In defence of commodity markets

In 2011, the French Government and the European Commission jointly organised an international conference on commodity markets. **Pierre Noël**, Senior Research Associate at Judge Business School, **University of Cambridge**, attended it, and reflects here on some of the issues raised

Mr Sarkozy's speech was a passionate plea for Europe to lead the world in regulating global commodity markets, which he characterised as without rules, opaque, immoral and a financial catastrophe in the making. That the oil price could, in 2008, collapse 50% in a few weeks while demand contracted by just a few per cent was proof to him that something was fundamentally wrong. With the oil derivatives market representing 35 times the physical market (46 times for wheat) he pointed to 'financialisation' and speculation as the cause, calling for rules to limit positions, improve transparency, and make it more expensive to trade in futures and derivatives.

Anti-market rhetoric resurfaces each time commodity prices go up. What is worrying is the apparent unwillingness of policy-makers to distinguish between market manipulations, which public authorities should indeed have the power to investigate and prosecute, and politically unpleasant market outcomes. The temptation to ban the latter is futile and can have consequences far worse that the targeted 'problem'. This risk is often overlooked because the functions performed by commodity markets are not properly appreciated. Let me mention three such functions, particularly important in today's globalised world.

First, global 'financialised' commodity markets are the only practical means to peacefully allocate scarce resources. They make resource wars redundant, hence much less likely. This is not a theoretical point. Mr Chavez has realised that selective oil embargoes are impractical while the Chinese are finding out that they do not need to control producing regions politically or militarily in order to get the oil they need. There is a growing acknowledgement in Beijing that China's oil security rests on a well-functioning global commodity market, not attempts to bypass it.

Secondly, international commodity markets are a very important supply crisis management tool. It is not a sense of responsibility but suppliers' and traders' profit motive that redirected cargoes of liquefied natural gas (LNG) away from Europe towards Japan after the Fukushima disaster. The LNG market is now commoditising quickly, which further increases security of supply for all. Conversely, the lack of proper gas transport capacity trading in Europe prevented spontaneous reallocation of supply to areas of shortage during the Russia-Ukraine gas crisis of January 2009. Had traders been able to 'profit from the crisis' markets would have transformed localised shortages into a pan-European rise in prices, alleviating the pain for the most impacted countries. Unfortunately the REMIT (Regulation of Energy Market Integrity and Transparency) legislation put forward by the European Commission will constrain the commoditisation of European gas, harming both competition and security of supply.

Thirdly, 'financialised' commodity markets help producers manage risks by selling all or part of their production at known and guaranteed prices long before they actually produce. A delegate from the Brazilian farm industry explained how access to the deep and liquid markets on the Chicago Mercantile Exchange was critical to running their business and that increasing capital ratios would make it more costly for them to hedge risks.

Not everything is fine with international commodity markets. Here is a list of possible actions for G8 and G20 governments to consider:

- Stop subsidising biofuels. Paying people to turn crops into fuel artificially links the poor's need for food and the rich's willingness to drive.
- Put forward international initiatives to combat export restrictions and commodity cartels.
- Remove implicit government guarantees to financial institutions so that they face the true risks of their trading activities, including commodity derivatives.
- Transfer money to poor countries when commodity prices rise.
- Reward governments that replace fuel and food subsidies by direct cash payments to consumers, which do not destroy incentives to conserve.

What of the 2008 oil price crash? I tried to explain that when the demand curve crosses the supply curve in its very steep section, even a small leftward shift can send the price plummeting. It holds, by the way, even if you were to put all greedy speculators into jail.

Global commodity markets should be acknowledged as useful economic institutions. If commodity traders make too much money out of them, simply tax them heavily at the margin. ■