Comments on IIF Task Force Report

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RESOURCES FOR THE FUTURE

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IIF’s Commentary on Research & Policy

- Not a research paper, but an assimilation of research from a valued practitioner perspective.
- Moderate tone and modest recommendations. Far above the level of many “white papers” offered up to serve a private agenda.
- Provocative for what it says about what research has so far achieved, and what remains to be accomplished.
- To be illustrated using five quotations drawn directly from the IIF report.

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1. Impact of Speculation on Prices

"Proponents argue that speculation does have a measurable impact on trends in commodity prices …"

- Correlation & Granger causality between trading and prices.
- What policy issue motivates this line of research?
  - Speculation affects prices? (Hopefully)
  - Speculation creates bubbles? (Hopefully not)
- Explosive behavior = bubble? (Phillips & Yu, 2010)
- Are we researching the right issue?

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2. The Role of Index Investors

"Non-commercial speculative activity is active in nature, as participants take both short and long positions. Index investors are classified as 'passive' investors; they mostly take long-only positions."

- Barclays Capital survey. (Norrish, 2010)
    - 43% diversification
    - 31% absolute returns
    - 17% emerging market growth
    - 9% inflation hedge
- Why does motivation of index investor matter?

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2. The Role of Index Investors (cont.)

- Noise traders falsely believe they have special information about the future price of the asset. (DeLong, et al, 2010)

- Noise traders may cause bubbles.

- Are index investors noise traders?

- Hedge funds may have stronger bubble potential, but are less researched. (Buyuksahin & Robe, 2010)

- Are we researching the right issue?

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3. Futures and Spot Price Divergence

"According to the Senate report, divergence between futures and cash prices, particularly when close to contract expiration, can be interpreted as an indicator of excess speculation."

- Convergence is achieved via arbitrage.
  (The Law of One Price)
- Does speculation or financialization impair arbitrage? Else, the Senate claim is not credible.
- Divergence may be caused by contract specs regarding delivery.\
- Theory should help us know what evidence to examine.

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4. Speculation in Non-Traded Goods

"The prices of these commodities reflect industrial demand, but are not traded in futures markets—as such, the index is seen as speculation-free and a good indicator of underlying supply and demand factors."

- Cash prices are influenced by speculation in the spot market (commercial traders).

- Spot market speculation is instrumental in disseminating private information, eliminating differences in beliefs, and reducing speculative futures trading. Smith & Thompson (2012)

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5. The Campaign for Transparency

"Proponents (of reform) and opponents alike would be able to benefit if the CFTC made its LTRS data set openly available, allowing a clearer assessment of the possible impact of speculation on prices."

- **Regulators and the public both value data transparency.**
- **The regulator (CFTC) is subject to strictures that sharply limit transparency. Paradox but no surprise.**
- **How can greater transparency be achieved within the letter of the law?**

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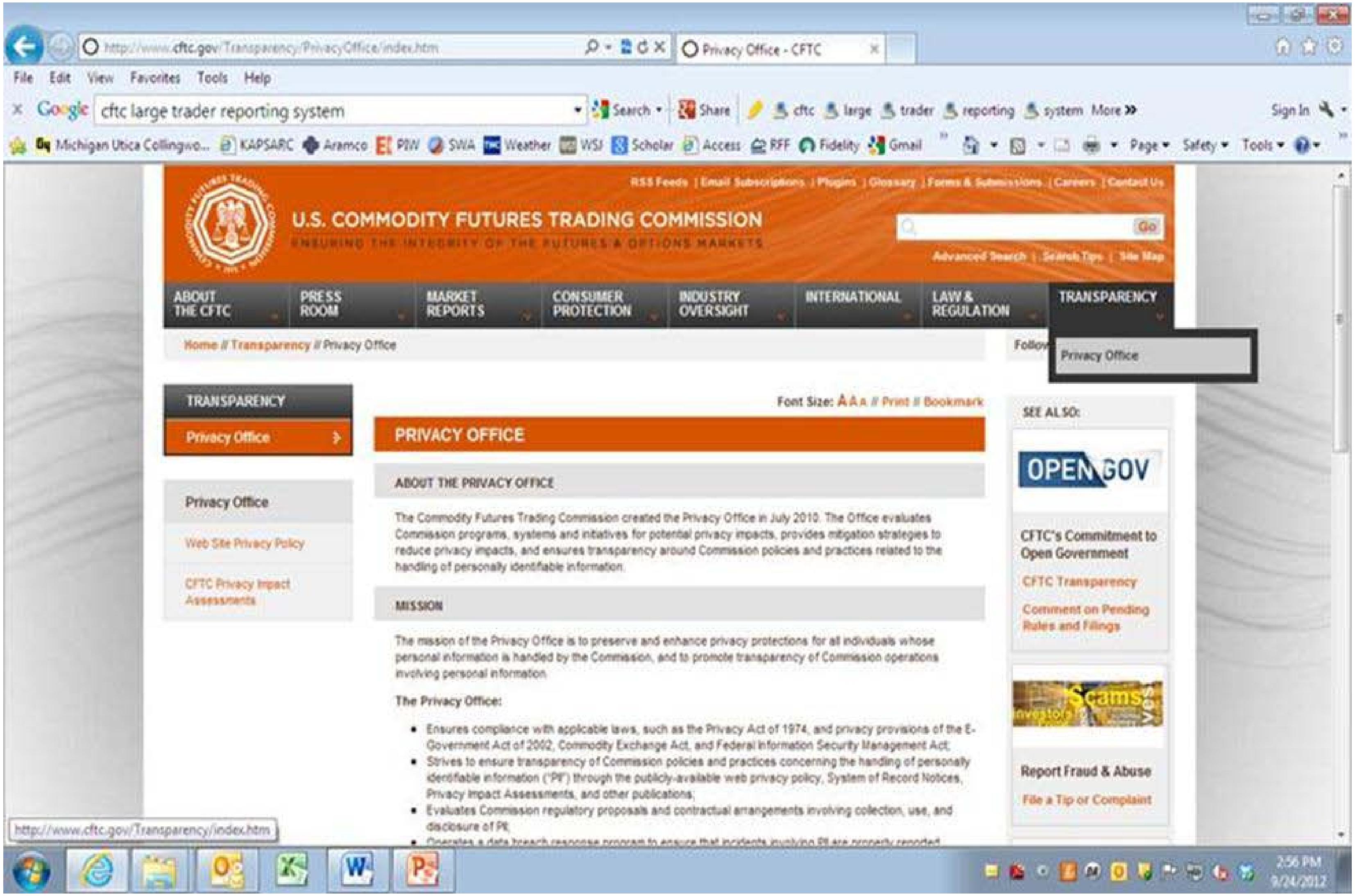
5. Transparency (continued)



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Déjà Vu, All Over Again

"The popular fear of engrossing and forestalling may be compared to the popular terrors and suspicions of witchcraft. The unfortunate wretches accused of this latter crime were not more innocent of the misfortunes imputed to them, than those who have been accused of the former.

No trade deserves more the full protection of the law, and no trade requires it so much, because no trade is so much exposed to popular odium."

-- Adam Smith, *The Wealth of Nations*, 1776

Thank You

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