Excessive Speculation in Commodity Markets Is Driving Up Prices and Harming Commercial Producers and Consumers

With extensive original analysis and empirical data on the commodity markets, Better Markets, Inc., a nonprofit organization that promotes the public interest in the financial markets, filed a detailed comment letter with the US CFTC on March 28, 2011. That letter demonstrates that excessive speculation in the commodity markets is very damaging and needs to be corrected by position limits. The comment letter (accessible at http://www.bettermarkets.com/assets/pdf/CL-CFTC-PL-Final.pdf) reveals the following facts:

- Speculation in commodity markets has dramatically increased, has become excessive and far exceeds amounts necessary to facilitate legitimate commercial hedging;

- Excessive speculation has caused increased volatility and increased prices in the futures markets;

- Volatility and price increases in the futures markets directly increase hedging costs and, as a result, the cost of production, thereby increasing the prices of underlying commodities;

- Price increases in the futures markets are transmitted to and affect the prices in the physical markets by standard pricing methodologies of physical products;

- While increased volatility and prices have increased the need for hedging by physical producers and purchases, the increased costs to hedgers described above have caused physical producers and purchasers to hedge less;

- Much of this, but certainly not all, has been caused by the creation and explosive growth of commodity index funds;

- Commodity index funds are liquidity takers and not liquidity providers while depriving legitimate commercial hedgers of sufficient market liquidity; and

- Commodity index funds have disrupted the commodities futures and physical markets in ways that distort price discovery and increase commodities prices.

In the last decade, we have witnessed a seismic shift in the worldwide mechanisms for pricing energy and agricultural commodities. This coincided with the extensive deregulation of commodities markets and the proliferation of electronic systems through
which buyers and sellers of derivatives are matched directly, out of sight of exchanges, clearinghouses and regulators.

These changes have profoundly affected the way that financial and fundamental forces interact to establish prices paid for bread in Egypt, petrol in London and cereal in California, and for most other basic commodities in the global economy. The advent of commodity index funds, and excessive speculation in general, have distorted the price discovery and hedging function of commodity futures markets. This in turn has affected physical commodity prices. Excessive speculation today is increasing costs for businesses and for consumers throughout the world, hurting the world’s poorest the most. It will continue to do so unless an effective position limits regime is put into effect.

Today, financial speculators have overwhelmed the commodity markets and driven out legitimate commercial physical hedgers. Historically, when commodity markets have worked well (i.e., when there is sufficient liquidity and meaningful price discovery for all physical hedgers who want to hedge), physical hedgers have constituted about 70% of the market and financial speculators have been about 30% of the market. The ratio of participants has reversed in many markets, with speculators now accounting for about 70% or more of the open interest in these markets while physical hedgers have fallen to only about 30% participation (and much lower in some markets).

In sharp contrast to the much larger capital markets, commodity markets exist for the purpose of providing a venue for producers and purchasers of physical commodities to hedge their risks. Financial speculators are tolerated as commodity market participants solely to ensure that physical hedgers have sufficient liquidity. Speculation far exceeds levels needed to facilitate hedging and now damages the market, increasing price levels.

The only way to effectively correct that and restore the commodity markets to their intended purpose is to take the following steps:

- Regulators must impose aggregate position limits on excessive speculation.
- Including, in particular, applying such limits to commodity index funds as a group or class.

*Speculation in commodity markets has dramatically increased and is excessive*

The diagrams above illustrate how the Speculation/Hedging ratios have reversed using the example of CBOT Wheat.

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The diagram below shows how commodity index funds have been behind most of the increased speculation, using the example of CBOT Wheat.

![Diagram showing percentage of reportable and classifiable open interest controlled by different entities over time.]

While we have used wheat as an example here, this is common across many commodities as we illustrate in our comment letter and on our website.

**Excessive speculation has caused increased volatility and increased prices in the futures markets**

![Diagram showing real oil price with marked events like the Iranian Revolution and Persian Gulf War.]

The diagram above illustrates that the volatility and price levels seen since the advent of excessive speculation are unprecedented, using the example of NYMEX WTI Crude Oil.
Much of this, but certainly not all, has been caused by the creation and explosive growth of commodity index funds

Highly structured commodity index investment vehicles have become dominant forces in the futures markets with dramatic impact in the physical markets. Commodity index investments were created to synthetically mimic ownership of market baskets of physical commodities valued according to indices derived from futures markets. These investments were marketed to large investors as new asset classes for diversifying investment portfolios and have injected more than $300 billion into the futures markets over the last several years, with commodities prices rising in tandem:

![Passive Commodity Index Investment](image)

Commodity index funds are liquidity takers and not liquidity providers while depriving bona fide hedgers of sufficient market liquidity

A common myth concerning index funds is that they “provide liquidity” to the market, balancing hedgers. However, commodity index funds do not trade on the basis of supply and demand fundamentals or in response to liquidity demands. Rather, they trade on the basis of investment inflows and the need to perpetually roll contracts forward as they expire. In some instances, this may balance out hedging liquidity needs, but when it does so it is incidental. Index funds have massive liquidity needs every month and, therefore, compete with hedgers for liquidity.

Commodity index funds have disrupted the commodities futures and physical markets in ways that distort price discovery and increase commodities prices

Commodity index fund trading and other speculative activity have generated volatility in the markets which is not associated with views of supply and demand. This volatility imposes direct costs on businesses legitimately using the markets to manage price risk. These costs become a cost of production, directly increasing prices.
In addition, distortions which artificially increase prices of longer dated futures contracts also increase physical prices. Energy and agricultural commodities are generally priced via contracts or auctions in which the reference price is the next expiring futures contract price. Where the futures price is not directly used, “reported prices,” such as those published by Platts, are used. These “reported prices” are calculated via methods that place a great emphasis on nearby futures prices. Therefore, nearby futures prices have an immediate and direct impact on physical commodities prices. Higher prices and volatility in futures markets, induced by excessive speculation, therefore causes physical prices to be pushed higher than they would otherwise be.

**Additional Data, Analysis and Information**


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