Centre for European Policy Studies

European Capital Markets Institute

PRESS RELEASE

Launch of Task Force Report 'Price Formation in Commodities Markets: Financialisation and Beyond'

ECMI and CEPS Deliver Fresh Look into Commodities Price Formation in Futures and Physical Markets and Priorities for Policy-Makers

Brussels, 09 July, 2013 – Commodities markets are at the core of the global economy and influence people's daily decisions about essential needs. Acquiring greater access to and control over commodities motivate the actions of many governments in economies that are increasingly dependent on resources produced in emerging markets. In the aftermath to the financial crisis, the rise of commodities price volatility alarmed policy-makers (e.g. G-20) and raised questions about the functioning of commodities markets and their interaction with the financial system. In response to those concerns, in September 2011, the Centre for European Policy Studies and the European Capital Markets Institute formed a Task Force comprising experts representing 30 members and many more observers, including commodities firms, financial institutions, price-reporting agencies, independent experts, academics and policy-makers. The group, chaired by the independent commodities expert and former Director at Chicago Board of Trade, Ann Berg, met six times over an 18-month period with the support of two Rapporteurs, ECMI Head of Research and CEPS Research Fellow Diego Valiante and CEPS Senior Research Fellow Christian Egenhofer.

The Final Report – authored by Valiante – reviews the interaction between physical and futures commodities markets and the price formation mechanisms in 11 different commodities markets (crude oil, natural gas, iron ore, aluminium, copper, wheat, corn, soybean oil, sugar, cocoa and coffee). After more than one year of data gathering and qualitative desk research, over and beyond the information collected through the Task Force meetings, the Report sheds light on a broad set of policy concerns by looking at long-term drivers of price formation in futures and physical commodities markets.

Key findings of the report are presented below. Contact author, Diego Valiante, at +32 2 229 39 14 or diego.valiante@ceps.eu. See disclaimer and information for journalists at the end of this press release. Download report from www.eurocapitalmarkets.org/commoditiestfreport from 9 July, 12:00 CET.

SELECTED KEY FINDINGS

➢ Market fundamentals are strong but interconnection may increase systemic risk

- Demand and supply **fundamentals** remain solid long-term drivers of futures price formation across all the commodities markets considered by this report.
- The **interconnection** between physical commodities markets at the global level (due to the development of international trade) and its interaction with the financial system (due to the access to international finance and accommodating monetary policies) have increased pro-cyclicality and amplified the magnitude of supply or demand shocks, also caused by shocks in the financial system.
- Growing links between commodities markets and international trade have intensified the effects of **government actions** such as export bans. Most notably, direct market interventions in an open market model with international trade are unable to create incentives to tackle underlying problems of market structure. When the fiscal capacity of a country is reduced, the market has to face sudden adjustments with highly volatile patterns.

- Public investment in infrastructure and alternative applications (e.g. new technologies to improve production) might be a beneficial alternative to price **subsidy programmes** with potential distortive effects, especially when opportunity costs of alternative productions dilute private incentives. In 2012, China surpassed the United States as the world's biggest subsidiser of agricultural commodities (roughly $180 billion). In fact, government subsidy programmes that have supported artificial prices in several commodities act as a disincentive to tackle underlying problems of market structure in an open market model with international trade.

The interaction of commodities markets with the financial system and the role of financial and non-financial participants

- **Financialisation**, which is the process of pooling returns from commodities with returns from pure financial assets ('pooling effect'), is the result of the *combined effects* of multiple circumstances, including the growth of international trade and cross-border interaction among physical markets, reinforced by easier access to international finance and credit partly due to widespread expansionary monetary policies, a favourable regulatory framework with the deregulation in the US and technological changes favouring electronic trading and promoting accessibility to futures markets from any remote location around the globe. Overall, the financialisation process has increased pro-cyclicality, i.e. responsiveness to the economic cycle and vulnerability of commodities markets to short-term shocks also coming from the financial system. However, the latter has been instrumental to the growth of international commodities markets. Unless governments want to push back on international trade and global markets, financialisation is a natural outcome of the new environment we live in. Despite the growing interconnection, fundamentals remain key drivers of futures price formation.
- The evidence in this report suggests that the **role of non-commercial participants** in commodities markets has been generally benign to date. So far the growth of index investments has not caused distortions in price formation. An indiscriminate ban of legitimate trading practices may result in liquidity losses at the expense of the efficiency of price formation.
- Empirical analyses confirm that **commercial futures open interests** still drive price formation in futures markets. The actions of supervisors, therefore, should focus on addressing damaging short-term trading practices embedded in high volumes, such as cornering and manipulation attempts in physical markets. Banning categories of traders or general trading intents can only harm the ability of physical players to access liquid markets to hedge. More data on volumes are needed to assess short-term implications for trading practices.
- **Trading houses** with interests across different commodities markets and significant financial exposure have boosted their physical holdings in international physical markets, and can potentially become 'too-physical-to-fail'. The use of financial leverage to increase physical holdings, through the easy access to international finance helped by accommodating monetary policies, may have systemic implications. Aggregate data on physical holdings, coupled with a minimum set of information confidentially disclosed to regulators, for example, may reduce risks of moral hazard for national governments that have to cope with the sheer size of these entities in case of trouble. The top 10 trading houses have generated about $1 trillion in revenues in 2011 alone.

Market organisation matters!

- **Futures markets** are an essential infrastructure to support risk management in physical markets and have supported the development of international trade and the consolidation of commercial participants fuelled by the opening up of international trade in the last decade. As market infrastructure adapts to a more global and interconnected environment after demutualisation, however, exposure to global risks requires a sophisticated surveillance mechanism and more coordination between supervisory authorities at international level.

- As the industry pushes for consolidation at regional and global level, a minimum set of requirements to ensure accessibility and interaction with competitors while preserving rights on key intellectual properties may be beneficial for the innovation of new products and services to attract liquidity and, ultimately, serve the interests of commodity users. The implications of financial reforms for the **market power** of market infrastructure operators should be carefully assessed.
- The **warehousing and delivery systems** behind recognised international futures/forward benchmarks should reflect underlying physical market characteristics. This would require regular adaptation of the rules set by the infrastructure to structural developments in the underlying physical market. Together with constant supervision over these rules and proper management of futures positions linked to a liquid physical market, this may be beneficial in improving futures-physical price convergence and avoiding the deterioration of the benchmarks that would lead to an increasing over-reliance on less transparent price-setting based on assessments. For instance, problems with the physical delivery of LME aluminium forwards are increasing the reliance on more opaque regional premia assessments (on average more than 15% of the nominal LME price in 2012), which are partially compensating for the natural fall in the price of the official benchmark following a long period of oversupply.
- **Conflicts of interests** in commodities markets can have harmful effects, with strong implications for physical flows and market competition. Therefore, rules for sponsored warehouses, for example, should be set by the exchange only once the interests of its shareholders (often sitting in the Board meetings) in the external market infrastructure, e.g. ownership of sponsored warehouses, are properly disclosed and ultimately managed. Conflicts may arise, in particular, when financial and non-financial activities are combined in the same entity. Therefore conflicts of interests between the ownership of market infrastructure and/or of physical/futures/other financial holdings of market participants need to be appropriately identified, disclosed and ultimately managed by the parties involved under the coordinated international supervision of competent authorities.
- Claims that **the size of futures markets** is many times larger than physical markets and thus may distort price formation based on underlying physical transactions cannot be proven, but they also cannot be ruled out. When looking at liquidity curves in futures markets, the size of open interest is only a fraction of the corresponding physical markets size, with high peaks only for cocoa and coffee (respectively at around 80% and 210%). However, when comparing yearly volumes of contracts with yearly production, futures markets are many times larger than the corresponding physical production (up to nine times larger for the main corn futures contract).
- The Report estimates the total notional value of outstanding (open interest) **over-the-counter and exchange-traded financial transactions in commodities** (e.g. futures and options) at around $5.58 trillion in 2012. Over-the-counter transactions make up roughly 38% of the total outstanding value (open interest).
- Full transparency of **methodologies and governance** and accessibility to underlying market data are crucial aspects for regulators in order to ensure the smooth functioning of price assessment services. A regulatory framework designed around public accountability to final users of the benchmarks will most likely preserve voluntary reporting by commodities firms and the right of judgement for price assessment entities in illiquid market conditions. The objective is to support the reputational market while at the same time avoiding the creation of a legally binding price assessment process that would only increase the systemic effects of market failures or discourage submissions.

See disclaimer and information for journalists on next page.

DISCLAIMER

This report is based on the discussions in the CEPS-ECMI Task Force on price formation in commodities markets, which met on six separate occasions in 2011 and 2012.

The findings of this Final Report do not necessarily reflect the views of all the members of the Task Force, or the views of their respective companies. Members contributed to the Task Force meetings and provided input to the discussions through presentations and relevant material for the Final Report. A set of principles has guided the Task Force meetings and the drafting process, with the aim of giving all the interests represented in the Task Force the chance to be heard. The Final Report, however, was independently drafted by the author, who is solely responsible for its content and errors. Neither the members nor their respective companies necessarily endorse the conclusions of the Final Report.

DOWNLOAD

Download the full Final Report from 9 July 2013, 12:00 CET (Brussels time), from www.eurocapitalmarkets.org/commoditiestfreport or www.ceps.eu.

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ABOUT CEPS

The Centre for European Policy Studies (CEPS) - *Thinking Ahead for Europe*

Founded in Brussels in 1983, the Centre for European Policy Studies (CEPS) is among the most experienced and authoritative think tanks operating in the European Union today. CEPS serves as a leading forum for debate on EU affairs, and its most distinguishing feature lies in its strong in-house research capacity, complemented by an extensive network of partner institutes throughout the world. CEPS' funding is obtained from a variety of sources, including membership fees, project research, foundation grants, conferences fees, publication sales and an annual grant from the European Commission.

ABOUT ECMI

The European Capital Markets Institute (ECMI) - *Informing Policy on European Capital Markets*

ECMI is an independent non-profit organisation created to provide a forum in which market participants, policy-makers and academics can exchange ideas and opinions concerning the efficiency, stability, liquidity, integrity, fairness and competitiveness of European capital markets and discuss the latest market trends. These exchanges are fuelled by the publications ECMI regularly produces for its members: quarterly newsletters, annual reports, a statistical package, regular commentary and research papers, as well as occasional workshops and conferences. ECMI also advises European regulators on policy related matters, acts as a focal point for interaction between academic research, market sentiment and the policy-making process, and promotes a multidisciplinary and multidimensional approach to the subject.

ECMI is managed and staffed by the Centre for European Policy Studies (CEPS) in Brussels. Its membership is composed of private firms, public institutions and universities.