International Chamber of Commerce
The world business organization

Mitigating the adverse impacts of commodity price volatility

Issue

Challenge: Commodity markets are inherently volatile, as evidenced by the 2007-2008 rise and fall of prices as well as by recent fluctuations due to global political tensions. Rising commodity prices, particularly for fuel and food, have placed millions at risk of malnutrition and hunger and are exacerbating social and economic tensions worldwide. During the recent period of global economic expansion – 2002 to 2008 – the factors that drove prices were a combination of strong global demand in emerging markets for global commodities, slow supply responses, and low inventories, thus reducing the ability of markets to react to events.

The post-quake humanitarian emergency in Japan and current unrest in the Middle East and North Africa remind us that we operate in a volatile world and must be ready to respond to external events. At the same time, we increasingly feel the effects of a long-term trend of surging global commodity demand, driven mainly by Asia's vibrant economies. The recent volatility in commodity prices has been largely driven by the underlying fundamentals, particularly in an environment of significant shifts in global supply and demand patterns. Much political, social and economic volatility is – by definition – short term. And the impacts are amplified by unprecedented speed of communication and by the increasing interconnectedness of the global economy. In addition, climate change impacts could add to worsening conditions in many areas.

Opportunity: In Cannes, G20 leaders have a historic opportunity to play a role in mitigating the adverse impacts of commodity price volatility. ICC welcomes the G20 Action plan on Food Price Volatility and Agriculture from the 22-23 June Meeting of G20 Agriculture Ministers in Paris. In particular, we stress the importance of; i) the need for a significant increase in agricultural production and productivity, ii) improved information in particularl for agricultural markets, iii) greater policy coordination, and critically iv) brining the Doha Round to a successful conclusion and avoiding trade barriers. This is a step in the right direction but more needs to be done, not only in Cannes but also in subsequent G20 meetings. The private sector is ready to work in partnership with G20 governments to achieve the recommendations that follow.

Analysis

1. *Role of financial investors in commodity markets*

Many have pointed to the role of financial investors in commodity markets as a crucial factor driving price volatility. An UNCTAD report on the role of speculation suggested that the acceleration and amplification of price movements can be attributed to commodities as a group[1]. Yet others have demonstrated that spot prices cannot be influenced by financial investors as they "only participate in futures and related derivative markets and only if they take and hold physical commodities in inventories" will they have an influence on prices[2]. The increase in participation of financial investors in commodity markets deserves proper analysis, but in general, the addition of greater liquidity and product innovation should aid

[1] UNCTAD (2011). Policy actions to mitigate the impact of highly volatile prices and incomes on commodity-dependent countries and to facilitate value addition and greater participation in commodity value chains by commodity-producing countries. Note by UNCTAD Secretariat. 2 February 2011, Geneva
[2] IBID

price discovery, provide enhanced risk tools and, with the right regulatory framework, help to reduce price volatility.

However, focusing solely on limiting the role of financial investors could have negative effects on volatility. The commodity markets reflect an understanding of the fundamentals of the marketplace today and tomorrow. It is primarily fiscal and regulatory uncertainty that discourages investment and it is inadequate investment that causes the long-term disjunction between supply and demand that leads to such marked price volatility. Regulating to limit the role of financial investors in the market would do nothing to address this.

G20 leaders should instead focus on ensuring competitive markets with improved levels of aggregate supply and demand information thus providing a a strong basis for understanding price formation and thereby attract additional market liquidity. Fundamentals are the key drivers of price volatility, and the mix of rapidly changing demand patterns with long lead time investments in recent years has proved a significant challenge for the private sector.

Over-the-counter derivatives (OTC), which companies use to protect against future movements in the price of commodities, are traded privately between businesses and banks, without being processed through a central clearing house to safeguard against the risk of default. They allow companies to cope with the sector's volatility, and increasing complexity.

In the wake of the global financial crisis, policy-makers have indicated their intention to increase the transparency of the derivatives market. One proposal is to push OTC transactions onto the public exchanges, while another is to require mandatory clearing of all trades through regulated central counterparties. While there is a clear need for greater transparency, governments and regulators must be wary of unintended consequences, particularly of limiting the private sectors ability to hedge risks.
Eliminating OTC deals, or forcing them all to be cleared centrally, would drive down business investment. To meet exchange collateral requirements, companies may have to divert investments in new productive capacity and technology. That would increase, rather than moderate, volatility.

G20 leaders should address the role of financial investors in commodity markets by:

- developing more predictable fiscal and regulatory frameworks that can ease volatility, and prompt the markets to take a longer-term view;
- providing more up-to-date information about the fundamentals of the marketplace; and
- avoiding measures that may increase volatility such as overregulating OTC deals.

2. Food[3]

Historically achieving food security was based on the expansion of agricultural land and productivity growth. Today, however, additional challenges exist which lead to a new agricultural production context causing increased pressure on both land and resources. Most agricultural commodity markets are characterised by a high degree of volatility. This is normal, as agricultural outputs vary due to natural shocks, demand elasticity relative to price, and long production cycles. As in 2007-2008, today the main concern about food price volatility is principally its role in raising prices on basic staples, particularly for the poor.

[3] This section should be viewed concurrently with more detailed IBC-ICC G20 CEO Task Force – Food Security Working Group Recommendations for G20 Agricultural Action Plan

Moreover in many developing and least developed countries, food security poses enormous challenge where even a marginal food shortage and its consequential adverse impact in terms of surging food prices can pose serious threat. Globally, there are about one billion people who are undernourished and every rise in food prices shifts millions of people below the poverty line.

Growing population and income in emerging and developing countries will also add significant demand for food in coming decades – by 2050 the world's population is expected to have reached at least 9 billion and the demand for food to have increased by 70 to 100% - this alone putting significant pressure on commodity prices[4]. In addition, climate change impacts, including water scarcity or droughts, could make conditions worse in many parts of the world.

Furthermore, domestic fears of food shortages in many countries are encouraging hoarding and a consequent turning away from the market in many parts of the world. A whole host of bans, quotas, taxes, and other restrictions on the export of food, and of other commodities and raw materials, is proliferating. Export restrictions distort an efficient domestic response to changes in food supply, exacerbate both price hikes and shortages, and add to overall agricultural inefficiencies that leave hundreds of millions hungry.

G20 leaders have rightly made the achievement of food security a high priority. The private sector has a key role in agricultural systems and is ready to work collaboratively with governments and civil society to address these challenges.

G20 leaders should address volatility in food commodity prices in the short term by:

- opening global markets to food trade by successfully concluding the Doha Round;
- avoiding export restrictions, price controls and similar bans as these will discourage the necessary additional investment required for agricultural production, impede access to agricultural raw materials, and threaten food security;
- eliminating trade-distorting subsidies to ensure a level playing field in the global marketplace; and
- avoiding limits on the use of technology which can hinder opportunities and deprives farmers of agricultural tools.

Over the longer-term, G20 leaders should address volatility in food commodity prices by:

- insuring cost-effective approaches to competition from other sectors for access to land, water, nutrients and energy sources;
- boosting innovation, education and capacity-building to better mitigate and manage price volatility including via improvement in agriculture distribution and storage systems; and
- focusing efforts on sustainable production and supply involving public-private collaboration and modern technologies integrated with local and traditional knowledge, as well as improving education and capacity-building.

[4] "Price Volatility in Food and Agricultural Markets: Policy Responses. Policy Report with contributions by FAO, IFAD, IMF, OECD, UNCTAD, WFP, the World Bank, WTO, IFPRI and UN HLTF, 2 June 2011

3. Energy price volatility

Rising energy prices, particularly for oil, are a threat to the recovering global economy and will strengthen inflationary pressures and cause a negative impact on the private sector, especially in developing countries. In addition this impact will be particularly strong on energy suppliers, transport industries, energy-intensive industries and service providers.

Many governments, notably in developing countries, have taken measures such as fossil fuel subsidies to lessen the impact of oil price volatility. A long-term policy goal should be to replace these subsidies with effective social protection programmes leading to both economic and environmental benefits.

The view that speculators are the main force behind fluctuations in energy markets, especially crude oil, has been challenged by recent analysis[5]. Instead market fundamentals – factors that disturb the balance between supply and demand are the likely primary drivers. High movements in the price of oil for example, are exacerbated by incomplete and obsolete market information. For instance, the International Energy Agency (IEA) can only publish oil statistics with a time lag of more than a year. In the absence of up-to-date information, the price of oil sometimes fails to reflect the underlying fundamentals of the marketplace.

G20 leaders should look to mitigate energy price volatility by:

- taking measures to diversify the energy mix to meet growing demand. No technologies or energy sources should be excluded as innovation may provide solutions to overcoming barriers that limit the use of some technologies today;
- creating a policy environment that rewards energy-efficient choices and encourages innovation over the medium and long term;enhancing the interconnectedness of energy systems, both primary and secondary, in order to reduce risks and increase flexibility;
- ending wasteful consumption subsidies while managing the phase out of targeted subsides for the poor - G20 leaders have already committed to phasing out over the "medium term" some of the $557 billion spent annually (2008) on fossil fuel subsidies;
- removing trade barriers, improving access to natural resources, and opening markets to competition to help minimize potential disruptions;
- reducing energy demand and energy needs along the supply chain, as well as extending resource life; and
- encouraging the International Energy Forum to press on with its Joint Oil Data Initiative.

4. Access to raw materials

Government interventions such as export restrictions for certain critical raw materials (e.g. rare earths, raw materials) can lead to supply constraints that induce excessive price volatility. As a consequence, increases of raw material prices combined with supply insecurities raise concern for producers and consumers regarding future production and ability to deliver finished goods. This uncertain environment drives consumers to change inventory management practices, thus exaggerating pricing signals, which in turn lead to increased volatility.

Overall government interventions such as export quotas or export taxes for critical raw materials like rare earths, lithium or other metal raw materials may hamper global

[5] "IEA experts examine fluctuations in this month's Oil Market Report" www.iea.org 21 March 2011

competition and could WTO-rules. Trade restrictions enacted in one country risks exacerbating global trade tensions and could have negative consequences for the WTO ruled-based trading system.

Market access to certain raw materials is essential for the future development of innovative technologies to tackle global challenges such as climate change or e-mobility. In addition, research and development of new products based on foreseeable production technologies depend on it. Therefore, if we are to meet global challenges efficiently and create a future with sustainable products and production methods, a stable and secure supply of these raw materials is essential.

Recommendations

Finally G20 leaders should look to improve access to raw materials by:

- avoiding interventions such as export quotas or taxes that are non WTO consistent;
- encouraging greater dialogue, including with the private sector on issues related to access to raw materials; and
- enhancing market access to raw materials that are, for example, critical to deal with global challenges such as climate change.

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