Handling gold granules at the Oegussa plant in Vienna, Austria. Unlike financial-based derivatives, physical commodity derivative markets are linked to goods with a finite supply

A consistent approach to commodity derivatives

We need a globally consistent stance towards the oversight of the physical commodity derivatives markets so they can carry out price-discovery and hedging functions while operating free from manipulation and abusive trading schemes

By Greg Tanzer, secretary general, International Organization of Securities Commissions (IOSCO)

Over the past few years, and especially in the aftermath of the financial crisis of 2008, volatility in commodity markets has been an issue of major concern for policy-makers around the world. In particular, politicians have raised legitimate concerns over the efficiency and integrity of commodity derivatives markets.

Both commodities and financial markets are global, and this means that an international approach is essential. Recognising this, the G20 leaders used their November 2010 summit in Seoul to task the International Organization of Securities Commissions (IOSCO) with carrying out further work on regulation and supervision of physical commodity derivatives markets, building on what it has done since setting up the Task Force on Commodity Futures Markets in September 2008. This work has culminated in the report of the task force and the IOSCO Technical Committee, setting out principles to regulate and supervise these markets, that it delivered to the G20 finance ministers last month ahead of the Cannes Summit.

The principles set out in that report will help to ensure that physical commodity derivatives markets serve their

Commodity prices listed at the New York Mercantile Stock Exchange. Regulators should set up a clear framework for commodities derivatives contracts, says IOSCO

fundamental price-discovery and hedging functions, while operating free from manipulation and abusive trading schemes. However, these principles are not intended to address absolute price levels or price volatility in the underlying physical commodities.

The principles aim to ensure a globally consistent approach to the oversight of commodity derivatives markets that will deliver effective supervision, combat market manipulatio, and improve price transparency.

So what is IOSCO proposing to the G20? The principles address five key areas: design of physical commodity derivatives contracts, surveillance of commodity derivatives markets, tackling disorderly markets, enforcement and information sharing, and enhancing price discovery and transparency. It is worth examining each one in turn.

Getting the design of commodity derivatives contracts right is important because that is the best way to eliminate or minimise the susceptibility of futures contracts to price manipulation or distortion. Where contract terms are not consistent with commercial practices or the delivery process is biased in favour of either participant, the contract may not be commercially successful or it may be susceptible to market abuses or manipulation and so contribute to price distortion and disorderly markets.

Regulators must therefore establish a clear framework for the design and review of the criteria and procedures for commodity derivatives contracts. Contracts must also have what IOSCO calls 'economic utility'. This means they should meet the risk-management needs of potential users and promote price discovery of the underlying commodity. This is important because the more accurately a commodity derivatives contract reflects the operation of the underlying physical market, the more likely it is to be useful as a tool for hedging and price discovery.

The derivatives contract must therefore correlate with the physical market. Reflecting the operation of the underlying physical commodity market will avoid, or at least minimise, the possibility of manipulation or price distortion in the derivative contract. In order to get the design right, regulators should take the views of potential contract users into account. The contracts themselves should be transparent so that the terms and conditions, as well as details such as delivery and pricing, are readily available to regulators and market participants.

The second broad area is surveillance of commodity derivatives markets. Surveillance is more than just a buzzword. Physical commodity derivatives markets are unique because, unlike financial-based derivatives, they are linked to goods with a finite supply. Effective surveillance programmes are needed to detect manipulative or abusive conduct, and to ensure the operation of fair and orderly physical commodity derivatives markets. There needs to be a clear and robust framework for surveillance, agreed methods for monitoring trading activity, and collecting and analysing market information.

Information is a critical tool for maintaining fair and orderly markets and ensuring market integrity. Obtaining this information is particularly critical during periods of high price volatility, in order to determine whether a market is functioning properly. Acquiring information on traders' positions also enables regulators to understand the composition of the market and to analyse the participation of both commercial and non-commercial market participants.

It is particularly important that regulators are aware of large positions and their owners – including positions owned or controlled by a third party on behalf of the true owner – and they may need additional information on related over-the-counter (OTC) and physical market positions. This is critical, as it will enable regulators to identify the build-up of concentrations of positions that could result in congestion or price distortion, and provide evidence of possible manipulation or other abusive trading.

The third area is the need to deal with disorderly markets. Disorderly conditions in physical commodity

derivatives markets can have significant negative effects on national economies. They can be caused by technical errors in the trading system, 'fat finger' mistakes and overreactions to major news or rumours, such as embargoes or natural disasters, that might affect supplies of commodities. IOSCO believes that regulators should be given powers to intervene in the market to prevent or address disorderly conditions.

Accordingly, it is critical that they have the necessary powers to intervene in the markets. In particular, they should have the power to stabilise markets when disorderly conditions exist, including ordering market participants to reduce the levels of their positions. In order for that to work, regulators need the power to set ex-ante limits on positions and to establish the principle of automatic consent by traders to follow an order of the regulator when that trader's position reaches a defined threshold size.

The fourth element of IOSCO's proposals is enforcement. Regulators must have powers to prohibit, investigate and take enforcement action against market abuses. This includes manipulation or attempted manipulation of the market. Clearly there must be clarity as to what constitutes manipulative, abusive conduct or other prohibited conduct, and IOSCO's reports set out 10 specific practices. Regulators also need adequate powers and the capacity to investigate and prosecute actual or suspected market abuse. The final element is the power to discipline market participants if an abusive practice has occurred in the market, ranging from a warning to expulsion as a member.

The final section of IOSCO's proposals aims to enhance the price-discovery function of commodity futures markets. Enhancing the availability and quality of information regarding the production, consumption, storage and trading of the physical commodities that underlie a financial market contract will improve the reliability of price discovery in the financial markets. This enhancement

> “IOSCO believes that regulators should be given powers to intervene in the market to prevent or address disorderly conditions”

will improve transparency in commodity derivatives markets and in OTC transactions. The process is critical, not only for signalling expectations about price, but also for providing data that might improve the analysis of any causal relationships between financial and physical market activity.

The principles that the Technical Committee has set out help to ensure that the physical commodity derivatives markets serve their fundamental price-discovery and hedging functions, while operating free from manipulation and abusive trading schemes.

These principles represent a valuable contribution to addressing the G20's legitimate concerns regarding the efficiency and integrity of commodity derivatives markets by presenting concrete recommendations that will support better-functioning, better-policed and more transparent commodity derivatives markets. By endorsing their implementation through a coordinated approach at their Cannes Summit, leaders will ensure the best prospects for improving the operation of both derivatives and commodities markets and for achieving the G20's objectives. ◆

Commodity-prices volatility: the reality behind the notion

Wildly fluctuating commodity prices have made it more difficult for governments to produce accurate economic predictions and have harmed the potential for growth. The world cannot afford to allow such volatile markets to go unchecked

By Arkady Dvorkovich, aide to the president of the Russian Federation and G8 and G20 sherpa

Today, the ongoing volatility in energy and commodity markets is central to the political agenda of the G20, but why does it matter in the first place?

In recent years, a number of commodities have demonstrated price fluctuations measured by double-digit percentage points. At extreme moments the price may even double or triple, as once happened to oil prices around the time of the 2008 financial crisis. Due to the magnitude of the economic and political impact of such fluctuations, the world can neither dismiss nor remain a passive observer of these market phenomena.

What is commonly described as volatility represents occasional and not necessarily anticipated price hikes, which undermine governmental efforts at predictable budgets and put at risk the projected profitability of a broader range of business. It is an unwelcome challenge at any time, and even less desirable under the current circumstances.

Exceeding certain limits, it may jeopardise the barely achieved small growth in the aftermath of the world economic crisis that is being currently enjoyed. Volatility also has a considerable impact on economic output, depending on which side of the trade interaction the country or company sits. Price fluctuations may also play a positive role in economic adjustments, sending a signal that may induce a structural change or amendment in market behaviour. The devil is, as always, in the detail, and there is, therefore, a question of what kind of signal and when it comes.

Lastly, there is the issue of whether there is the time or capacity to adapt. If one only relies on the invisible hand of market forces, then government regulation as such remains obsolete. Left unattended, price fluctuations may easily cross the line to where they might develop into energy or food security challenges.

Volatility matters for Russia, because it is a major player in the international oil and gas markets, as well as in markets for some metals, grains and other commodities. An upward dynamic of certain commodities (primarily hydrocarbons, grains and timber) gives the Russian government extra means to fill its exchequer, yet it also has adverse effects on its policy of maintaining a stable and predictable budget. Clearly, Russia cannot complain when prices go up; but it has a sober understanding of the necessity of long-term stability in both trade relations and internal challenges for its currency and inflation.

> "Russia cannot complain when prices go up; but it has a sober understanding of the necessity of long-term stability"

Following the work of G20 working groups, there has been a series of consultations with market players and regulators on the issue of energy price volatility. Here are some of the results of these consultations:

The volatility discussion that has been taking place at the G20 is directly linked to a broader debate about the need to streamline the regulation of financial markets that, with certain ups and downs, has remained high on the political agenda since the 2008 economic crisis. Mandated by the G20, the International Energy Agency (IEA), the International Energy Forum (IEF), the International Organization of Securities Commissions (IOSCO) and other international bodies are engaged in a fact-finding mission to explore the perceptions of the financial speculation behind recent price spikes and, if any exist, finding who is responsible for that speculation, and then offering some suggestions on what to do.

Cautious assessments

Remarkably, yet predictably, all these organisations are careful not to draw decisive conclusions. There are at least two reasons for this. First, although references to excessive volatility and abuses in financial markets have emerged as a cliché, there is still no substantive or, more importantly, legal definition of what is meant by these terms. There are no clearly defined criteria for how to differentiate 'excessive volatility' from, say, normal or acceptable price fluctuations or how to distinguish decent operations to buy and sell derivatives and other securities from punishable financial speculation that needs to be constrained by regulatory measures.

Second, there is a solid consensus among business people that observed volatility reflects a tightening of the market and fundamental factors, and that to fight volatility politicians need to introduce measures to improve the supply side. Traders believe that it was good news rather than bad when commodity derivatives turned into financial assets: it increases liquidity and facilitates hedging risks in tight markets. Business leaders also warn that any action to constrain derivatives, if not carefully designed, might have adverse effects on the performance of markets.

This perspective is not without argument, but there is another side of the coin. Institutional investors that demonstrate growing interest in investing in commodities have made the interconnection of physical and financial markets much tighter. The amount of resources invested

Workers at Rosneft Achinsk oil refinery, one of the biggest Siberian fuel producers. Volatility in commodities prices is influenced by more than simply supply and demand

increased from $13 billion in 2003 to between $180 billion and $200 billion in 2008. These factors contribute to price hikes being deeper, speedier and more dramatic.

Moreover, financial players do not think in terms of high or low prices. They earn their income from price differences – in other words, the more volatile the environment, the more profit they make. Bullish behaviour is the dominant strategy for those who invest in 'paper' instruments, as it is an easier strategy to follow.

Finally, a decade ago, financial institutions generated about 15 per cent of the profits of US companies. Today, their share has grown to 45 per cent. Almost a million new fortunes have been created through financial operations. In other words, after becoming an asset in itself, investment in securities, especially derivatives, became more attractive than any investment into the 'real economy' – a hedging instrument from a subsidiary function turned into a primary one that overshadows physical trade.

With regard to Russia's position, it is uneasy about substantial and unpredictable price fluctuations in commodities in world markets. This volatility creates extra risks for operational stability for a number of key sectors of the economy, as well as for monetary policy and budgetary planning. Russia has no intention of being associated publicly with any move to unduly raise the prices for end consumers.

The view from Russia

What is Russia's standpoint? Russia suggests that the G20 consider the following recommendations:

Any discussion of whether commodity prices should be high or low makes little economic sense, since those fluctuations reflect not only the dynamics of the balance between supply and demand, but also major macroeconomic factors and, not least, the financial policies of the United States and European Union (including US dollar exchange rates).

The G20 should call on experts to come up with draft definitions of what constitutes excessive volatility and speculation or abuse of the market. Without a consensus on what these labels mean, no constructive discussion is possible, much less proposals for practical measures.

Russia supports the extension of Joint Organisations Data Initiative (JODI Oil) to other commodities starting with natural gas (coal is tricky from technical point of view), with the caveat that this makes sense only if data on the financial aspects of respective markets are collected concurrently. If the gap between knowledge of 'physics' and 'money' remains as it is, there will be no basis either for analysis or for practical action.

Steps to a global information system

Russia has already started to apply this approach on the national level, introducing a law on the State Information System on Energy, which passed its first hearing in parliament in September. This experience could be useful if all agree that it is necessary to explore the creation of a global information system on energy data, supplementing existing databases of national and international bodies.

To conclude, the keys to success are a closer dialogue between the consumer and producer countries and the coordination of the energy policies of the major players. When, as happened in the spring, Russia learned about the release of US oil reserves from media reports and not from its counterparts on energy, it does not contribute to price stability. My strong belief is that this was just an exception that proves the rule. The rule is that everyone sits in the same boat, and only synchronised and carefully crafted energy policy will keep that boat afloat in the turbulent waters of today's economy. ◆

We need consultation rather than a ban on OTC derivatives trades

By Christian Katz,
chief executive officer,
Six Swiss Exchange

More than three years have passed since Lehman Brothers collapsed, precipitating a global financial crisis from which the world has yet to recover. Back in those dark days of September 2008, one of the key challenges facing market participants and policy-makers centred on the extent of over-the-counter, or OTC, derivatives trades in which not only Lehman but nearly all financial institutions were involved. Not centrally cleared, weakly regulated and often opaque, the vast OTC derivatives universe was extremely difficult to assess, in terms of both individual exposure and overall market vulnerability.

Politicians and regulators concluded, not unreasonably, that this situation was deeply unsatisfactory and that structural reform was needed.

G20 leaders subsequently stated that all standardised OTC derivatives contracts should be traded on exchanges, cleared through a central counterparty and reported to trade repositories. These proposals have since been ratified by the Dodd-Frank Act in the US, while the European Union has agreed to tighten regulation of OTC contracts and is working on legislation towards that end.

So far, so commendable. Regulated exchanges offer unparalleled liquidity, a supreme degree of transparency and very low transaction costs. During well-established opening hours, they operate robust trading platforms and provide strong protection against market abuse. Almost without exception, they performed superbly even during the most painful months of the crisis, proving easy to analyse, regulate and monitor. Furthermore, as exchanges realised that standardised OTC derivatives should and would move to regulated markets, they started to build new solutions to trade these contracts in a variety of asset classes, including foreign exchange, commodities, equities and bonds.

To superficial observers, therefore, it might seem logical to move all derivatives contracts on-exchange, ridding financial markets in one fell swoop of OTC trading – by its nature, hard to control or influence.

Such a move would be gravely misconceived. As with other markets, financial markets cater to a wide variety of customers, each with different needs. For some, price and liquidity are all-important; for others, discretion is paramount. Today, customers of financial markets have that choice. The suite of on-exchange derivative products is growing fast as the industry tries to implement private, entrepreneurial solutions to the problem, ahead of political, governmental remedies. Nonetheless, occasionally customers need something special – and that is where the OTC market comes in.

The important point is that OTC markets and centralised, regulated markets are in a symbiotic relationship, and each would be hard-pressed to survive without the other. OTC markets not only offer specialist service; they also spawn innovation. By their very nature, these are often the markets where new products are created. Once a new OTC derivative becomes more widely used and more standardised, it becomes more suited to regulated exchanges. This creates fresh liquidity, which serves as a basis for new investment and risk management approaches, driving further innovation in the OTC field.

That does not mean markets should be allowed to continue as they were before 2008. But it does mean financial market products are not essentially good or bad, and policy-makers cannot assume that they are.

We are at a crucial stage. And as we move towards the execution of structural reform and regulation, there is a grave danger of throwing the baby out with the bathwater, imposing blanket bans on certain products or certain trades, and weakening the entire financial system as a result.

OTC markets and centralised, regulated markets are in a symbiotic relationship, and each would be hard-pressed to survive without the other. OTC markets not only offer specialist service; they also spawn innovation

Now, more than ever, a consultative approach is needed, particularly on three key points.

First, how do we properly standardise derivatives, ensuring the abuses of the past are not repeated and making markets more effective, while giving them the freedom to flourish?

Second, if many more trades rely on central counterparties for clearing, how should we deal with the increased concentration of risk accrued at central clearing houses?

And third, if policy-makers are keen to consolidate trade data in trade repositories so there is a consolidated audit trail of trades, how can we ensure the costs involved are evenly spread in a global roll-out?

On the first point, market participants, policy-makers and regulators are already working on what is and what isn't a standardised derivative. It is essential that this consultative approach continues, even if it takes some time. Policymakers and regulators need to rely on exchange industry and banks' input, even if they retain ultimate decision-making powers. Certainly, we need to move more derivatives contracts onto exchanges and regulate them more closely, but such moves need to be effected with care and sensitivity. Outlawing all OTC trades, limiting short-selling, imposing unreasonable obligations on market-

makers, creating a financial transaction tax on trades – these are the kinds of proposals that may have superficial political appeal but would ultimately restrict market activity, thereby harming the pensions, savings and investments of the very people they are designed to protect.

We also need to bear in mind that increasing the role played by central clearing houses will minimise the risk borne by market participants, but it will also concentrate more risk in the clearing houses themselves. Some of them will become systemically relevant, so governments and central banks will have to treat them as such.

The question of achieving transparency through trade data is extremely important as well. Whether a global solution is feasible within the next few years remains very doubtful indeed. But, to date, at a regional level, much of the cost of data gathering, monitoring and so forth has been borne by regulated exchanges. If global trade repositories were to be constructed, captured volumes would soar – and so would costs. These must, therefore, be more fairly apportioned at a national, continental and global level, between the private and the public sector. Given that ‘guesstimates’ for the US alone range from $100 million to $2 billion, this is no small matter and due care should be taken before final decisions are made.

Overall, SIX Swiss Exchange is in favour of proposals to shift more OTC derivatives trading to regulated markets. The line between OTC and regulated markets must, however, be drawn intelligently in consultation with the industry. What should be avoided at all costs is excessive interference in regulated exchanges from well-meaning policy-makers. Most mature financial markets run by exchanges are well regulated, highly liquid and transparent. Putting too many obstacles in their way would encourage market participants either to withdraw from these regulated markets or to seek out new, unregulated ways of executing trades. Neither option is in the interests of regulators, traders or investors.

Injecting confidence into the derivatives markets

It is important that the G20 takes steps to bolster the commodity derivatives markets by implementing transnational financial regulation and focusing on scaling back the freedoms afforded to deregulated operators and markets

By Chiara Oldani, Department of Economics, University of Viterbo 'La Tuscia'

Commodity prices are influenced strongly by their derivatives, especially in the energy market. The commodities market has played a key role in financial markets over the past five years, thanks to the diversification it provided to portfolio managers, increased volumes of transactions and growing prices.

The markets for both exchange-traded commodities and over-the-counter (OTC) commodities are dominated by oil contracts, followed by agricultural products and precious metals. The largest exchange-traded commodities market is the CME-CBOT – the merged Chicago Mercantile Exchange and Chicago Board of Trade. According to the Bank for International Settlements, OTC commodity contracts reached the nominal value of $2,922 billion in the second half of 2010, corresponding to $526 billion in gross market value (see table, opposite). However, there is very little disclosure of detailed data on the counterparties, exposure, delivery and prices of OTC contracts.

According to finance theory, derivatives influence underlying contracts positively by reducing the spread between the bid and the ask price and by increasing market liquidity. Such positive effects are welcome in markets characterised by structural friction, such as the commodities market, where physical delivery and reserves strongly influence prices and demand. Nevertheless, the virtues of derivatives vanish in the presence of ineffective

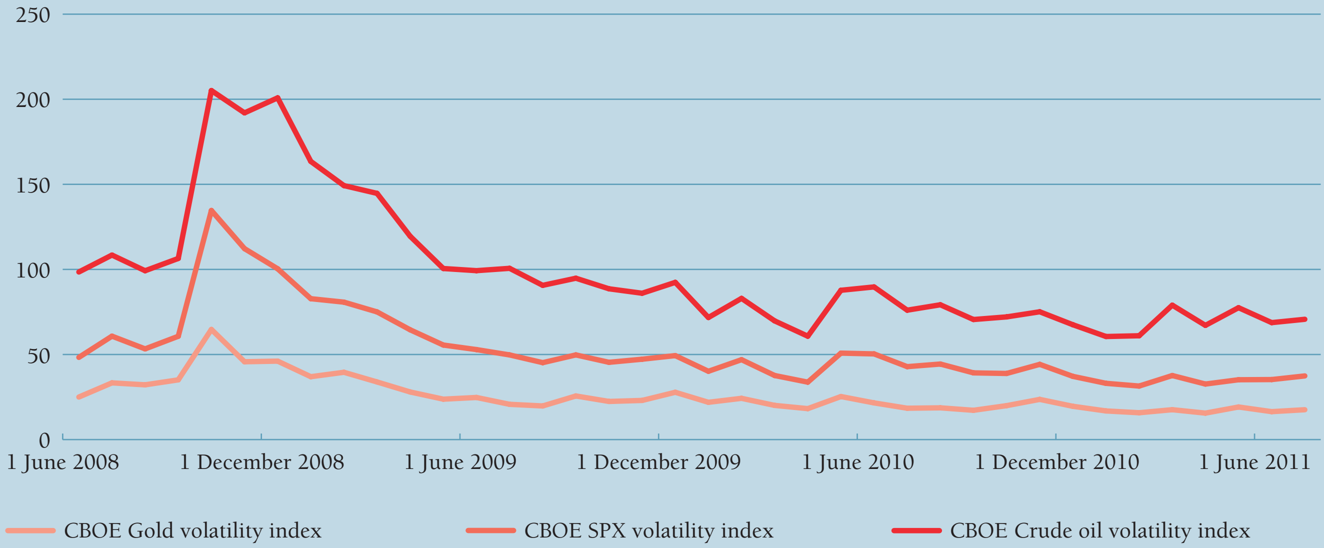
Table: Amounts outstanding (in billions of US dollars)

	National amounts outstanding				Gross market value			
	H1 2009	H2 2009	H1 2010	H2 2010	H1 2009	H2 2009	H1 2010	H2 2010
Commodity contracts[a]	3,619	2,944	2,852	2,922	682	545	457	526
Gold	425	423	417	396	43	48	44	47
Other	3,194	2,521	2,434	2,525	638	497	413	479
Forwards and swaps	1,715	1,675	1,551	1,781	…	…	…	…
Options	1,479	846	883	744	…	…	…	…

[a] Adjustments for double-counting partly estimated

Source: BIS Quarterly Review, 2011.

Graph: Monthly volatility indices



Source: Thomson Financial Datastream

regulation and supervision and market segmentation. Excess volatility in the commodities market is the result of excess demand combined with a thin market and constrained supply. After the subprime crisis of 2007-08, governments intervened to smooth excess volatility in the interest-rate market. Indeed, central banks in Europe, the United Kingdom and United States actively intervened in the interbank market to smooth the excess volatility of interest rates, thus reducing financial volatility. In 2010-11, central banks also intervened in the sovereign bond market.

Two factors explain the consequent freedom of the commodity and derivatives markets: the fear of the inflationary consequences of such interventions and the impossibility of acting successfully in all financial sectors. The oil volatility index and the gold volatility index are highly correlated to the financial volatility index (see graph, above). There is no conclusive evidence of any systematic influence of speculative activity in the commodities market, although the limitations of the available data will inevitably affect this result.

Most research so far has focused on the oil market, its efficiency and its relationship with the macroeconomy, while other commodities are neglected because they make up less than one-third of the market. Energy derivatives contracts proved to be efficient and liquid, by reducing the underlying market bid-ask spread. Prices of non-fuel commodities – for example, agricultural products such as coffee, wheat and maize – and metals have shown three-digit percentage increases over the past two years; in this market, the limited availability of hedging tools and the small amount of liquidity did not contribute to alleviating the loss of buying power for low-income population and small firms. For example, derivatives on pork bellies – a product widely consumed, but not appreciated, in financial markets – were delisted in July.

At this stage, the G20 needs to coordinate transnational financial regulation in order to restore and improve market confidence. The financial services regulations of the World Trade Organization should constitute the base from which the G20 should start its coordinating activity. The Cannes Summit should focus on diminishing the freedom of deregulated operators – specifically hedge funds – and markets (such as OTC derivatives).

The European Union recently stated that the "proposed EU Regulation has in key areas different prudential regulatory requirements for CCPs [central counterparties] than what the US has proposed so far [in the Dodd-Frank Act] and therefore this could potentially create market access problems for CCPs based in the US seeking access to the EU market".

The financial regulatory improvements (such as the US Dodd-Frank Act and directives passed by the EU) and capital requirements (specifically the Basel III reforms issued by the Basel Committee on Banking Supervision) should reduce the regulatory asymmetry and misalignment that, at present, fuel OTC sector volatility. In particular, OTC derivatives should be traded on exchanges and electronic platforms, in order to shift the clearing of these instruments away from opaque bilateral structures to centralised clearing through transparent, regulated CCPs. ◆

> "The markets for both exchange-traded commodities and over-the-counter commodities are dominated by oil contracts"

A new relevance for gold

By Aram Shishmanian, CEO of the World Gold Council

In 2001, the price of gold averaged $273 an ounce. Since then, the price has increased every single year, averaging more than $1,500 an ounce in the first six months of 2011 and rising still further since then. This performance has prompted suggestions that gold is a speculative investment; that it is in a bubble and that the price will surely tumble in time. But these suggestions have no basis in reality.

Even a cursory look at supply and demand data shows that the price of gold is being driven by robust market fundamentals. In 2010, global gold demand was valued at $157 billion, the highest figure on record. Appetite for bullion has continued this year, with strong quarterly figures in terms of both value and volume.

Behind these statistics lies a series of interwoven facts, which, together, are increasing gold's relevance in the world today.

Jewellery has been the prime source of demand for gold over many decades, and it remains in poll position. In 2010, it accounted for just over half of global demand and the trend has persisted this year. Consumer appetite is in evidence across the world, particularly in gold's cultural heartlands, China and India. The economic growth experienced by both countries is well-documented. As individuals become wealthier, they are purchasing gold as jewellery and as an investment, since both are seen as synonymous with wealth. This tremd presages well for the future, especially as higher prices have done nothing to dent demand – over the past decade, for example, gold has risen 400 per cent in rupee terms in India but demand has increased by 25 per cent. Adding to this groundswell, the numbers of people joining the Indian and Chinese middle classes are expected to soar by hundreds of millions over the next decade.

In the West meanwhile, a number of factors contribute to make gold part of the fabric of financial markets. This is not a new role. Indeed, gold has been considered to be a reliable hedge against credit risk, currency risk and inflation for some time. As the financial crisis has mutated from a mortgage crisis to a banking crisis and now to a sovereign debt crisis in the largest economies of the world, gold has been a constant source of value for savers, for investment managers and for the wealth of our nations.

Reserve asset managers have reassessed both the optimal level and composition of reserves needed. Significant reserves are required to survive in a world that, though three years into the financial crisis, remains deeply imbalanced. The world needs a multi-currency reserve system: that is evident from the 'Triffin dilemma' that contributed to the current crisis. But the nascent diversification into eurobond markets has been abruptly curtailed by the sovereign debt crisis. Exchange rate policies in the rest of the world, and the lack of sufficiently deep government debt markets elsewhere, have ruled out diversification. Gold has emerged as a solution.

Gold has been a constant source of value for savers, for investment managers and for the wealth of our nations

Emerging market countries around the world are buying huge volumes of gold and while European central banks have halted sales, the world's central banks are now large net buyers of gold. They have bought more than 200 tonnes of gold so far this year and are expected to accumulate considerably more

Emerging market countries around the world are buying huge volumes of gold and while European central banks have halted sales, the world's central banks are now large net buyers of gold

by the end – a far cry from the 400-tonne sales that were the norm only a few years ago.

The hardest challenges of all are being faced by the world's leaders. Our financial system is broken. Bold steps and new thinking are required to fix it – nowhere more so than in our global regulatory framework, which allowed financial markets to so badly misprice risk. The right steps are being taken.

G20 leaders' commitment to augment the use of central counterparty clearing houses and Basel III will reduce systemic risks, and here too gold is playing a role. Leading clearing-houses and international banks, such as the Chicago Mercantile Exchange in the US, ICE Clear Europe and JP Morgan, have started to accept gold as collateral. Gold's lack of credit risk, counter-cyclical behaviour and deep and liquid market make it an ideal choice. As the credit quality of other traditional sources of collateral continue to deteriorates, this use for gold is likely to grow. This is also a reason why the liquidity buffers proposed under Basel III should be extended to cover low risk and high liquid assets such as gold.

Other roles for gold may yet emerge, possibly in the international monetary system. This is currently being investigated by the highly respected think tank, Chatham House, where discussions are at an early stage.

In the meantime, three points stand out: supply and demand fundamentals for gold are stronger than ever, respect for gold is higher than it has been for decades, and appreciation for gold's relevance in today's troubled world is just beginning.

Commodities and the global economy

Rapid increases in the prices of key commodities in recent years have contributed to the lacklustre recovery from the global financial crisis seen in many parts of the world. Policies to reduce the effect of speculation on prices are urgently needed

By Donald GM Coxe, strategy advisor, BMO Financial Group

Why should the G20 concern itself with commodity prices? Don't the busy leaders of the world have more serious problems?

They need to be concerned about a new version of stagflation that threatens the global economy, with inflation rates forecast by the Organisation for Economic Co-operation and Development (OECD) remaining modest at a time of very strong commodity prices. The G20 leaders are rightly considering policy reforms to ensure that the prices of key commodities – particularly foods and fuels – are driven overwhelmingly by supply and demand, not speculation. Rising food prices have exacerbated the problems of the poor across most of the world, while soaring oil prices bring back memories of past recessions induced by oil shocks.

The rising price of foodstuffs

According to US data, in the past six years, the price of corn has roughly trebled, the price of wheat has doubled and the price of soybeans has more than doubled. Most food industry observers believe that corn's outperformance among the grains is because roughly 40 per cent of output is mandated into the production of ethanol. Wheat prices have responded primarily to adverse weather conditions in the key exporting countries. Last year's embargo of Russian wheat exports produced a sudden sharp price increase worldwide, but prices have since stabilised.

The basic driver of grain prices is the increase in vegetable protein demand from rapidly growing Asian economies. The number of hectares under cultivation worldwide has been increasinging more slowly than the rate of consumption, although increased use of fertilisers and other technologies has increased output in most of the major grain-growing areas. However, as the CEO of Nestlé said, when asked how to reduce food inflation: 'Ban ethanol!' Ending European demand for palm-oil-based diesel fuels is also worth consideration. Can farmers produce enough grain and oilseeds to feed the world – and keep oil prices under control? Not likely.

Many observers also note that pension funds and other investors in passive commodity funds that roll over their exposures as contracts expire have accumulated large positions in the grains at various times in recent years. Considering the Open Interest positions at the Chicago Mercantile Exchange (CME), a reasonable observer could conclude that when new investment funds were pouring into these contracts, they – temporarily at least – accentuated upward price moves.

The oil business is so huge in comparison to the grain business that it attracts speculators and hedgers on a vast scale. Once again, the passive investors in rollover funds seem to be capital suppliers to oil producers and professional speculators, rather than price manipulators or generators of commodity inflation.

Historically, oil prices have tended to trade in what is known as 'backwardation': the 'front month' contract is priced higher than the next months, so a passive investor keeps earning the difference as contracts are rolled over.

However, since US financial authorities began requiring oil companies to price their forward hedges – long and short – to market, oil futures have tended to trade most of the time in 'contango' – in which oil for future delivery trades at a higher price than spot. As a result, passive investors lose almost every month, as they end up acquiring fewer barrels of oil. The stronger the oil market, the more money they lose. That these roll funds and stock exchange-traded vehicles still have such huge sums under management is remarkable.

After the crashes and bailouts of 2008-09, governments and regulators are reviewing the large scale of oil, gas and products trading that is not effected transparently on exchanges, but do so undisclosed – through financial institutions. To many observers, it is unclear why non-transparent trading offers societal benefits. What is clear is that the financial industry has tended to vigorously resist all attempts to constrain its commodity operations.

> "Rising food prices have exacerbated the problems of the poor across most of the world, while soaring oil prices bring back memories of past recessions"

Eminent personages such as American economist Paul Volcker have long complained that banks' involvement in commodity trading puts them at risk without generating benefits to society at large. Governments could conclude that financial institutions

whose failure would put the economy at risk should not be permitted to trade commodities for their own accounts – except on public exchanges where the scale of their involvement and risk is made public.

Regulating the commodity exchanges

The US Commodity Futures Trading Commission proposes position limits on the scale of derivative contracts – futures and swaps – on 28 commodities, including foods and fuels. No participant would be permitted to control more than 25 per cent of 'deliverable US supplies' for any covered commodity (apart from commercial hedging for normal business purposes – such as flour mills hedging their exposure to wheat, or oil refiners hedging their exposure to oil).

At first sight, non-commodity investors might regard these rules as reasonable. They are controversial, however, precisely because history shows that attracting speculative capital into futures markets from outside those markets has benefited farmers, miners, oil producers and refiners, bakers and food processors. These consumers need to hedge their inventories and price risks, and highly liquid futures markets have been crucial for them. That said, huge speculative positions in foods and fuels can certainly drive prices far higher – at least for a few months – than market forces would dictate.

Historically, commodity exchanges have tended to be tardy about imposing higher deposits on futures contract exposures when a commodity is in a runaway bull market. Perhaps governments could consider imposing automatic increases in investors' and speculators' cash commitments when a commodity rises more than a certain percentage within a defined period of time. That kind of self-functioning constraint would probably have prevented oil from leaping from \$96 to \$147 a barrel in five months in 2008 – and collapsing to \$36 in the ensuing panic.

Traders in the Corn options 'pit' at the Chicago Mercantile Exchange Group in Chicago. The price of corn has trebled over the past six years

Although OECD governments have long agreed in principle that embargoes on food exports carry damaging consequences for the global economy, they still happen. One reason is that food processors, farmers and investors manage their businesses by estimating future grain prices using data on global inventories and crops yields. When a major grain exporter suddenly embargoes its exports, the disruption is global – the equivalent of the impact on oil prices of a sudden civil war in a major oil-producing state.

Uncharted territory on prices

High commodity prices have historically been the best 'cure' for high commodity prices – as excess production is brought on stream, driving prices down and keeping them down for years.

This time seems to be different – because history offers no parallel to the sudden, sustained growth in commodity demand from China, India and Indonesia. The OECD has no experience with sustained high prices for foods and fuels at a time of slow economic growth.

The commodity futures markets also lack that experience. Therefore governments should agree how to ensure that those markets collectively respond in consumers' interests. ◆

Life

**As the world grows smaller,
the ifs in life are getting bigger.**