

Excessive Speculation in Commodities

Michael Masters

Financial Reform And The Real Economy

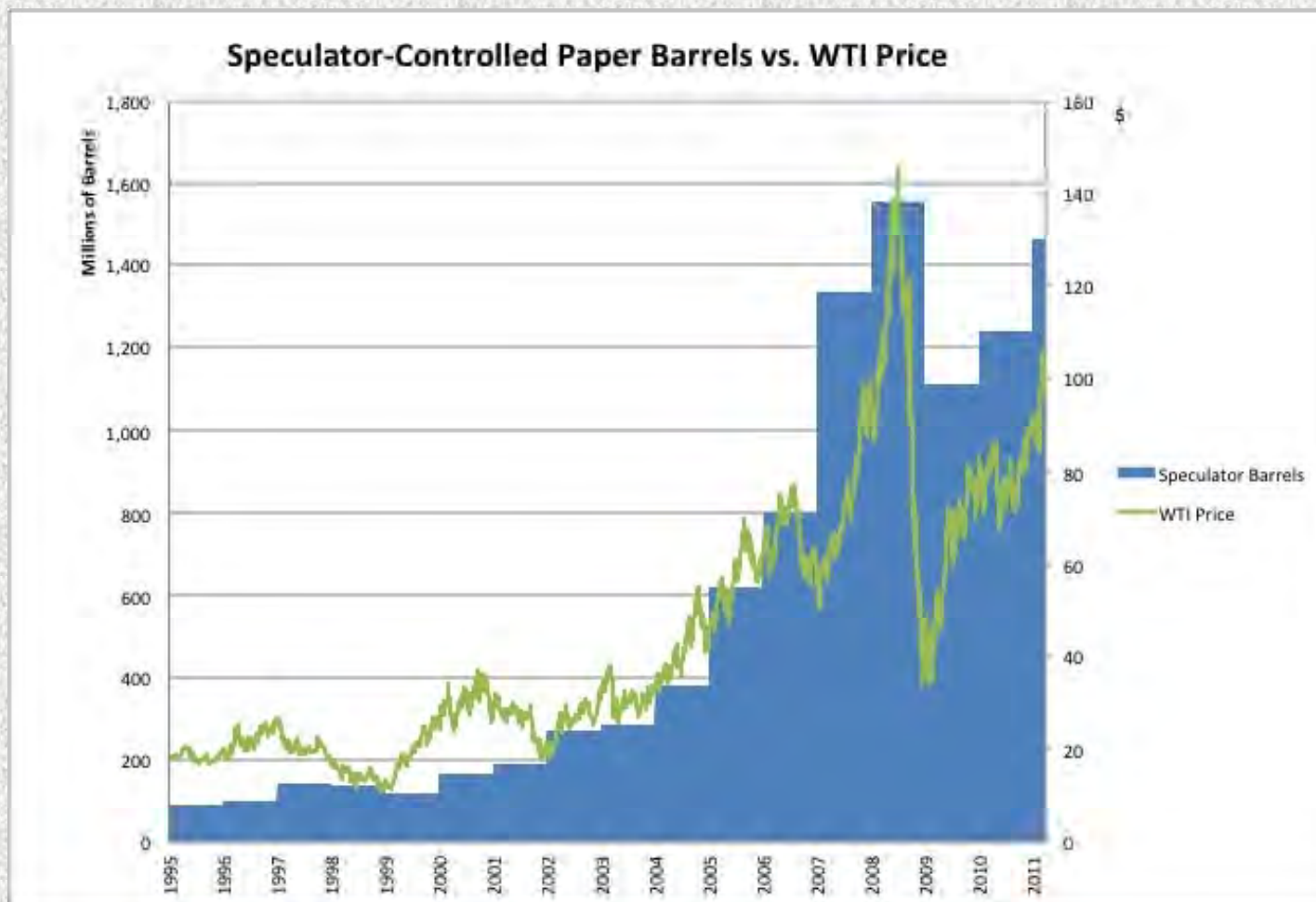
Ford Foundation, New York City

April 13th 2011



“Added Liquidity” or Market Invasion?

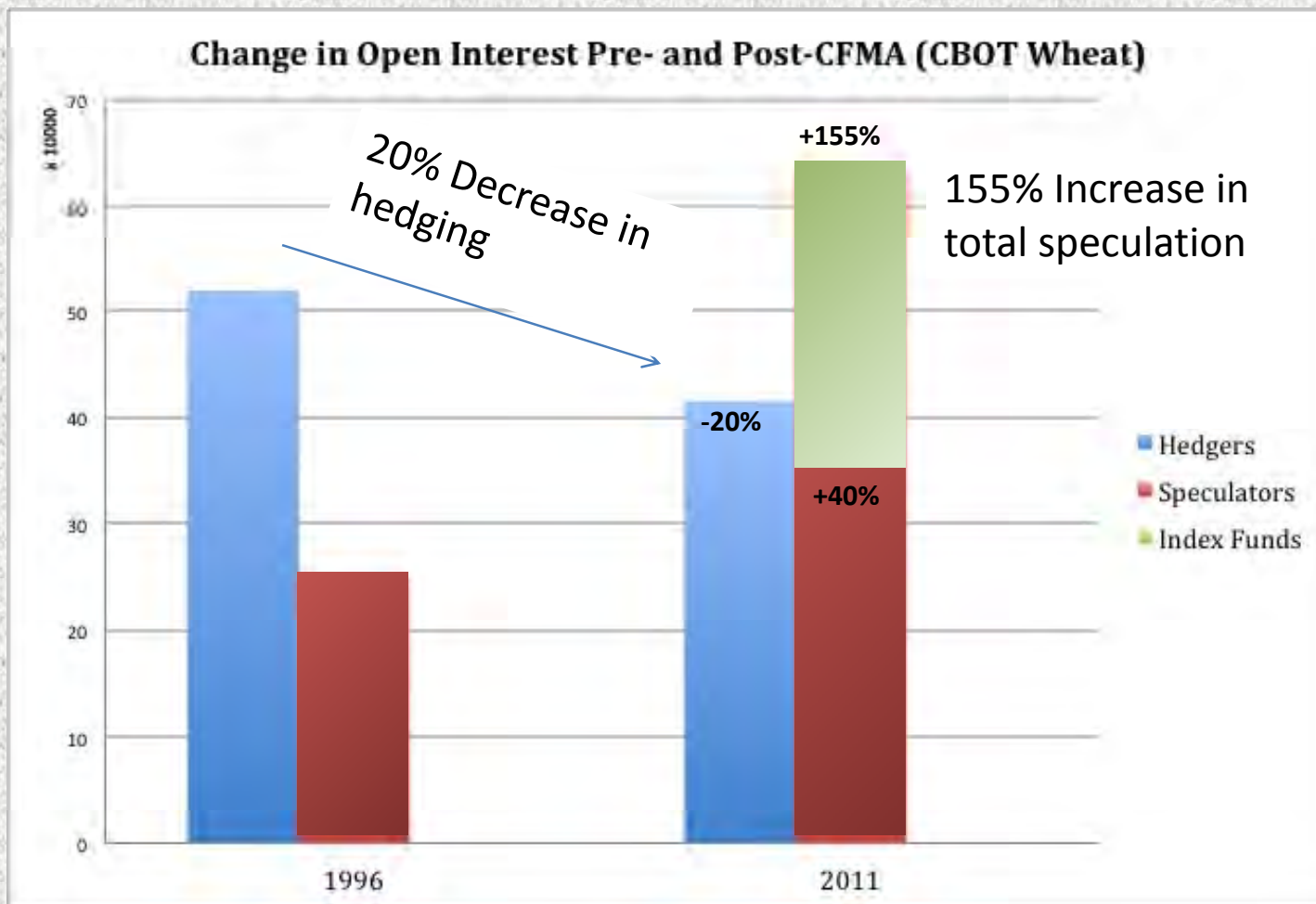
- *Opponents of regulation claim that increased speculation has added liquidity.*
- *Yet, in the late '90s and early '00s nobody complained that there was insufficient liquidity.*
- *Since then, speculators have increased their holdings by around 4000%. Today, they hold NYMEX contracts equivalent to 1.5 billion barrels.*



What About The “Primary Constituents”?

Since Deregulation in 2000:

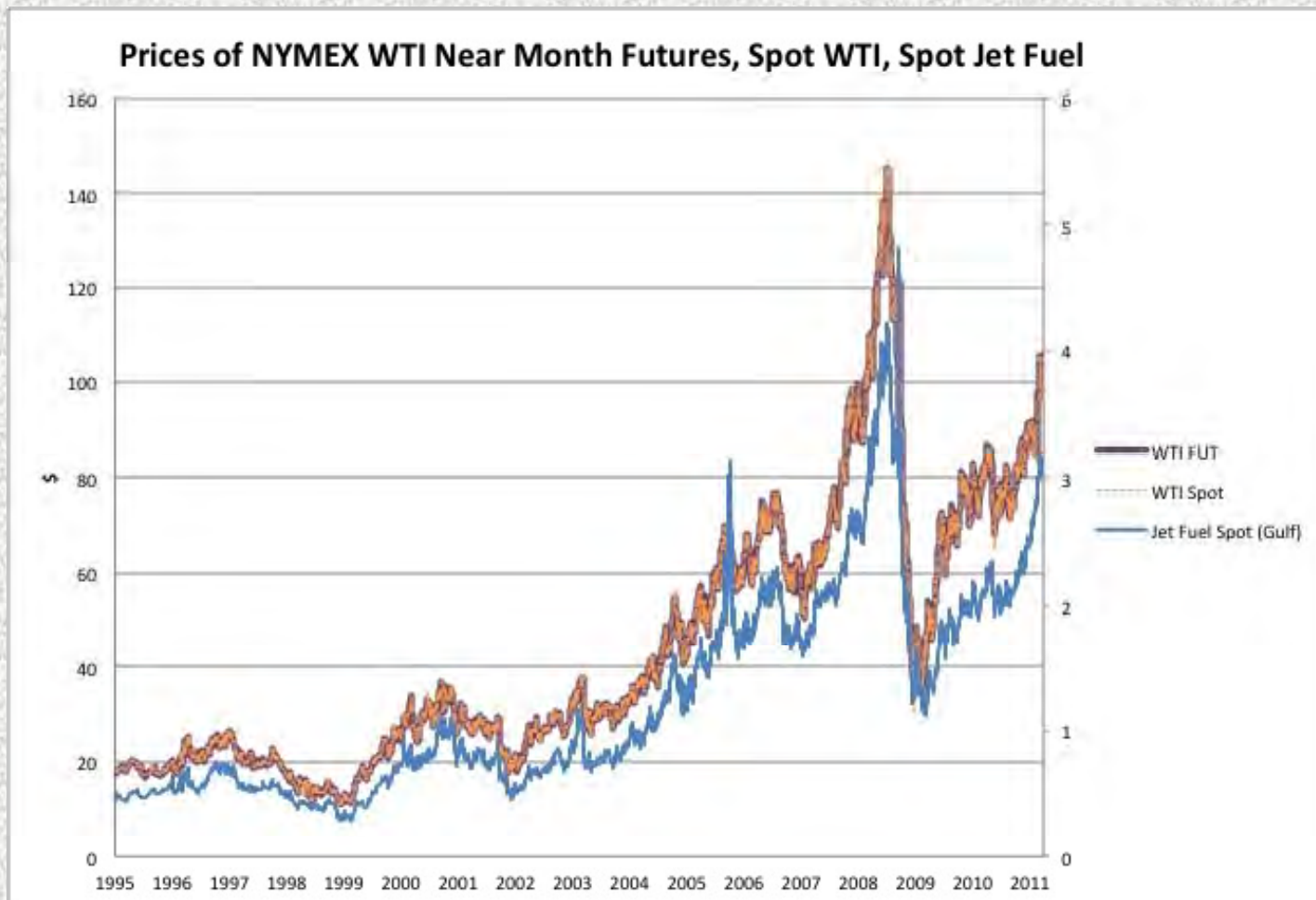
- *Hedgers used to be 70% of the market, with speculators the other 30%.*
- *Since CFMA, the ratio has reversed, with speculators 70% and hedgers just 30%.*
- *Commodity Index Funds are a key component of this change.*



Futures Prices And Spot Prices Move Together

Futures prices
DRIVE spot prices
because:

- *Futures prices set the benchmark price for physical auctions.*
- *Many physical delivery contracts DIRECTLY use futures prices as their reference price.*



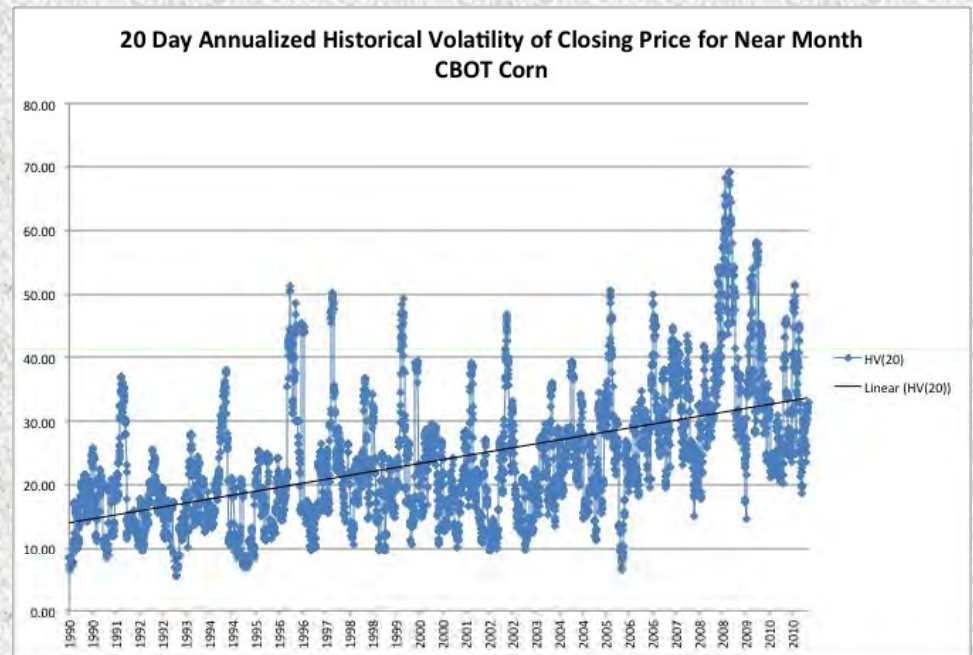
Excessive Speculation Hurts Producers

- **Hedging costs more** because excessive speculation makes futures prices higher and more volatile.
- **Hedging works less well** due to non-convergence caused by the presence of structured financial products (Commodity Index Funds).
- **Physical prices become distorted** and less dependable because they follow the futures markets.

Higher
Hedging
Costs

Worse
Hedging
Value

Distorted
Physical
Prices



What Must We Do To Fix The Problem?

Restore The Markets To The Structure That Worked So Well Until Deregulation Destroyed It:

- The existing CFTC proposal is inadequate to tackle excessive speculation.
- We need a 30% cap on the overall level of speculation in each commodity market.
- Additionally, we need to eliminate or severely limit commodity index traders.

