SUERF Workshop and Special OeNB East Jour Fixe

Commodities, Energy and Finance

On March 3, 2008, the OeNB hosted a Special East Jour Fixe on "Commodities, Energy and Finance," which was organized as a joint event with a SUERF workshop. Around 100 participants from over 16 countries followed a day of debates on the dynamics between financial, commodity and energy markets in Europe, on the challenges of oil wealth and on the role for monetary policy with respect to commodity and energy prices. The event was opened by OeNB Governor Klaus Liebscher, who referred to the staggering developments in commodity and energy prices and also mentioned the related issue of climate change. The workshop brought together both professional and academic perspectives on the role of commodities in five sessions:

- Session 1: Commodities as an asset class
- Session 2: Financial investors and commodity market dynamics
- Session 3: Energy markets in Europe – state of play, future prospects and implications for financial markets
- Session 4: Oil revenues: Role and management of sovereign wealth funds, and the challenge of a dual economy
- Session 5: Policy panel: How should monetary policy take commodity and energy prices into account?

The first session – chaired by Beat Bernet of the Swiss Institute of Banking and Finance at the University of Sankt Gallen – explained why investors increasingly regard commodities as an asset class, a safe haven or a useful portfolio supplement for enhancing return and diversifying risks. With a view on the long-term properties of commodity futures, K. Geert Rouwenhorst, Deputy Director of the International Center for Finance at the Yale School of Management, pointed out that commodity futures are less risky than stocks, negatively correlated with stocks and bonds, and perform better during inflation periods. John Cavalieri, Real Return Product Manager at the international capital investment company PIMCO in California, envisioned the continued potential of commodities to enhance returns and diversify risks in an environment of increasing demand, supply constraints and a secularly weak U.S. dollar.

The second session, chaired by Ernest Gnan, Head of the OeNB's Economic Analysis Division, addressed various effects of financial investors' activity on commodity and energy markets by asking two questions: First, to what extent is financial activity in commodities markets driving commodities and energy prices away from fundamentals; and second, are commodities markets becoming more complete and liquid through derivatives markets? Alexandra Heath, Senior Economist at the Bank for International Settlements, stated that fundamentals still provide strong anchors for commodity prices and that financial investors have improved the depth of commodity markets. Michael Lewis, Global Head of Commodities Research at Deutsche Bank London, confirmed increased commodity speculation which follows rather than leads commodity prices, as commodities are ultimately driven by physical rather than financial factors. However, he saw a risk of overshooting (in precious metals, copper and oil) given that financial market turbulences have lured more investors into commodities, but also due to the overshooting of the U.S. dollar.

The third session, chaired by Doris Ritzberger-Grünwald, Head of the OeNB's Foreign Research Division, focused on energy markets in Europe. This session described and analyzed recent developments and the current state of play in the organization of European energy markets by addressing the following questions: How well developed are the markets for trading energy across Europe? To what extent have liberalization and privatization increased competition and lowered prices for consumers and business? Which obstacles remain to be overcome? Juan Delgado of the Brussels-based think tank BRUEGEL highlighted the constraints of the common EU energy market by physical/technical factors and economic/political factors. He pointed to world competition for resources as well as the growing prominence of energy efficiency and climate considerations. Delgado described an "impossible trinity" of security of supply, competition/competitiveness and environmental sustainability. Walter Boltz, CEO at the Austrian energy regulator E-Control in Vienna, commended the EU Commission for its third energy liberalization package given its potential for consumer gains, while also pointing out that it may provoke collusion between national and companies' interests. According to Boltz, cross-border capacity congestion results in higher prices for consumers. Active households are crucial for avoiding abusive supplier behavior.

The fourth session, chaired by Peter Mooslechner, Director of the OeNB's Economic Analysis and Research Department, dealt with oil revenues. It addressed the role and management of sovereign wealth funds, and the possible challenge posed to oil exporting countries by the risk of a dual economy. Birger Vikøren, Director of the Financial Markets Department at Norges Bank in Oslo, highlighted the experiences of Norges Bank with organizing the Government Pension Fund. The three objectives of oil revenue accumulation in this sovereign wealth fund are intergenerational justice (transforming natural wealth into future financial wealth), economic stabilization (protecting the nonoil economy from volatile oil prices and extraction) and fiscal discipline (restraining immediate consumption of oil income). He also referred to the unprecedented ethic standards the bank follows while perusing its investment policies. Vasily Astrov of The Vienna Institute for International Economic Studies (wiiw) in Vienna described the Russian Oil Fund as a tool of fiscal stabilization and monetary sterilization (avoiding inflation) and pointed to the risks of a recent reform, as more spending could fuel overheating and corruption. Drawing on research conducted with Stephan Barisitz from the OeNB, Simon-Erik Ollus of the Bank of Finland Institute for Economies in Transition (BOFIT) in Helsinki, discussed signs of Dutch disease in the Russian economy, as oil and gas revenues contribute nearly one-third to Russia's GDP and two-thirds to its export revenues. Given substantial real rouble appreciation he observed some symptoms of Dutch disease. As policy advice he proposed prudent fiscal and monetary policies, diversification, integration and competition.

The concluding policy panel, chaired by Már Gudmundsson, Deputy Head of the Monetary and Economic Department at the Bank for International Settlements, discussed the implications of commodity and energy prices for monetary policy. The issues facing monetary policymakers include: How should monetary policy react to changes in commodity and energy prices? Should monetary policy pay more attention to core or headline inflation? How should commodity and energy prices be taken into account in measuring core inflation? Do these prices serve as leading indicators of activity and inflation? Ulrich Kohli, Alternate Member of the Governing Board of the Swiss National Bank, recommended distinguishing between relative price changes, general price level changes and inflation (i.e. a continuous increase in the price level). He reasoned that if energy prices increase, real wages need to decrease, since a real shock requires real adjustment. The appropriate monetary policy depends on whether a demand or a supply shock is given. Kohli warned against monetary accommodation as it only delays real adjustment at the cost of higher inflation. Yet to ignore energy price hikes by using an exclusion-based core inflation indicator ("cold and hungry index") is also inappropriate. Monetary policy needs to consider the general price level, i.e. headline inflation, and should not exclude specific items, particularly if energy prices rise for an extended period. He finished in saying that central bankers target the real price of money. Irma Rosenberg, First Deputy Governor of the Sveriges Riksbank suggested that perhaps it is only now that the successful low inflation policy is put to the test. She stated that flexible inflation targeting is a simple principle with complex implementation. According to Rosenberg, one has to distinguish between price shocks with a lasting versus temporary impact on inflation. She concluded that in order to maintain the credibility of inflation targets, rising inflation calls for counteraction. Frank Smets, Deputy Director General Research of the European Central Bank, complemented in the same spirit by starting with a remark that relative price changes allow resource reallocation to happen. He stated that terms-of-trade shocks are like productivity shocks. Their effect on the equilibrium interest rate depends on the balance of supply and demand effects. Smets attributed the apparently decreased inflationary impact from oil shocks to higher central bank credibility and lower real wage rigidity. The appropriate monetary policy response depends on the (perceived) persistence of inflationary effects – first-round effects depend on expected second-round effects. He finally reiterated that central bank credibility helps to anchor inflation.

In his wrap-up, Ernest Gnan turned the focus to mid- and long-run economic issues of a growing and developing world population facing scarce (energy) resources: Will massive swings in relative prices of production factors translate into a global shift in income and wealth? How will financial markets reflect these developments? How should economic policy react? He also referred to important noneconomic aspects, such as the social consequences of rising food and energy prices, environmental issues and geopolitical (military) consequences, which would ultimately influence economic and financial market developments. As exemplified by price-increasing effects of biofuels and price regulation, narrow and short-term thinking may yield undesired results.