



Role of Speculation –A False Confidence in the Commodity Market

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Available online at: www.isca.in

Received 29th August 2012, revised 30th August 2012, accepted 3rd September 2012

Abstract

The term speculation is known as the practice of buying at low prices with the intention of selling later at a higher price. Speculation periodically becomes the subject of intense debate. One claim that speculation, especially in the form of short selling, leads to higher market volatility. Another claim is that speculation leads to unjustified drops in price, in late 2008, the Securities and Exchange Commission imposed a temporary ban on short selling of the stocks of certain financial institutions. But the problem is not always short-selling. It is commonly stated that speculative buying by index funds in commodity futures and over-the-counter derivatives markets created a ‘Fizz’ in commodity prices, with the result that prices, and crude oil prices, in particular, far exceeded fundamental values at the peak. Speculators sometimes are accused of causing unjustified rises in prices. Speculation has always been criticized in the popular language and political discourse, such as to make easy money at the gaming and gambling, also has been made responsible, especially when linked to hoarding, to produce higher prices and thereby harm consumers. This paper is an effort made to draw the attention on the urgency need of speculation and its role in trading system especially in oil, gas and food prices. In this paper, it is concluded that speculation has tremendous impact on the economic growth and the economic system. The researcher focuses on the need to initiate actions to control gambling so that the currency rate can be in bar.

Keywords- Speculation, commodity, trading system, derivatives, economic growth.

Introduction

Speculation generally includes the credit of money for the purchase of resources, a guarantee or debt but in a style that has not been given thorough evaluation or is considered to have low edge of protection or a considerable chance of the loss of the major investment choice. Investors may depend on a resource admiring in price due to any of a number of aspects that cannot be well enough comprehended by the speculator to make an investment-quality choice. Some such aspects are moving customer choices, varying financial circumstances, purchasers' modifying thoughts of the worth of a standard options protection, financial aspects associated with industry right time, the aspects associated with completely chart-based evaluation, and the many impacts over the short-term activity of investments. There are also some economical automobiles known speculations.

Impact of Speculation on Indian Stock Market

Sustainable Consumption Development: Speculation usually involves more risks than investment. Service provided by speculators to a market is that by risking their own capital in the hope of profit, they add liquidity to the market and make it easier for others to offset risk, including those who may be classified as hedgers and arbitrageurs. When a harvest is too small to satisfy consumption at its normal rate, speculators come in, hoping to profit from the scarcity by buying. Their purchases raise the price, thereby checking consumption so that the

smaller supply will last longer. Producers encouraged by the high price further lessen the shortage by growing or importing to reduce the shortage. On the other side, when the price is higher than the speculators think the facts warrant, they sell. This reduces prices, encouraging consumption and exports and helping to reduce the surplus.

Market efficiency: A speculator (e.g., a pork dealer) may exploit the difference in the spread and, in competition with other speculators, reduce the spread. Some schools of thought argue that this creates an efficient market. But it is also true that, as more and more speculators participate in a market, real demand and supply can become diminishing small compared to supply and demand which is a result of speculation and thus prices become distorted and bubbles appear.

Bearing risks: Speculators also sometimes perform a very important risk bearing role that is beneficial to society. For example, a farmer might be considering planting corn on some unused farmland. Alas, he might not want to do so because he is concerned that the price might fall too far by harvest time. By selling his crop in advance at a fixed price to a speculator, the farmer can hedge the price risk and is now willing to plant the corn. Thus, speculators can actually increase production through their willingness to take on risk

Finding environmental and other risks: Hedge funds that do fundamental analysis "are far more likely than other investors to try to identify a firm's off-balance-sheet exposures", including

"environmental or social liabilities present in a market or company but not explicitly accounted for in traditional numeric valuation or mainstream investor analysis", and hence make the prices better reflect the true quality of operation of the firms.

Winner's Curse: The winner's curse is however not very significant to markets with high liquidity for both buyers and sellers, as the auction for selling the product and the auction for buying the product occur simultaneously, and the two prices are separated only by a relatively small spread. This mechanism prevents the winner's curse phenomenon from causing miss pricing to any degree greater than the spread.

Economic Bubbles: Speculation can also cause prices to deviate from their intrinsic value if speculators trade on misinformation, or if they are just plain wrong. This creates a positive feedback loop in which prices rise dramatically above the underlying value or worth of the items. This is known as an economic bubble. Such a period of increasing speculative purchasing is typically followed by one of speculative selling in which the price falls significantly, in extreme cases this may lead to crashes.

Volatility: Overall return volatility approximately three times higher than the stock market index benchmark. Such levels of volatility, responsible for his spectacular investment performance, would be achievable today only through the most aggressive instruments. It is a controversial point whether the presence of speculators increases or decreases the short-term volatility in a market. Their provision of capital and information may help stabilize prices closer to their true values. On the other hand, crowd behavior and positive feedback loops in market participants may also increase volatility at times. It is a controversial point whether the presence of speculators increases or decreases the short-term volatility in a market. Their provision of capital and information may help stabilize prices closer to their true values. On the other hand, crowd behavior and positive feedback loops in market participants may also increase volatility at times.

Study of Live Examples of Changes in NSE Nifty and BSE Sensex Indices in December 2011

It was positive momentum for the afternoon trade of January 6 in the NSE and BSE stock market, but morning trade saw both the NSE nifty and BSE sensex indices exhibiting downtrend. While nifty reached a low of 4,686.85, it soon rose 4.15 points or 0.09% to end at 4,754, BSE sensex ended flat with a rise of 10.65 points or 0.07% at 15,867.73. Selling pressure was witnessed in metal, realty and capital goods stocks in the morning trade.

Investors were taken by surprise in the afternoon trade with European markets going green. With market rumors about an expected joint conference from both Reliance and ADAG being spread, or in short rumored stock recommendations, ADAG

stocks saw fast buying, triggering the NSE Nifty and BSE sensex indices going up in the afternoon trade. The automobile segment, especially two and three wheelers, ended on a negative note. It was oil marketing companies listed on BSE sensex and NSE nifty that closed up with decent gains owing to declining international crude prices.

Speculation in the Oil Market

Historically, the primary driver of oil price has been global demand. An expanding global economy demands more raw inputs, including oil, and this increased demand pushes up prices. However, the past decade has seen a surge in the financialization of commodities—that is, the creation and trading of financial instruments indexed to commodity prices. Many policymakers and economists have observed that this rapid and unprecedented growth in commodity index trading coincided with a boom in commodity prices; some have extended that observation into a conclusion that speculation by financial traders—and not supply and demand—drove the recent bubble in commodities.

This kind of argument is perhaps strongest in oil markets, where large investment banks, hedge funds, and other investment funds have invested billions of dollars in oil futures contracts over the past decade. We investigate these allegations by identifying four components that contribute to the price of oil and assessing each of them individually. Disentangling the true drivers of oil prices over the past decade is a critical first step for allocating resources efficiently and designing good policy.

Global Supply: Simply, the availability of oil inversely affects the price of oil. For example, when the Organization of Petroleum Exporting Countries (OPEC) unexpectedly decides to decrease oil production, oil prices increase.

Global Demand: A booming world economy demands more industrial commodities, and at the top of that list is oil. Continuous growth in emerging countries such as China and India, for example, increases the aggregate world demand for oil. The same principle that applies to supply also applies to demand—but in the opposite direction: As demand for oil increases, so does its price.

Oil Inventory Demand: This concept is related to precautionary demand. Expected future shortfalls in oil supply, relative to demand, motivate people to store oil for future use. The possibility of either a sudden shortage in production or a new source of demand can create an expected shortfall. For example, uncertainty about future oil supply may arise from political instability in key oil-producing countries, such as Nigeria, Iraq, Venezuela, or Iran. Such uncertainty increases demand for storing oil, which drives up the current price.

Speculation: Speculation is the act of purchasing something today in anticipation of selling it at a higher price at a later date. Financial markets allow traders to speculate on oil prices in the following way: Traders buy a contract for oil to be delivered at a later date (a futures contract), sell that contract before the oil is due for delivery, and use the proceeds to purchase other futures contracts for delivery at a more distant date. Investors who expect the price of oil to rise in the future are motivated to take this position in these contracts; moreover, as demand for these futures contracts increases, so does their price, which also raises the current price of oil¹.

These factors all interact to produce an overall price pattern, but it is instructive to see what their effects would be if they were disentangled from one another. So, we investigated the degree to which each factor individually contributed to oil price trends over the past decade. Our results were not surprising. The past decade adheres to the expected historical pattern: Global demand has been the main driver of oil prices. Our estimation in this scenario shows that global demand explained about 40 percent of the oil price increase within the past decade. Speculation was the second-largest contributor to oil prices and accounted for about 15 percent of the rise. The effect that speculation had on oil prices over this period coincides closely with the dramatic rise in commodity index trading—resulting in concerns voiced by policymakers.

Just as interesting as the rise in the price of oil was its sudden collapse in the second half of 2008. This was driven by the financial crisis and was manifested in two ways: a sharp contraction in demand, due to the global recession, and a decline in commodity index trading, due to diminished risk appetite in financial markets.

Oil inventory demand played a smaller role in the oil price buildup, though this demand accounted for a large share of the

spike from mid-2006 to mid-2008. And oil supply contributed the least to both the boom and bust in oil prices.

On balance, the evidence does not support the claim that a sudden explosion in commodity trading tectonically shifted historical precedent: Global demand remained the primary driver of oil prices from 2000 to 2009. That said, one cannot completely dismiss a role for speculation in the run-up of oil prices of the past decade. Speculative demand can and did exacerbate the boom-bust cycle in commodity prices. Ultimately, however, fundamentals continue to account for the long-run trend in oil prices.

Speculation in food commodity

Most analyses focus on changes in demand and supply to explain increased food prices. With rapid economic growth, along with a global population growth, demand for meat and grains (and grain-fed animals) has increased. This rising demand is coming up against supply constraints due to bad weather (and increased production of crops for biofuel). Moreover, the high cost of oil (at over US\$130 per barrel) is increasing investment in ethanol production. An additional cause of the food crisis, often mentioned by the media, is export bans. Around 40 food exporting countries have imposed some sorts of trade restriction of food: taxes, quotas, or across-the-board bans.

Currently, commodity prices are making headlines as much for the size of the price increases as for the simultaneity of price hikes across all types of commodities. Figure 1 reveals that, prior to the global recession; upward price trends took hold in a variety of commodities. The financial crisis and ensuing recession induced an acute decline from the 2008 peak in prices. But beginning in 2009, the prices of all types of commodities began to rise once again at astronomical rates².

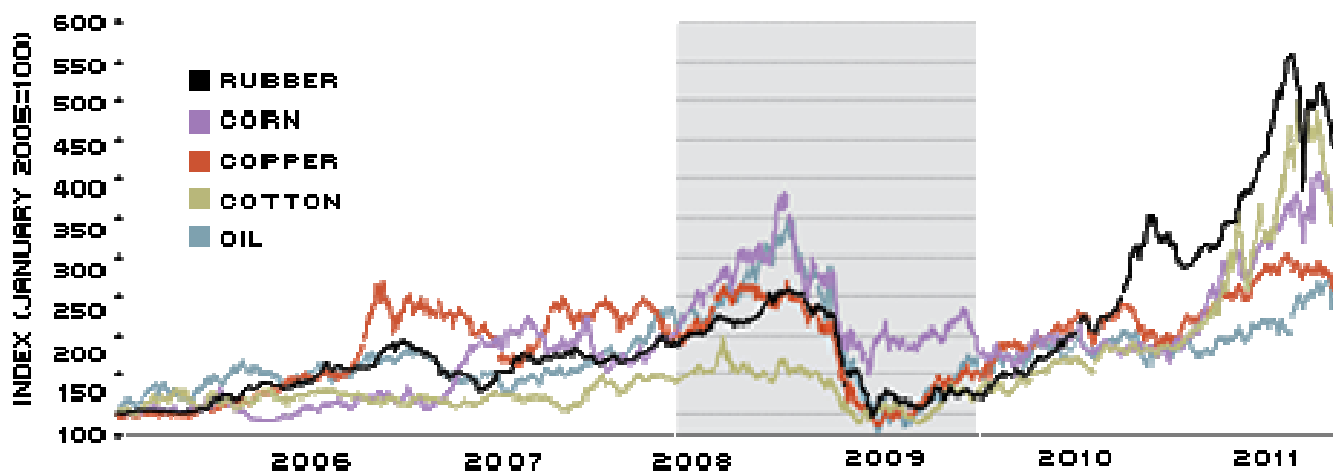


Figure-1
 Recent Commodity Price Growth

Sources: The Wall Street Journal and Bloomberg.

Note: The shaded area indicates the recession, as dated by the National Bureau of Economic Research

Need to Regulate Speculation

The need is to regulate the stock market to control the crisis that arose from the financial crisis either of systemic risk or of market efficiency. Stock recommendations exhibited online changed phases too given the volatility. If as an investor, stock recommendations at a reliable news portal, you gain a competitive advantage. Securities regulation is driven by more than economic theory. , people perceive that speculation does not create value—“mere gambling.” In any exchange transaction, the interests of the traders are partly in conflict. This can be naively construed as a zero-sum game, especially for speculation. It is easy to see the benefit when a restaurant owner serves a customer pancakes. Speculative trading also helps security prices impound new information. This is vital for guiding financing and investment activity, but not salient. A swashbuckling story about making a killing on the stock of a new social media firm attracts attention. But the fact that such activities promote innovation and help direct capital to strong businesses over weak ones.

Incase, the derivatives' positions held by the counterparties of Bear Stearns and Lehman had served a particular business purpose, such as hedging business risks. With the failures of those dealers, the counterparties needed to replace their derivatives' positions quickly. A surge of demands for new derivatives' positions with other dealers caused severe pressures on a range of financial markets, sometimes distorting normal price relationships and adding to the general disruption³.

Recommendations

Derivatives' markets are efficient if trading costs are low and risk is *well distributed* among investors. AIG, the most egregious example of the CDS/CDO type, was bailed out in response to losses suffered by its subsidiary AIG FP, which had sold CDS protection on more than \$400 billion of CDOs. As AIG's losses mounted, downgrades to its credit rating were about to trigger contractual obligations, meaning that AIG would have to post large amounts of additional collateral on its CDS positions. When AIG did not have the resources to meet those calls for more collateral, the federal government stepped in, at a massive cost to U.S. taxpayers. All the proposed legislation for derivatives' reform can be evaluated using several policy options that are believed, in varying degrees, to reduce systemic risk and improve the efficiency of the derivatives' markets. These are as follows

Centralized clearing: Clearing insulates counterparties from one another, provided that the clearinghouses are themselves well designed and capitalized. In addition to any direct reductions in counterparty risk, clearing reduces the sort of run-on-the-bank behavior that likely quickened the failures of Bear Stearns and Lehman.

Improved price transparency: Markets tend to be more efficient when the “going price” is well known by market participants. OTC derivatives' markets have limited price transparency. Some analysis should be devoted to the question of which markets deserve additional levels of price transparency, for none of the main legislative proposals require such transparency.

Improved position transparency: Another issue is the availability of data on the sizes of derivatives' positions, which would allow the monitoring of risk concentrations with systemic implications. Concerns exist, however, about what amount and type of data are appropriate to be disclosed and to whom. Proposed legislation calls for all OTC derivative trades to be reported to qualified trade registries. Those data will be available to regulators, with some summary information possibly provided to the public.

Migration of over-the-counter trading to exchanges: More extensive use of electronic trading platforms and of the kind of price transparency found in TRACE (Trade Reporting and Compliance Engine) would reduce the inefficiencies associated with OTC market opaqueness. Legislation appears likely to require that all “standardized” derivatives be traded on exchanges or on “alternative swap execution facilities,” subject to exceptions allowed by the enforcing agencies: the Securities and Exchange Commission and the Commodity Futures Trading Commission. Forcing derivatives' trading onto exchanges by regulation should, however, be done with caution.

Speculative position limits: It has been proposed that speculative derivatives' trading should be severely curbed or even—in the case of CDS markets—outlawed. Such proposals, however, are based, at least in part, on a misconception of the role of speculation. Outlawing the speculative use of credit default swaps to buy protection would have the unintended consequences of reducing market liquidity (because those selling protection would have less incentive to incur the costs of remaining informed and active traders) and of driving this form of speculation “under the radar,” through the use of less-effective and transparent types of financial products.

Allowance for customization and innovation: Derivatives that are not easily cleared or exchange traded are typically those customized to suit the specific business uses of investors, for which there should be some tolerance for innovation and customization. Economic efficiency is harmed if those with commercial needs for hedging are forced into standard derivatives' positions that are relatively poor hedges or if derivatives' markets are unable to innovate along with changes in the economy⁴.

Conclusion

Speculators may rely on an asset appreciating in price due to any of a number of factors that cannot be well enough understood by the speculator to make an investment-quality decision. Some such factors are shifting consumer tastes, fluctuating economic conditions, buyers' changing perceptions of the worth of a stock security economic factors associated with market timing, the factors associated with solely chart-based analysis, and the many influences over the short-term movement of securities. The increased use of central clearing represents the most powerful way to reduce the systemic risk arising from OTC derivatives' markets. Some key steps that regulators should take are (i) pressuring dealers to adopt specific numerical targets for lowering exposures (before collateral) on un cleared derivatives positions, (ii) increasing regulatory capital requirements for un cleared-versus-cleared derivatives, (iii) persuading dealers to clear a greater fraction of dealer-to-customer positions, and (iv) fostering international coordination in the regulation, supervision, and failure resolution of clearinghouses.

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