APAC Agricultural Policy Analysis Center
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PolicyPennings by Daryll E. Ray & Harwood D. Schaffer

Index funds and the 2006-2008 run-up in agricultural commodity prices

One of the overriding questions surrounding the sudden and sharp increase in agricultural prices in the 2006-2008 period is the role of the index funds in the increase. We have written about it before, as have Derek Headey and Shenggen Fan in their IFPRI Monograph, "Reflections on the Global Food Crisis." Those who believe that the index funds contributed significantly to the price bubble believe that commodity exchange rules need to be changed. They would like to see similar position limits and other rules put on index funds that are already in place for traditional speculative traders.

Overall, in our view, IFPRI's Headey and Fan report on the 2006-2008 global food crisis is a solid analysis and we commend them for it. We recommend it as required reading by anyone trying to understand what brought about the "2006-2008 food crisis." That said, there are some topics that we believe Headey and Fan glossed over too quickly or omitted completely. In previous columns we have discussed a couple of those perceived shortcomings including the role of stocks as reserves and early farmer-based efforts to boost grain prices by jumpstarting the production and use of ethanol.

We also believe Headey and Fan did not dig deeply enough into whether the index funds were important accelerators of grain prices during that time period. One concern is that Headey and Fan use language at times that suggests a lack of understanding about the futures market or at least could provide readers with a misunderstanding of terms and effects of futures trading. For example, they write, "a short futures position (involving contracts that function up to 6 months) protects against price decreases, whereas a long futures position (involving contracts of longer than 6 months) enables the holder to benefit from price increases in the longer term." The part not included in parentheses is correct but long and short positions are not defined by the length of the contract as suggested in the parentheticals.

At another point Headey and Fan write, "these contracts are just bets on future prices, so why should a bet affect an actual price outcome?" While a single "bet" would not affect an actual price outcome, the total collection of bets or transactions in the futures markets do determine the day-to-day actual prices country elevators offer farmers for their grain as well contribute to the longer-term price discovery process.

Turning specifically to the index funds, Headey and Fan fail to fully explain how the operation of the index funds differs from the way traditional future market participants interact with the market. Producers (or elevator managers after taking possession of the commodity) use the futures market by taking short position on futures contracts to lock in a price for the commodity they are producing or have on hand. Similarly purchasers of these commodities, such as livestock producers or millers, use the futures market by taking long positions as a means to protect themselves against increases in the prices of grain required to produce their products.

Speculators-the other traditional category of participants in futures markets-provide liquidity. They take out both long and short positions, balancing out the market. These traditional speculators may switch from long to short positions or vice versa in a matter of minutes, hours, day, or weeks based on changes in perceptions of market fundamentals, trend analyses or other reasons.

The index funds, on the other hand, are long-only. They buy futures contracts for commodities in the belief that the price in the future will be higher than the present price of that future contract-fundamentals of farm-based commodities are irrelevant to their decision. That is because the prospectus of the index fund sets forth the balance that the fund must maintain among the various commodity futures they are holding. Energy and then mineral commodities typically dominate the basket of commodities with agricultural commodities being a relatively small component.

This means that the fundamentals and/or expectations in the energy and mineral markets rein supreme-grains are along for the ride with little-to-no regard to what is happening in the grain sector. Worries during the period about the availability of oil drove up the price of crude, which caused index funds to rebalance their portfolios by making additional purchases of the other commodities to maintain the specified balance. Since the resulting price increases in agricultural commodities had virtually nothing to do with their market conditions, the record level of activity in the futures market by index funds would seem to make index funds a logical source of possible price overshooting.

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At this point, the jury is still out on the importance of the "index fund effect" on farm commodity prices during 2006-2008 but, in our view, it should not be implicitly dismissed as readers could interpret it in the Headey and Fan analysis.

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