LCERPA Working Paper No. 2016-02

November 2016

Volatility Spillovers Arising from the Financialization of Commodities

Bryce Shelton,

Wing Chan,
Department of Economics, Wilfrid Laurier University

Volatility Spillovers Arising from the Financialization of Commodities

By Bryce Shelton and Wing Chan

Abstract

The author found that the rapid growth of capital flowing into commodity markets as they develop into a formal asset class has put downward pressure on the realized volatility of non-energy commodities in the United States. These findings are a result of analysis performed using a difference-in-difference (DID) framework looking into the volatility characteristics of commodities included in the S&P GSCI versus off-index commodities. Additionally, two OLS models directly test the relationship between financialization and realized volatility while controlling for economic and financial fundamentals. Policymakers and regulators should be cognizant of the benefits financial investors (speculators) introduce to commodity markets. These diversified investors improve the ability to distribute risk among market participants, which lowers volatility and risk premiums. Lower risk premiums allow commodity producers and farmers to hedge at higher futures prices. (JEL Q02, G10)