COUNCIL ON FOREIGN RELATIONS

58 EAST 68TH STREET • NEW YORK • NEW YORK 10065
Tel 212 434 9622 *Fax* 212 434 9875 *Email bsteil@cfr.org*
www.cfr.org

statement of

Dr. Benn Steil
Director of International Economics
Council on Foreign Relations

co-author of
Financial Statecraft (Yale University Press, 2006)

before the

Committee on Homeland Security and Governmental Affairs
United States Senate

May 20, 2008

Financial Speculation in Commodity Markets

Thank you Chairman Lieberman, Ranking Member Collins, and members of the Committee for the opportunity to present to you this morning my views on the causes of rising financial speculation in commodities markets.

The sharp recent rises in global commodities prices, particularly in the energy and agricultural sectors, are undoubtedly causing hardship for many Americans, and are indeed threatening the health of many millions in developing countries. There is also no doubt that these price rises have been accompanied by a corresponding rise in interest from institutional investors in commodities as an asset class. The value of commodity index investments, for example, has grown by about 1/3 since the beginning of the year, to more than $250 billion.

Certainly, much of this inflow is “speculative,” in the sense that it is anticipating future supply constraints and robust demand. Both have been very much in evidence in recent years, and to the extent that speculation is driven by such factors it is playing a proper and indeed important role; that is, signaling the need to expand investment in production capacity, and providing liquidity to hedgers.

If this inflow is “manipulative,” on the other hand, it should be a matter of immediate regulatory concern. But there is very little evidence that it is. Low and declining levels of inventory for major food crops, for example, indicate no potentially manipulative hoarding going on in that sector. In the crude oil futures market, the evidence suggests that changes in speculative

positions follow the reactions of commercial traders to relevant news, so that commercial rather than speculative position changes are driving price changes.

So-called "fundamental" factors, related directly to supply of and demand for specific commodities, can certainly account for a goodly portion of the run-up in prices in recent years.

The supply of global farm acreage and crop output is shrinking relative to a global population that is rising both in size and wealth.

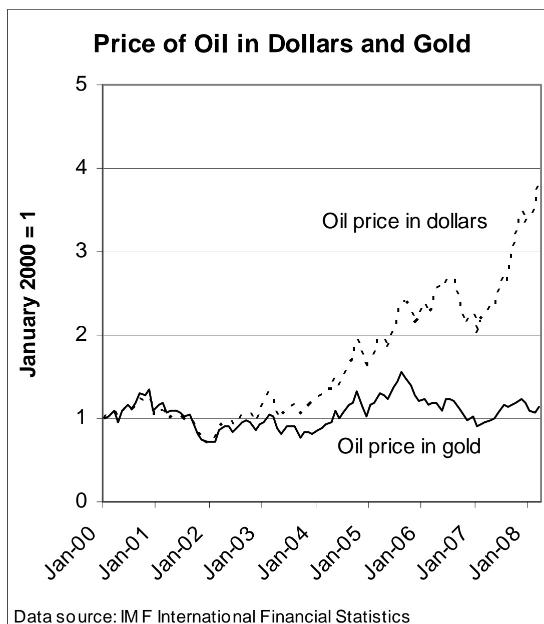
Rapidly growing demand from China is certainly part of the equation. Demand from China accounts for about 30% of the increase in crude oil demand over the past decade. A 6% rise in base metals demand last year was driven by a 32% increase in demand from China.

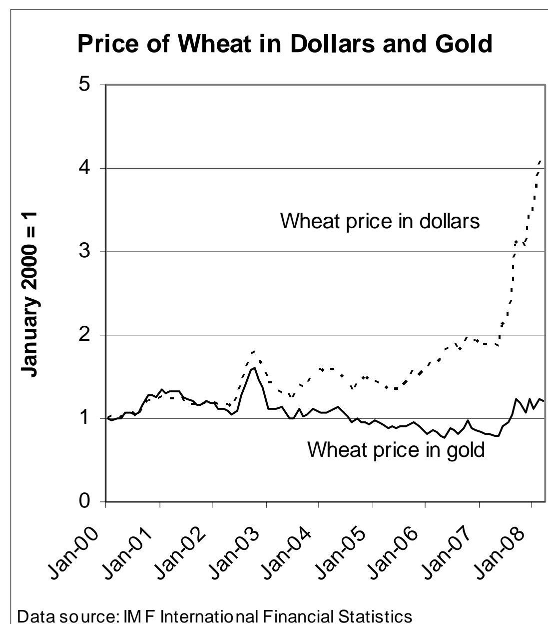
The tripling in oil prices since 2004 has spurred the production of biofuels, like corn-based ethanol, which has in turn contributed to record prices in corn and rival grains. These in turn have made products whose production relies on grain-based feed, such as milk and eggs, more expensive. This year, about 30% of US corn production will go into ethanol, rather than into world food and feed markets.

While all of these factors are acting to constrain supply or boost demand, governments around the world exacerbate these effects through public policy. Governments subsidize consumption of agricultural staples and energy products, for example, with the effect that demand does not moderate as it should. Governments have also been imposing agricultural export tariffs and bans, with the unintended consequence that farmers are motivated to reduce supply.

Yet all these fundamental factors, as important as they are, cannot explain the magnitude of price rises in recent years. The stories about global population growth and the rise of China, for example, are by now very old.

Many have recognized this, and have therefore asserted that we are experiencing a "commodities bubble." This conclusion, however, presumes that the US dollar, which the world uses to price and trade commodities, is a fixed unit of measurement, like an inch or an ounce. Yet it is not, and, worryingly, it has become less so in recent years. Whereas the prices of oil and wheat measured in dollars have soared over the course of this decade, they have, on the other hand, been remarkably stable when measured in terms of gold – gold having been the foundation of the world's monetary system until 1971.

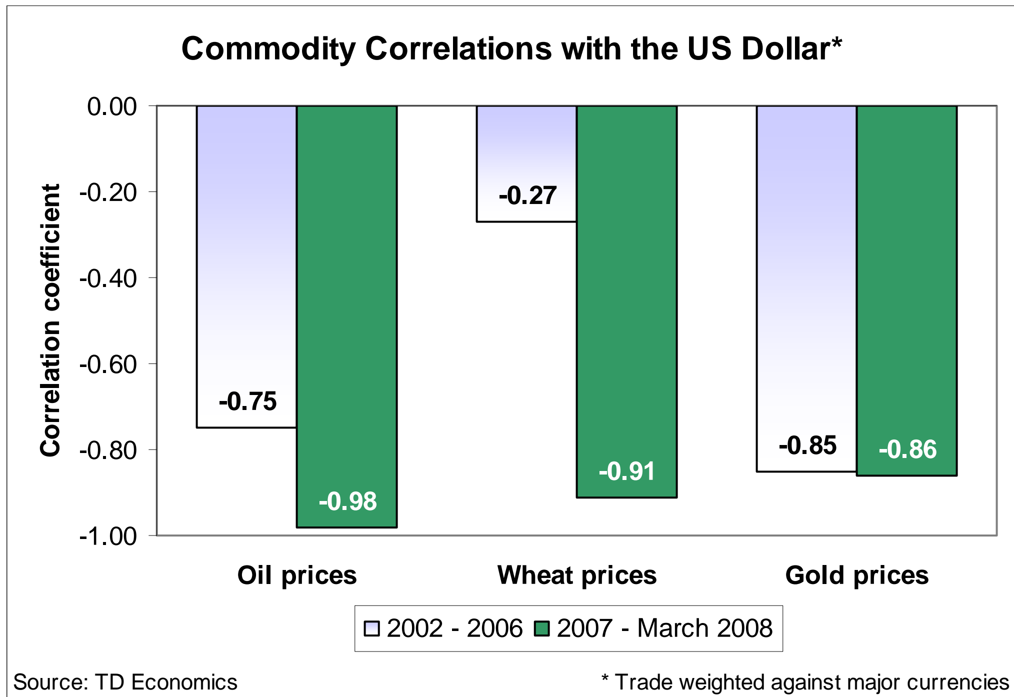




It is therefore reasonable to conclude not that we are a experiencing a commodities bubble, but rather the end of what might usefully be termed a "currency bubble."

The early 1980s witnessed the painful restoration of the global credibility of the dollar under the tight-money policy of the Paul Volcker-led Federal Reserve. We reaped the benefits of this achievement in the subsequent decade. The period of the 1990s through the early part of this decade was a golden age for the dollar. Investors around the world bought up dollar-denominated assets and central banks sold off their gold reserves, believing they were no longer necessary or desirable, allowing our country to enjoy the fruits of a sustained period of low interest rates and low inflation. But the Federal Reserve pushed rates too low and held them low for too long, and has since last autumn been exceptionally aggressive in driving them well below the rate of inflation. The Federal Funds Rate now stands at 2%, while consumer price inflation is near 4% and wholesale price inflation near 7%. More worrying, the latest survey from Reuters and the University of Michigan found that consumers' one-year inflation expectations have risen to 5.2%, up from 4.8% in April and 4.3% in March.

The dollar's value against the euro being tightly linked to the interest rate differential between the currencies, investors have shifted funds dramatically from low-yielding dollars to higher-yielding euros in recent years. Much more worrying, however, the correlation between dollar depreciation and commodities prices has become dramatically more pronounced since 2007, as illustrated in the figure below.



Institutional investors around the world – prominent among them, large US public pension schemes, such as CalPERS – have come to view commodities as part of a rapidly growing asset class devoted to inflation-protection.

Longer-term, governments themselves may actually fuel the upward commodities price trend by diversifying central bank reserves into commodities as a way to avoid precipitating further depreciation (vis-à-vis other currencies) of their existing huge stocks of dollar-denominated assets – in particular, US Treasurys.

What happens to commodities investment, and therefore commodities prices, going forward is therefore heavily dependent on the path of inflation and inflation expectations, and this path is itself critically dependent on developments in US monetary policy.

What policy measures, then, could help to relieve the damaging upward pressure on global commodities prices? I would identify two broad areas that merit attention.

First, we and other nations need to revisit honestly and objectively the range of subsidies and taxes we apply to encourage or discourage consumption and investment in the agricultural and energy sectors. The mix is far from optimal, and is becoming more damaging over time.

Second, more of the burden of dealing with the fallout from the mortgage and interbank credit crisis should be moved "on balance sheet." That is, Congress should look to targeted, explicitly funded, and market-oriented interventions to help revive the credit markets, which in turn will help revive the broader economy. To date, far too much of the burden has been borne by monetary policy, which is threatening to cause higher inflation, and leading individuals and institutions around the world to question whether the dollar will remain a credible long-term store of value. One highly undesirable result of this is soaring global commodity prices.