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# The Financialization of Commodity Markets:

## A Short-lived Phenomenon?

POLICY REPORT


Editor:

YVES JÉGOUREL

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# Summary

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## List of Abbreviations

bbl : barrel of oil

CAP : Common Agricultural Policy

CBOT : Chicago Board of Trades

CCC : Commodity Credit Corporation

CFTC : Commodity Futures Trading Commission

CFR : Cost and Freight

CIT : Commodity Index Trader

CME : Chicago Mercantile Exchange

COT : Commitment of Traders

CTA : Commodity Trading Advisors

CZCE : Zhengzhou Commodity Exchange

DAP : Di-Ammonium of Phosphate

DCE : Dalian Commodity Exchange

DJ-USBSCI: Dow Jones-Union of Bank of Switzerland Commodity Index

EIA : U.S. Energy Information Administration

ETP : External Trade of Products

HRC : Hot Rolled Coils

ICA : International Commodity Agreement

ICE : Intercontinental Exchange

IEA : International Energy Agency

IMM : International Monetary Market

JKM : Japan Korea Market

KBT : Kansas Board of Trades

LLDPE : Linear Low Density Polyethylene

LNG : Liquefied Natural Gas

MAP : Mono Ammonium Phosphate

mb/d : million barrels per day

MCX : Multi Commodity Exchange of India

mmbtu : million British thermal units

NASDAQ: National Association of Securities Dealers Automated Quotations

NPK : Nitrogen (N), Phosphorus (P), Potassium (K)

NYCE : New York Cotton Exchange

NYMEX: New York Mercantile Exchange

NYSE : New York Stock Exchange

OECD : Organization of Economic Cooperation and Development

OPEC : Organization of Petroleum Exporting Countries

OTC : Over the Counter

SGX : Singapore Exchange

SHFE : Shanghai Futures Exchanges

SOE : State Owned Enterprises

SPGSCI: Standard and Poor's Goldman Sachs Commodity Index

TSP : Triple Super Phosphate

USSR : Union of Soviet Socialist Republics

VAR : Vector Auto Regressive

WTI : West Texas Intermediate

WWII : World War II

## Foreword

Financialization is a neologism now widely used in the media and political sphere, but also in the academic world. A concept that has acquired such importance and seems so well known that sometimes it does not need to be defined. The problem with this approach is not so much that this notion is ambiguous, but that the perimeter granted to it varies considerably. According to the Roosevelt Institute, this phenomenon is indeed characterized, in its most general sense, by "the growth of the financial sector, its increased power over the real economy, the explosion in the power of wealth, and the reduction of all of society to the realm of finance" . On the other hand, in a much narrower approach dedicated to the commodity world, the phenomenon of financialization has often been defined as the growing importance of investment funds, such as ETFs, whose vocation is to offer their subscribers a financial performance resulting from the increase in commodity prices. With such diversity, delineating with the utmost precision the contours of a phenomenon whose economic and, in some cases, societal consequences are considerable, is essential.

In that connection, and faithful to its vocation to both fully engage in issues of interest to the African continent and to produce a number of studies or recommendations in the field of public policy, OCP Policy Center has invited a number of international experts to propose their analysis on the definition and stakes of the financialization of commodity industries. Despite the end of the so-called commodity "super-cycle" which has witnessed the dismissal of "long" speculation on ever-rising commodity prices over the period 2002-2012, this remains indeed an unavoidable topic with keenly debated but unanswered questions. What is the medium by which financialisation takes place? What are the implications for producers and consumers of strengthening commodity derivatives markets? Who are the main beneficiaries and what is to be feared? In particular, to what extent does financialization fuel speculation and exacerbate physical market instability? What are the recent trends in commodity market financialization and what will be its reality in the years to come? So many questions that call for answers.

In a first chapter, Pr. Helyette Geman reminds us, through a review of recent literature, that financialization is multifaceted and that it has therefore been analyzed in a significantly varied way. Pr Geman also clarifies what was the responsibility of index funds in the very sharp rise in commodity prices over the first decade of this century. She dedicates the last part of her chapter to the analysis of a market that has not yet seen any financialization and which is of growing importance for the world and Africa: that of fertilizers. John Baffes offers us a different analysis by favoring a historical approach to the different price-setting mechanisms that prevail in the commodity world. In particular, the author's ambition is to show how competitive pricing mechanisms have asserted or faded over the past two centuries. He reminds us that competitive pricing reemerged after the collapse of the Bretton Woods system with the introduction of financial derivatives, market-friendly policies, the shift to market-orientation of centrally planned economies, and the collapse of International Cartel Agreement. This question relating to the nature of price references on commodity markets is of particular importance because the notion of financialization cannot be reduced to the mere question of commodity index funds. The affirmation of a derivative market means, first and foremost, the emergence of a price that will not only serve as a reference for an entire industry but that will also be subject to both changes in the fundamentals of physical markets and to speculative dynamics. Pr. Luciano Gutierrez, in his chapter, focuses on the analysis of agricultural markets, which we know were at the heart of the debates surrounding the dangers of financialization. In addition to identifying the main benefits but also the risks associated with this profound change, Luciano Gutierriez proposes an econometric analysis based on the VAR methodology to measure the impact of financialization on corn, wheat and soybean price formation. In this context, he shows that this phenomenon has amplified food price movements with spot prices for maize and wheat being influenced by financial variables in the short-run. Yves Jégourel also examines financialization in the context of specific commodity markets: primary aluminum, iron ore and steel. These choices have not been made randomly for each of these minerals/metals strongly illustrates that the path towards greater financialization is not unique. In this context, he suggests that the specific nature of the conundrum that links the financialization process to the industrial organization that produces, processes, trades and consumes a given commodity should be investigated. With regards to the fifth and final chapter of this report, Pr. Michael Tamvakis focuses on Chinese commodity derivatives markets. After briefly recalling the history of these markets and describing the reality of futures contracts which are traded on the Dalian Commodity Exchange, on the Zhengzhou Commodity Exchange or on the

Shanghai Futures Exchange, Michael Tamkavis looks at their performance and discusses the next steps that could make China a country with reference derivatives markets.

This report would probably not have been possible without the close relationship that the OCP Policy Center has with the academic world and its researchers, whether senior fellow of the OCP Policy Center or not. It is one of many contributions from the OCP Policy Center and I can only invite our readers to consult on our website.

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