"A Model of Financialization of Commodities"

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Abstract

A sharp increase in the popularity of commodity investing in the past decade has triggered an unprecedented inflow of institutional funds into commodity futures markets, referred to as the financialization of commodities. In this paper, we explore the effects of financialization in a model that features institutional investors alongside traditional futures markets participants. The institutional investors care about their performance relative to a commodity index. We find that in the presence of institutional investors prices and volatilities of all commodity futures go up, but more so for the index futures than for nonindex ones. The correlations amongst commodity futures as well as in equity-commodity correlations also increase, with higher increases for index commodities. Within a framework additionally incorporating storage, we find that commodity spot prices and inventories go up with financialization. We show that in the presence of institutional investors’ shocks to any index commodity spill over to all storable commodity prices and inventories. Finally, we model explicitly demand shocks which allows us to disentangle the effects of the presence of institutional investors from the effects of demand and supply (fundamentals), and conclude that the effects of financialization are sizeable.

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