commodification corollary have created more market opacity as witnessed by increasing market complexity caused by shadow banking and derivatives markets around the world. While mainstream financial theories emphasize the importance of financial instruments in stabilizing the economy, the 2008 financial crisis has revived a longstanding debate on the role and effectiveness of financial markets and their compliance with the regulatory institutions as well as constitutional, collective and operational rules. The debate on how some bad theories can destroy good management practices resonates well in academia. Let's consider the case of the highly controversial Efficient Market Hypothesis. The theory states that stock markets cannot outperform since they reach their fair value equilibrium in financial markets by dispersing risk and setting the optimal price. Critiques of the Efficient Market Theorem argue that stock price fluctuations reflect information asymmetries that result from speculative movements and lead to spillover effects across financial and commodity markets. Similarly, while acknowledging the importance of banking intermediation in expanding trade for agricultural products, the absence of regulation in the financial industry has been at the origin of erratic and speculative price fluctuations in the commodity markets. Consequently, the growth of market for derivatives and the hedging instruments such as collateralized debt obligations, credit-default swaps and forward and future contracts have led to increasing financial claims on the banking system. This, in turn, has adversely affected the production, investment, and distribution cycles in the real sphere of the economy. While speculation on financial yield has enhanced investor participation, growing opacity surrounding commodity markets and complexity of hedging instruments have impaired the production cycle. The concern over growing moral hazard, whereby a person's decision about how much risk to take brings someone else to bear the cost when things go wrong is clearly a manifestation of an insatiable quest for speculation and financial gain as witnessed by the 2008 seismic crisis ([Krugman, 2009](#)). One should be reminded of major financial crises that occurred in the United States prior to the 2007–2008 subprime mortgage crisis, 1857, 1893, 1907 and 1929. In most cases, crisis was triggered by changes in financial market regulation, lax regulatory oversight and an abnormally low interest rate to stimulate investment ([Bordo, 2008](#)). More specifically, the 2008 financial crisis stemmed from massive subprime mortgage loans under a defective regulatory regime within highly concentrated financial markets. A collapsing housing market diverted available liquidities to the agricultural markets inflating demand for soft commodities futures as a substitution for mortgage-backed assets.

This article is organized as follows. Section 1 provides an introduction to the causes and consequences of financialization and the path to financial crisis and economic meltdown of 2008. Section 2 discusses the growing financial embeddedness of the economy and the development of the derivatives markets in conjunction with a wide array of soft commodities. We investigate the opportunistic behavior of investors and its implications for investment and production cycles as well as development of exchange traded funds. Section 3 examines the specific nature of the agricultural and soft commodities markets. We argue that in the absence of effective regulatory mechanisms and appropriation regimes, opportunistic and rent seeking behaviors will increase the overall cost of economic transactions. The section discusses the importance of the commons and common-pool resources in maintaining stability in the food and soft commodities market. We will end by examining the pivotal role of institutions in defining market rules in order to safeguard an optimal appropriation regime of common-pool resources needed to produce a wide array of food crops and soft commodities.

2. The food dilemma: economic commodity or social necessity?

Food constitutes the most basic human need and an essential ingredient for harmonious social and economic development. Placed within an historical perspective, food crops and agricultural products, produced by peasant farmers and appropriated by feudal aristocracies, have been at the heart of early market and monetary exchange mechanisms. The emergence of capitalism led to a greater pronouncement of 'food as commodity', since food crops could be traded for not only their immediate use value but also future exchange value. Over time, a significant portion of food which was initially produced for personal consumption and destined to local markets came to be produced on large landholdings for consumers in distant markets. Regions and countries endowed with high quality arable land and natural and human resources could promote large-scale production for global agricultural market. Economic theory views welfare as an ability to satisfy a wide array of human needs, including but not limited to food, shelter and drinking water. It is noteworthy that in ancient times, water constituted the very essence of material wealth. The first of a succession of Greek philosophers before Socrates, Thales considered that the originating principle of nature depended on a single material substance, water ([Cohen et al., 2011](#)). [Aristotle \(1999\)](#) made a distinction between how wealth was to be acquired and distributed by making a distinction between "chrematistics" or the art of "acquiring wealth" and "economics" as the science of "managing the household". The relationship between agriculture and economic wealth was first explored by French physiocrats who studied the source of value and riches in the 17th century French agrarian economy. Quesnay's "Economic Table" was a scientific attempt to describe the origin of economic laws as the emanation of a "natural order" upon which all social relationships were to be constructed. In line with the feudal social and economic order physiocrats defended free trade of grain in the name of efficiency emanating

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