Lim Hng Kiang: Issues, challenges and opportunities presented by commodities

Speech by Mr Lim Hng Kiang, Deputy Chairman of the Monetary Authority of Singapore and Minister for Trade and Industry, at the Global Financial Market Summit, Singapore, 9 July 2008.

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Introduction

I am very honoured to be invited to participate in this Conference on Global Financial Markets and in particular on the commodity markets. High food and fuel prices continue to hog the headlines nowadays. I am sure the proceedings of this Conference will attract strong interest.

The commodities world

The importance of commodities cannot be over-emphasised. Commodities are the critical raw materials that feed our peoples and our factories, and power our economies. In countries where Governments have had to reduce fuel subsidies, this has sparked heated protests by consumers and workers, from farmers to fisherman to truck drivers, causing economic and social disruptions. Some have also likened the oil rally to the dot.com bubble and are wary of a third oil shock since the 1970s and 80s.

Boom in commodity prices

What has led to the boom in commodity prices? The global increase in commodity prices has been widely attributed to the mismatch between physical demand and supply. On the demand side, there has been a significant increase in consumption of fuel and grain. In Asia, demand for oil has been driven by tremendous growth in emerging markets such as India and China. Globally, rising household income due to economic expansion has also led to higher consumption levels. Increased demand for meat consumption as a result of rising affluence means more grains are channeled from humans to animal feed while biofuels diverted food from people to petrol tanks.

On the supply side, underinvestment in oil and gas exploration has caused output growth to lag behind demand gains. Disruptions in Nigeria, Iraq, and declining production in Russia have added to supply woes. Political tensions in the Middle East further threaten to reduce oil taps. Climate change has also led to poor harvests of corn, soya bean and wheat. Regions such as the US suffered from excessive rain while Australia underwent severe drought. Soaring prices for fertilizer and diesel have also made it costly for farmers to plant, reducing farm output.

Besides the economics of demand and supply, financial market dynamics might also have played a part in fuelling the commodity price boom. Commodities have been found to be uncorrelated or negatively correlated to traditional asset classes of equities and bonds, therefore holding commodities in investment portfolios can reduce risk and enhance potential returns. More recently, following the sub-prime fallout and relatively less attractive debt and equity markets, some investors could have switched to commodities as an alternative investment class, pushing up their prices further. As commodities prices rise, they in turn attract non-traditional players to the market, adding to trading volume. According to BIS data, global turnover in commodity derivatives (measured in number of contracts) grew from 420 million to 489 million in the first quarter of 2008. On a year-on-year basis, turnover grew 52%, led by agricultural and energy products.

Others have pointed the finger at speculators for the historically high commodity prices although the extent of this has not been well established. There are concerns over speculative activities giving rise to a disconnect between the physical and futures markets. In the US where commodities are actively traded, there are claims that speculators' interest in crude oil now account for about 70% of all trading in West Texas intermediate crude on the New York Mercantile Exchange ("NYMEX"), compared with 37% in 2000. On the other hand, some have attempted to make a distinction between speculative trading (which at the core, means taking positions based on one's view of the market) and market manipulation (or collusive trading that interferes with the free play of demand and supply, and has an illicit element). They argue that speculators play a vital role in providing liquidity and take the risk that hedgers want to avoid. Without speculation, consumers would likely pay more for energy and other commodities. Whatever the causes, whether physical demand and supply or speculation, the world now has to grapple with higher commodity prices.

What are the implications and effects of the commodities boom? Clearly the hike in oil prices, for instance has crimped the real incomes of households. This would hold back consumption spending, and hence GDP growth, in the oil importing countries. Not surprisingly, the world economy is expected to slow in 2008, led by the US and other developed economies, amidst falling asset prices and tighter credit conditions as well. The US is weighed down by falling house prices, weak consumer spending and continued credit market distress. Domestic demand in Europe is expected to be subdued while softer external demand and the strong Euro could constrain export growth.

Some slowdown is to be expected in Asia, although firmer domestic demand conditions should offset some of the weakness in exports. The region would also be buoyed by continued strong growth expected of China, India and the Middle East, which would help to mitigate the impact of the softer G3 economies. Indeed, inflation has emerged as a bigger concern in Asia, particularly among the faster growing economies I have just mentioned, including Vietnam. Thus, governments and central banks in the region not only have to deal with slower growth prospects, but also guard against rising inflationary pressures arising from strong domestic monetary expansion as well as higher commodity prices.

High commodity prices would shape manufacturing decisions and define future trade flows. Higher shipping costs from fuel hikes have eroded the wage advantage of low cost producers such as China and Vietnam especially in inexpensive items that have high freight cost relative to final sale price. For instance, it has become cheaper to manufacture steel in the US, instead of importing them from China where steelmakers have to transport iron ore from Brazil and Australia to the mills, and then ship the manufactured steel to the US. China has also recently agreed to pay close to 100% more for its iron ore. The costs are likely to be passed on to steel buyers and this could fuel inflation.

Rising commodity prices have also increased the prominence of commodities in the financial markets. Commodity markets have in fact, become more financial market like. Traditionally, financial activity in commodity markets focused on exploiting arbitrage opportunities, with investors hedging their production or consumption in the futures market. The entry of new market players such as banks and hedge funds, with their different risk appetite and investment horizon, has given rise to varied trading strategies. They have also given birth to a wider variety of financial instruments in the likes of index and exchange traded funds, as well as structured commodity products. These new players also demand the sophistication that they are used to in financial markets. As a result, commodity markets have moved towards electronic trading, high speed communication links and greater efficiency in trade processing. There is also an increasing need for infrastructure such as commodity exchanges and clearing facilities to facilitate trading.

While market development is generally welcomed, the risks have to be managed. As commodities become the flavour of the day, market participants should ensure that they understand the risks as they participate more actively in the markets. In their eagerness to ride the commodities wave, banks and other intermediaries should put in place appropriate risk management systems and processes, ensure they have adequate resources including qualified staff, and uphold proper market conduct. Investors too, should carefully evaluate complex structures as they seek attractive returns.

Singapore as a commodities hub

Singapore has historically played an important role to connect importers and exporters. Besides being strategically located, Singapore offers a high level of connectivity with its efficient infrastructure and business friendly environment. Today, Singapore is a key aviation and shipping hub, and an international financial centre. In the area of commodities, over 230 global trading companies have their offshore trading, marketing and procurement operations in Singapore. We enjoy the reputation as the top energy trading hub in Asia, and is increasingly a location of choice for other sectors including agri-commodities, metals and minerals.

Singapore continues to be the hub for over the counter ("OTC") commodities derivatives trading in the region, capturing more than 10% of global OTC commodities. In May 2006, the SGX launched a central counterparty clearing facility or SGX AsiaClear, for OTC commodities trading to mitigate counterparty risks and create efficiencies for the market place. Today, SGX AsiaClear has seen growth in energy, freight and petrochemical derivatives and potentially agriculture commodities.

We welcome further development of the breadth and depth of the commodities market and infrastructure in Singapore. To strengthen our position as Asia’s leading commodity derivatives trading centre, we have taken measures to encourage the growth of the futures market which would facilitate the price discovery process. Since February 2008, the regulation of financial and commodity futures has been consolidated under MAS to facilitate Singapore’s growth as a futures trading hub. MAS has also reviewed the capital requirements for brokers trading only in commodity futures contracts to ensure the relevance of our capital requirements in light of developments in the commodity futures market. We would continue to engage the industry as the market evolves to ensure our regulatory framework remains robust, while offering a business friendly environment for commodities trading.

Conclusion

The surge in commodities prices presents a challenge for the global community. The Organisation for Economic Cooperation and Development sees agricultural commodity prices retreating from peaks but rising up to 50% higher in the next decade. The UN Food and Agriculture Organisation says food production must rise by 50% by 2030 to meet demand and has warned that close to one billion people faced the prospect of hunger. Commodities form the heart of a man’s basic needs. World demand and supply of commodities would find a balance in due course. Proper functioning markets, both physical and financial, can help to make this adjustment and transition more efficient and less disruptive. Towards this objective, we welcome a healthy development of the commodities market in Singapore.

On this note, I wish you a fruitful discussion on the issues, challenges and opportunities presented by commodities.

Thank you.