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Editorial

Understanding international commodity price fluctuations☆

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A B S T R A C T

An overview is provided of recent work on commodity prices, focusing on three themes: (i) "financialization" of commodity markets–commodities being considered by financial investors as a distinct asset class, (ii) trends and forecasts of commodity prices, and (iii) fracking—a shorthand for the emergence of new sources of energy supply. Lessons are drawn on the role of fundamentals and expectations in driving the rapidly changing nature of commodity markets.

1. Introduction

Commodity prices have been on a roller coaster for several years. In 2008, oil prices hit $145 a barrel and prices of many metals were soaring on the back of demand from emerging markets. High food prices provoked riots in 35 countries and added more than a 100 million people to the ranks of the hungry. The global financial crisis reversed the increase in commodity prices, but they have since rebounded and remained elevated and volatile.

The papers in this special issue of the *Journal of International Money and Finance* foster a better understanding of international commodity price fluctuations. The papers were presented at a conference in Washington, D.C., on September 20–21, 2013 organized jointly by the Research Department of the International Monetary Fund and the Oxford Centre for the Analysis of Resource Rich Economies at the University of Oxford.

In this overview we discuss three the key questions tackled in the papers, panel discussion and speeches: (i) Are commodity prices increasingly being driven by financial speculation? (ii) Do newer techniques to forecast commodity prices beat a random walk? (iii) What are the economic and environmental impacts of new sources of energy supply?

☆ The views in this paper are those of the authors alone and do not necessarily represent those of the IMF or IMF policy. All remaining errors are our own. Support from the BP funded Oxford Centre for the Analysis of Resource Rich Economies is gratefully acknowledged.

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The remainder is organized as follows. Section 2 discusses the consequences of financialization of commodity markets. Section 3 reviews recent developments in testing the Prebisch–Singer hypothesis and forecasting commodity prices. Section 4 explores the actual and prospective consequences of the spread of the use of fracking technology to extract new source of energy and its consequences on energy prices, the environment and the economy. Section 5 concludes.

2. "Financialization" of commodity markets

A theme explored in many papers in the issue is the "financialization" of commodity markets – commodities being considered by financial investors as a distinct asset class. There is debate on whether this increased interest is resulting in commodity prices, particularly oil prices, becoming disconnected from fundamentals.

In principle, the financialization of commodity markets is a welcome development. For instance, in the crude oil market, having investors willing to take long forward exposure can enhance the potential for risk sharing and hedging. It should improve the process of price discovery and contribute to price stability, helping both producers and consumers. But short-term effects at times may have clouded the longer-term benefits.

Financialization does open up the possibility for noise trading and momentum strategies to affect prices. It remains a matter of debate whether such trading played a role in the acceleration of commodity prices between 2005 and 2008. The papers in this special issue contribute to the debate in several ways by providing: empirical evidence of financialization and quantifying the role of the speculative component in explaining the oil-price spike in the run-up to the global financial crisis; a structural explanation for the development in the futures markets for oil and the role of low interest rate; evidence for the role of information and "reflexivity" in driving commodity futures prices; and evidence of the presence of bubbles in the food market.

2.1. Evidence of financialization and speculation

Jim Hamilton of the University of California, San Diego and Jing Cynthia Wu of the University of Chicago provide a structural model linking volatility in the oil futures market to the flow of dollars into commodity-index funds that take the long position in crude oil futures contracts. In Keynes' theory of normal backwardation, producers of commodities hedge by selling futures contracts and pay a premium. Arbitrageurs are forced to take the other side and are thus exposed to non-diversifiable risk and compensated. When financial investors who buy commodities futures for portfolio diversification get involved, they exert a similar effect to the one describe in Keynes's theory but in the opposite direction. That is financial investors' involvement shifts the receipt of the risk premium from the long side to the short side of the contract. The application of the methods developed in their paper to the price of crude oil futures contracts provides evidence that there are significant changes in the risk premia in 2005 as the volume of futures trading grows significantly. Traders taking long positions earned a positive return on average prior to 2005 but that premium decreased substantially after 2005. This is consistent with the claim that, historically, commercial producers paid a premium to arbitrageurs for the privilege of hedging price risk, but in more recent periods financial investors have become natural counterparties for commercial hedgers.

Michel Robe of American University and Bahattin Büyükşahin of the Bank of Canada provide evidence that greater participation by financial investors in commodity futures markets raises co-movement between commodities and equities returns. The evidence supports the hypothesis that commodities are increasingly considered as an asset class on their own alongside equities. The authors use a unique, non-public data set of individual trader positions in 17 U.S. commodity futures markets. They show that the correlation between the rates of return on commodities and equities rises with greater participation by speculators generally, hedge funds especially, and funds that trade in both equity and commodity markets in particular. They also find that the predictive power of hedge fund positions is weaker in periods of generalized financial market stress. Their results indicate that *who* trades helps predict the joint distribution of commodity and equity returns. They also give empirical insight on how much speculative activity exceeds net hedging demand.