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## Testing for bubbles in agriculture commodity markets

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***Title: Testing for bubbles in agriculture commodity markets***

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Since 2007 the world experiences dramatic swings in internationally traded food commodity prices. Within the period of five years, food markets, and especially grains, have experienced a number of price surges. In June 2008, December 2010 and, more recently in the autumn of 2012, food prices increased sharply and subsequently declined for their peak, only to remain at relatively high levels, as compared with the 2005-2006 average.

Food prices are inherently volatile and addressing the consequences of such volatility is one of the most challenging issues facing policy makers, especially in developing countries. Since Gustafson's (1958) price behavior model for a storable staple, over 50 years of empirical analysis have added a lot to our knowledge on the behavior of commodity and food prices. Unrelated commodity prices move together (Pindyck and Rotemberg, 1990); they are highly autocorrelated and significantly volatile (Deaton and Laroque, 1992). Their long run downward trend (Grilli and Yang, 1988) is subject to violent upward spikes which are not matched by the few, or no downward spikes (Deaton and Laroque, 1992). The shocks that generate these spikes tend to have a persistence effect on prices over the years (Cashin et al., 2000), while at the same time. Finally, with regard to causes of commodity prices following cyclical patterns, there is little evidence that such cyclical patterns are determined by business cycles (Cashin et al., 2002).

In spite of what we have learned about commodity price behavior during the last 50 years, the 2008 commodities price episode revealed a gap in our knowledge on the drivers that determine commodity, and especially food prices. Since 2005 real food prices exhibit an upward trend, and in mid-2008 they increased in a violent surge by more than 60 percent, as compared to the 2007 levels. Since then food prices remain at a level significantly higher than the average of the 2000-2005 period and exhibit large fluctuations, with slumps followed closely by booms in 2009, 2010 and 2012 as shown in Figure 1 which depicts the FAO Food Price Index. Indeed, the evidence so far suggests that volatility is both persistent and increasing (FAO, 2011; Rapsomanikis, 2011) with the macroeconomic environment and climatic shocks generating wide price movements.

Persistent food price volatility can have significant effects, especially on developing countries. In the short run, for net food importing developing countries price shocks can negatively affect the balance of payments, foreign currency reserves and worsen the ability to

implement social safety programs. In the longer run, the diversification of activities to minimize exposure to price risk, inhibits efficiency gains from specialization in production and hinders the development of the agricultural sector (Kurosaki and Fafchamps, 2002). Income risks may also blunt the adoption of technologies necessary for agricultural production efficiency, as producers may decide to apply less productive technologies in exchange for greater stability (Larson and Plessman, 2002).

The violent spells of food price volatility in world food prices strengthened the attention of policy makers to agriculture and fuelled the debate about the future reliability of world markets as a source for food. They have also generated a wide array of opinions concerning their nature and drivers, and have led to an equally wide array of policy proposals among policy makers. At the heart of the debate lies the question of whether such price surges are generated by the market fundamentals – the forces of food demand and supply, or by other drivers such as trend-following behavior in both physical and financial markets.

The debate on whether the drivers of food price volatility go beyond market fundamentals is reflected on the wide range of the policies proposed. Investing to accelerate agricultural productivity growth to meet increasingly stronger demand for food and ease the pressure on prices (FAO, 2011) is a proposal founded on the understanding that supply, demand and stocks are the relevant drivers of volatility. Proposals such as the establishment of ‘virtual funds’ to intervene in the food futures markets by executing a number of progressive short sales are based on the surmise that changes in supply and demand fundamentals cannot fully explain volatility and speculation, especially in the futures markets, plays an important role in determining price movements (von Braun and Torero, 2009). There is no consensus between economists on the nature and drivers of food price volatility and, unsurprisingly, between policy makers on the policies to mitigate it.

In sum, the debate centers on whether agricultural and food prices experienced a ‘rational bubble’, which as in the finance literature reconciles trend-following behavior with rational expectations on future earnings. Stiglitz (1990) presents a straightforward definition of a bubble: if the reason that the price is high today is only because investors believe that the selling price will be high tomorrow – when fundamental factors do not seem to justify such a price – then a bubble exists (Stiglitz, 1990, p. 13).

A number of tests and dating algorithms have been developed and used to identify rapid increases in prices followed by a collapse, also known as explosive bubbles (Phillips, Wu and Yu, 2011; Phillips, Shi and Yu, 2012; Gilbert, 2009; Gutierrez, forthcoming). Previous analysis on agriculture commodities by Gilbert (2009) and Gutierrez (forthcoming) applied the tests developed by Phillips, Wu and Yu (2011) and focused on four agricultural commodities. In contrast, We apply the more recent generalized sup augmented Dickey-Fuller (GSADF) test for explosive bubbles (Phillips, Shi and Yu, 2012) to monthly time-series for food, beverages, agricultural raw material, cereals, dairy, meat, oils and sugar indices and a total of 28 agricultural commodities between 1980-2012. We found price bubbles occurred for some commodities within food markets.

### **The Debate**

Assessing the extent to which prices reflect fundamental values or not is difficult. It entails testing the validity of the present value model. If this fails, the question whether one can separate bubble behavior for the possibility that the model itself is misspecified. With such difficulties, examining the evidence in an indirect manner, such as exploring both fundamental and non-fundamental factors and reconciling their movements with price variation, consists of an approach often encountered in the agricultural economics literature.

A number of authors underline the importance of the fundamental forces of supply and demand in explaining the food prices surges of 2008 and 2010. Growing population and income in emerging and developing countries adds significantly to the demand for food, while the rate of growth of agricultural production has not kept pace with demand (Alston et al., 2010; Bioversity et al., 2012). This alone is sufficient to exert pressure on commodity prices. The growing demand for food and feed crops for the production of biofuels is another significant factor, resulting in food and energy markets being integrated (Serra, et al., 2010; Balcombe and Rapsomanikis, 2008). Very inelastic derived demand for maize by the biofuel sector contributes to both higher prices and greater price volatility (Abbott, forthcoming). A response to the strong demand for grains due to high income growth and biofuels mandates is the decline of aggregate grain stocks relative to utilization. Indeed, the global grain market stocks-to-utilization ratio has been fluctuating at a low point since 2005-06, signifying a reduction in the buffer capacity of the global market. Even small supply and demand shocks as well as trade policies can generate wide price variations (Wright, 2010). Wright (2010) encapsulates the above strand of literature based on the competitive storage model, and concludes that the balance between consumption, available supply and stocks is sufficient to justify the recent wide grain price movements.

Beyond market fundamentals, dramatic increases in commodity futures investments by financial institutions coincided with the 2008 food price surge, giving rise to questions on whether the forces of demand and supply alone are sufficient to explain such price developments. While most of the speculative capital is invested in non-agricultural, especially energy futures, investments in agricultural futures, reflected by market open interest,<sup>1</sup> marked a significant increase from 2007 to 2008, a period with rapid increases in food prices, especially for maize, soybeans and wheat. Once again in 2010, although increases in the

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<sup>1</sup> Open market interest is a calculation of the number of active trades for a particular market calculated using futures and options contracts.

global market price of wheat were triggered by market fundamentals – reduced supply from Russia and the black Sea region due to drought and export restrictions, open market interest in commodity exchanges increased significantly.

Robles et al. (2009) stress that, along with market fundamentals, rising expectations, speculation, hoarding, and hysteria played a significant role in the increasing level and volatility of food prices, attributing the 2008 food price episode partly to ‘speculative bubbles’. UNCTAD (2011), in the similar line, lay emphasis on the ‘financialization’ of commodities, a term which implies that the activities of ‘non-commercial’ financial participants tend to drive commodity prices away from levels justified by market fundamentals. Non-commercial investors do not engage in physical markets, as commercial investors do. The latter include producers and processors who hedge price risks, while the former view commodity futures as assets exhibiting relatively high returns which are negatively correlated with those from other assets, such as equities and bonds, providing effective portfolio diversification. However, these non-commercial investors are far from homogeneous and their behavior in the market differs. Commodity index funds form the majority of financial investors on commodity futures and follow a passive positive-feedback strategy: they identify a trend and take a long position, purchasing commodity futures, when the trend is positive and *vice versa*. Hedge funds follow discretionary trading strategies: they adjust their investments in commodity futures in line with changes in asset prices to stabilize and diversify their portfolio (Gilbert, 2010; UNCTAD, 2011). The concern is whether these non-commercial investors and their trend following behavior feed price bubbles, thus detaching both prices from their market fundamental values, and inevitably, the test for speculative bubbles becomes an investigation of the impact of non commercial traders on futures prices. Such an impact would be also reflected in the physical markets, as the

information flow runs from futures to spot markets (Hernandez and Torero, 2010), thus distorting price signals.

Friedman's (1953) theory on efficient markets underlines that, given rational behavior and rational expectations, the price of an asset will always reflect market fundamentals. Any divergence of the price from its market fundamental value, caused by non informed traders, can be eliminated as it provides an opportunity to informed traders to trade against non-informed ones, make profit, and bring the price back to its fundamental value. Nevertheless, divergences may occur and although short-lived, can be frequent. There are many empirical exceptions to the theory of efficient markets. For example, informed traders may choose to follow positive-feedback trading strategies. If they expected prices to continue rising, they will chase the trend in the short run, thus feeding the bubble, instead of alleviating it (de Long et al., 1990). DeMarzo et al. (2008) point out that even rational and informed traders may choose to join trend-chasing due to the risk underlying trading against the majority of participants. Dass, et al. (2008) focus on the incentives fund managers have to trend-chase, as they are assessed against the performance of other fund managers. This provides strong incentives for herding and accentuating a bubble.

In the debate of whether agricultural and food commodity prices are unjustifiably volatile and detached from market fundamentals, the agricultural economics literature has mainly centred on analyzing whether the 2008 dramatic food price increases were induced by speculative purchases of futures contracts by non-commercial institutional investors on prices. These analyses do not constitute tests for the detection of a bubble, but focus on identifying the possible avenues through which positive-feedback strategies in commodity exchanges contributed towards price increases that could not be explained by market fundamentals. Nevertheless, in these analyses the term 'bubble' is used liberally.



Irwin et al. (2009) assess the impact of speculative purchases of food commodity futures by index funds on futures prices by means of Granger causality tests and conclude that the argument that speculators caused the food price bubble does not hold. Sanders and Irwin (2010) investigate the effect of index funds' positions on the prices of a number of agricultural and food commodities, finding no impact when quarterly and monthly data were used, and only weak evidence when weekly data was analyzed. They concluded that, overall, the evidence that non-commercial investors with passive strategies affect agricultural futures prices is scant. Sanders and Irwin (2011) find little evidence of an index-induced food price bubble for a number of markets with the exception of soybeans.

Gilbert (2010) assesses the impact of an index of futures positions in twelve major agricultural futures markets on the International Monetary Fund (IMF) Food Price Index, in addition to the impact of other variables such as the price of oil, money supply and the US exchange rate. He concludes that index fund investment is sufficiently large to influence food prices. , In another paper, Gilbert (2010) formally tests for a bubble in three food commodities, maize, wheat and soybean, using futures prices and applying the methodology of Phillips, Wu and Yu (2011). He finds clear evidence for a bubble in soybean prices in December 2009 and in January 2009, but no evidence for explosive behavior in the wheat and maize prices. Gilbert (2010) finding concurs with that of Sanders and Irwin (2011) on the role of index funds in this market, but the interpretation of such results is not easy. First, the question relates to the avenue through which non commercial investment behavior would generate a price surge. Gilbert (2010) notes that an increase in the demand for futures contracts will tend to raise long-dated futures prices and increase inventory demand, which in the short term will result to an increase in the cash price. Recently, Gutierrez (forthcoming) found speculative bubbles for wheat corn and rough rice prices and minor evidence for soya bean prices. Such differences, as pointed out by Gutierrez (forthcoming), may be due to

differences in the bootstrap method used and differences in the method used to define the critical values.

## Theory

Among the potential analytical frameworks for explosive price behaviour, the most widely applied are models with rational bubbles which can be illustrated on the basis of the present value model. We follow Pindyck's (1993) application of the present value model on rational commodity pricing, where the price of a commodity  $P_t$  is determined by the stream of current and expected future payoffs  $\varphi_{t+i}$ . Pindyck (1993) draws an analogy with the rational pricing of assets, such as stocks, and underlines that for a storable commodity the stream of payoffs  $\varphi_{t+i}$  is the convenience yield accruing to the owner of the inventory in terms of benefits related to the facilitation of processing, sales and the avoidance stock-outs. The convenience yield that accrues to the owner of the inventory is directly analogous to the dividend on a stock. Therefore, the standard arbitrage condition becomes:

$$P_t = E_t \left[ \frac{1}{(1+\delta)} (P_{t+1} + \varphi_{t+1}) \right] \quad (1)$$

where  $\delta$  denotes the discount rate and  $E$  is the expectation operator conditional on information at time  $t$ . For equation (1) to hold, stocks should be positive and no stock-outs occur in contrast to the competitive storage model (Gustafson, 1958; Deaton and Laroque, 1992) where stock-outs play a central role in determining commodity prices in the absence of the convenience yield. The forward iteration of the difference equation (1) results in:

$$P_t = E_t \left[ \sum_{i=1}^{T-t} \frac{1}{(1+\delta)^i} (\varphi_{t+i}) \right] + E_t \left[ \frac{1}{(1+\delta)^{T-t}} P_T \right] \quad (2)$$

Equation (2) suggests that the equilibrium commodity price has two components: (i) a market *fundamental* component, the first term in the right hand side, which is the discounted value of

the expected future convenience yields; and, (ii) a *bubble* component, the second term in the right hand side, which is the expected capital gains, or discounted resale value. The presence of the bubble, although it reflects that the price of the commodity can exceed its fundamental value, is entirely consistent with rational expectations; however, it gives an infinite number of solutions for the price, hence the term ‘rational bubble’. For example, as Shiller (1978) suggests, a rational bubble could start at any time and, as in the specification of Blanchard and Watson, could burst and restart repeatedly. It also echoes Keynes’ thoughts on investors who forecast the yield over the life of the asset and speculators who forecast the psychology of the market: if agents believe that the selling price of a commodity will be high in the future, then it will not be only the fundamentals that will determine the current price, but also the expected capital gains.

Typically, in order to obtain a unique solution, the bubble component, that is the discounted value of the commodity, is normally assumed to converge to zero in the indefinite future. This is the transversality condition which rules out rational bubbles on the basis of a general equilibrium zero-sum argument (Tirole, 1982): the purchase of one unit of the commodity would make an infinitely lived agent worse off, as her utility would increase only by the fundamental component, that is the discounted value of the expected future convenience yields. In other words, no one would be willing to buy an over-priced commodity.

If the transversality condition holds, equation (2) reflects that the price is determined by the discounted value of the expected future convenience yields, giving rise to the standard present value model for commodities, as in Pindyck (1993). This model underlines the importance of the convenience yield reflecting the fundamental market forces: expectations on changes in supply and demand cause changes in the expected convenience yields, rendering the present value model a parsimonious and reduced form of a dynamic supply and demand system.

In spite of ruling bubbles out, many observers believe that bubbles exist and the literature treats such non-fundamental bubbles as possible within an empirical context. The possibility that bubbles could exist was stressed by Stiglitz (1990) who questioned that the transversality condition could be satisfied with agents that are not infinitely-lived and market institutions that do not support infinite planning, such as future markets extending infinitely into the future. More recently, Wang and Wen (2012) also show that, given incomplete financial markets and borrowing constraints, any inelastically supplied storable good can support a bubble, which can serve even infinitely-lived agents as a liquid asset.

Without imposing the transversality condition, any of the infinite solutions for the commodity price can be written as:

$$P_t = F_t + B_t,$$

$$\text{where } F_t = E_t \left[ \sum_{i=1}^{T-t} \frac{1}{(1+\delta)^i} (\varphi_{t+i}) \right] \text{ and } B_t = E_t \left[ \frac{1}{(1+\delta)} B_{t+1} \right]. \quad (3)$$

The statistical properties of  $P_t$  are determined by those of  $F_t$  and  $B_t$ . For example, if  $\varphi_t$  is an I(1) process,  $F_t$ , the discounted future stream of expected convenience yields is also an I(1).

The relation  $B_t$  is an empirical expression which embodies an explosive property and introduces ‘bubble’ movements in the price  $P_t$  over the fundamental component  $F_t$ . In the absence of bubbles,  $B_t = 0$ , a special case of (3), the current price of the commodity is determined according to market fundamentals is when, yielding the standard present value model with  $P_t = F_t$ , and if  $F_t$  is I(1), current prices are also I(1). If  $B_t \neq 0$ , current prices will exhibit explosive behaviour, as  $B_t$  reflects a submartingale process, that is a stochastic process in which the expected value of next period's value, as forecast on the basis of the current period's information, is greater than or equal to the current period's value.

Given the different stochastic properties of the fundamental and the bubble components, early tests for explosive behaviour in asset prices were based on standard Dickey-Fuller tests. As a series' explosive behaviour is still prevalent after differencing, Diba and Grossman (1988) tested both stock prices and dividends for nonstationarity. Evidence of stationarity after differencing was taken as providing no support for the existence of a bubble, while, cointegration between stock and dividends would support the conclusion that stock prices did not diverge from their fundamental values. Evans (1991) criticised this integration-based approach, stressing that unit root and non cointegration tests are not effective in making a distinction between a unit root or a stationary autoregression and a process which exhibits periodically collapsing bubble behaviour. The recursive tests proposed by Phillips, Wu and Yu (2011) are not subject to this criticism, being effective in distinguishing unit root processes from periodically collapsing bubbles and date-stamping their origin and collapse. Their methodology is based on a repeated application of the augmented Dickey-Fuller test (ADF), estimating through a recursive regression the specification:

$$\Delta y_t = \alpha_{r_w} + \beta_{r_w} y_{t-1} + \sum_{i=1}^k \varphi_{r_w}^i \Delta y_{t-i} + \varepsilon_t, \quad \varepsilon_t \sim N(0, \sigma_{r_w}^2) \quad (4)$$

where  $y_t$  is the logged price of the commodity studies at time  $t$ ;  $\alpha, \beta, \varphi$  are parameters to be estimated;  $r_w$  is the sample window size; and,  $k$  is the lag order. The recursive regression involves the estimation of (4) by least squares starting with  $r_w = r_0$  fraction of the sample, and repeatedly expanding the sample forward, with the last regression utilising the full sample  $T$ . For example, the first regression utilises a subsample  $\tau_0 = [Tr_0]$  from the first observation of the sample to the  $k^{th}$  observation, selected to ensure estimation efficiency. This produces an ADF statistic denoted  $ADF_{r_0}$ . The second regression expands the sample by one observation to the  $(k + 1)^{th}$  observation, utilising a subsample  $\tau_1 = [Tr_1]$  and producing an ADF statistic denoted by  $ADF_{r_1}$ . Subsequent regressions expand the sample window size  $r_w$ ,

from  $r_0$  to 1, with 1 being the whole sample and  $ADF_1$  corresponding to the whole sample ADF statistic. Phillips, Wu and Yu (2011) by expanding the sample forward, generate a sample of ADF statistics and test the null hypothesis of a unit root against the right-tailed alternative of explosive behaviour with the supremum  $ADF, r_{w \in [r_0, 1]}^{sup} ADF_{r_w}$ , utilising the critical values.

Although the *sup* ADF detects periodically collapsing bubbles, date stamping its origination and subsequent collapse, Phillips, Shi and Yu (2012) underlined its weakness when there are multiple bubble episodes within the same sample period, a condition characterising food commodity prices since 2007.

Econometric analysis of explosive processes using *sup* ADF has been conducted mainly in financial research (Phillips, Wu and Yu, 2011). *sup* ADF differs from the GSADF in that the former uses a fixed initialisation window whereas the latter uses a moving window, which avoids results being sensitive to sample start data. Also, the GSADF does allow for the possibility of periodically collapsing bubbles (Phillips, Wu and Yu, 2011).

We use the generalised version of the *sup* augmented Dickey-Fuller (GSADF) test recently developed by Phillips, Shi and Yu (2012), which has not been applied using agricultural prices, to test for bubble phenomena. This test is characterised by its ability to deal with multiple bubbles (Phillips, Shi and Yu, 2012). The first order Augmented Dickey-Fuller regression model used by Phillips, Shi and Yu (2012) is

$$\Delta y_t = \alpha_{r_1, r_2} + \beta_{r_1, r_2} y_{t-1} + \sum_{i=1}^k \varphi_{r_1, r_2}^i \Delta y_{t-i} + \varepsilon_t \quad (5)$$

Following the GSADF approach by Phillips, Shi and Yu (2012) we allow for variable window widths in the recursive regressions. This allows the starting points  $r_1$  to change within a feasible range. The standard Augmented Dickey-Fuller (ADF) tests the null hypothesis of

non-stationarity  $H_0: \beta_{r1,r2} = 0$  against the alternative hypothesis  $H_1: \beta_{r1,r2} > 0$  which implies explosive behaviour. Significant ADF test statistics indicate a bubble episode. The estimated parameters  $\alpha, \beta, \varphi$  of model (5) are obtained through recursive ordinary least squares (OLS)<sup>2</sup>. The idea behind is that if an explosive behaviour exists this will be present over a subsample  $[r1, r2]$  of the entire sample  $[1, T]$ .

Phillips, Shi and Yu (2012) provide critical values of GSADF tests against an explosive behaviour. These critical values were obtained setting the lag order to be zero (i.e. zero lags). We obtained the asymptotic 90, 95 and 99% critical values for lag orders set from 0 to 12 by numerical simulations, where, as in Phillips, Shi and Yu (2012), the Wiener process is approximated by partial sums of 2,000 independent  $N(0,1)$  variates and the number of replications is 2,000. For our empirical application we set the smallest sample window  $r_0 = 0.4$ . The asymptotic critical values obtained are shown in the Appendix.

## **Data**

We apply the most recent methodological development in identifying price bubbles by Phillips, Shi and Yu (2012) to examine whether recent increase in agricultural prices can be categorised as price bubbles (i.e. strong deviations from their intrinsic values). We analyse price indexes for food and beverage and agricultural raw materials as well as 28 individual agriculture commodity prices (see appendix for list of price definitions).

We use monthly price indices data from the Food and Agriculture Organisation of the United Nations (FAO), as well as from International Monetary Fund (IMF). The FAO indices include the food price index, as well as indices for meat, dairy, cereals, oils and sugar from January 1990 to August 2012 comprising 271 observations for each index. We examine the IMF indices that include which include the food and beverage index, and indices for food,

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<sup>2</sup> We use 10% of the total sample as the starting sample.

beverages and agricultural raw materials from January 1980 and February 2012 comprising 386 observations.

Data on the 28 individual agricultural commodity prices are collected from the International Financial Statistics of the IMF from January 1980 and February 2012 and deflated using the US monthly CPI obtained from the US Department of Labour.

## Results

We follow the approach by Phillips, Shi and Yu (2012) and apply the generalised version of the supremum ADF to test for multiple bubble phenomena in food and agricultural raw materials prices. We estimate equation (4) allowing for variable window widths in the recursive regressions. Phillips, Shi and Yu (2012) provide critical values of GSADF tests against an explosive behaviour using Monte Carlo simulations, setting the lag order to be zero (i.e. zero lags). We obtained the asymptotic 90, 95 and 99% critical values for lag orders set from 0 to 12. As in Phillips, Shi and Yu (2012), the Wiener process is approximated by partial sums of 2,000 independent  $N(0,1)$  variates and the number of replications is 2,000. For our empirical application we use 10% of the sample, as our initial start-up sample,  $r_0=0.1$ , and set the smallest sample window  $r_w = 0.4$ . The asymptotic critical values obtained are shown in the Appendix.

Table 1 shows the maximum ADF test obtained from estimating the GSADF model (4) repeatedly over the feasible ranges  $r_1$  and  $r_2$ . Maximum values greater than the critical values reported show evidence of bubble behaviour in the particular index or price as the tests reject the null hypothesis  $H_1: \beta_{r_1}^{r_2} > 0$  in favour of the right tailed alternative hypothesis  $H_0: \beta_{r_1}^{r_2} = 0$ . The tests provide evidence for bubble behaviour at the 10% significance level for the both the FAO and IMF food price indices, the IMF food and beverage price index, the FAO cereals, dairy and oils indices, and the prices of wheat, rice, soybean oil, rapeseed oil,



sugar and coffee. In order to date-stamp the origin and conclusion of the explosive behaviour in the series we plot the relevant recursive  $ADF_{r_1}^{r_2}$  statistics (Figure 2).

Our results show bubble behaviour during the end of 2007 and the first months of 2008 in six out of the ten indices examined. For the FAO food price index, the evidence suggests persistent explosive behaviour from August 2007 until June 2008, while the IMF food and food and beverages price indices bubble behaviour is found during January, February and March 2008. Within the food and beverage index (IMF) it is possible that the food component is the factor behind the bubble behaviour since no explosive behaviour is attributable neither to the beverage index nor to any of the individual beverages analysed during the period 2007-2008. For the FAO cereals index, there is evidence for bubble behaviour from December 2007 to April 2008, and for the FAO oils index during February and March 2008. Not entirely synchronised explosive behaviour of indices may be attributable to the different aggregation and weighting methods. The FAO food price index is trade-weighted and as trade increased at a fast rate during the 2007-08 period, the results show persistent bubble behaviour. Amongst food commodities the strongest evidence for a price bubble occurring is for rice, for which the explosive behaviour lasted for three months, from February 2008 to April 2008, and again in July 2008. Prices of wheat, soybean oil and rapeseed oil show bubble behaviour during February and March 2008.<sup>3</sup>

The analysis provides some interesting findings. First, our recursive regressions suggest that the price surge of 2007-08 is of a different nature than that of 2010 and 2011, as no evidence is found of explosive behaviour in indices and prices outside the period August 2007 to July 2008. Although in 2010 and 2011, wheat prices surged as a result of climatic factors and policies, such as the export ban by Russia in 2010, there is no evidence that prices exceeded

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<sup>3</sup> Evidence for bubble behaviour was also found for sugar and robusta coffee, but is unrelated to the recent price increases in agricultural commodities prices and therefore is not presented here.

their fundamental value. In sum, we do not detect multiple bubbles in the food price series after the summer of 2008, a finding that suggests that since that time, food prices respond to the fundamental forces of demand and supply. Second, the analysis suggests that price bubbles are relatively short lived. With the exception of the FAO food price index, explosive behaviour in food prices lasted for a limited period of time amounting to two, three or, at most four months, before collapsing. Thirdly, for the individual commodity prices, the tests provide evidence for bubble behaviour in the wheat, rice, soybean oil and rapeseed oil price series all of which have exhibited record increases during the first months of 2008 relative to other commodities. In their peak, wheat and rice prices were 350 and 530 percent higher, as compared to January 2002 levels which could mark the beginning of an upward trend in food prices.

Although our analysis provides answers as to if, and when food prices exhibited bubble behaviour, the results raise a number of important questions related to the drivers of explosive behaviour. As far as the price of rice is concerned, the results concur with the panic –driven trade policy reactions of countries in Asia. Export restrictions, in the form of both taxes and bans, beginning during late 2007 were crucial in generating bubble behaviour in the price of rice. In late September 2007, Vietnam, the second largest exporter in rice, announced a ban on commercial sales. In October 2007, India, the third largest rice exporter, imposed an export tax on non-basmati rice and in March 2008 imposed a complete ban in March. These export bans, in conjunction with aggressive and panic-driven buying by Philippines, the world's leading importer, during March and April 2008 at prices over US\$ 1,100 per tonne, as compared to an average of US\$ 326 per tonne in 2007, contributed towards the price of rice being over-valued, detaching from market fundamentals.

The results for bubbles in the wheat and vegetable oil prices, though not surprising, are more difficult to be interpreted, especially because no explosive behaviour was detected in the

prices of maize and oilseeds. At their peak in 2008, soybean oil prices increased by 410 percent as compared to their January 2002 values, proportionally more than those of soybeans which increased by 350 percent. Maize prices also registered a significant increase at their peak in 2008 from their January 2002 level by about 300 percent, a rate lower than that of wheat prices. For all four commodities, markets were tight in 2007-08: oilseeds and oils markets suffered from poor growth and low stocks; in the wheat market, stagnant production in conjunction with very low carryover stocks resulted in an extremely tight global market; and, maize prices also faced pressure from strong demand from the biofuels industry, although the 2007 record crop relatively lessened the strain on the market.

Beyond fundamentals, even if the GSDAF detects price bubbles, it does not provide sufficient evidence that these bubbles are the result of trend-following behaviour in the futures markets. Nevertheless, the lack of evidence on explosive behaviour in maize and oilseeds prices questions the conjecture that trend-following behaviour in futures markets has been the driver of food price increases. Maize and oilseeds futures are traded in commodity exchanges and, like wheat, their contracts are included in commodity indices. There are some differences in index investments movements across these commodities, but these do not correspond with our findings on explosive behaviour. Between December 2007 and June 2008, the index funds' net positions on wheat increased from 38.2% to 41.9% of the total open interest. During the same six months period, for maize the share of the index funds net positions was not as substantial as that of wheat, but also increased from 25.8% to 27.4% of the total (Gilbert, 2010). With such a high share of the wheat open interest held by non-commercial traders, in an already tight market, the possibility that the demand for long-termed wheat futures contracts may have affected prices and generated bubbles through strengthening inventory demand, should not be ignored. The size of index funds' wheat net positions come second only to the share of open interest they held on live cattle and lean hogs, which amounted to

over 40 percent during 2007-08. In spite of this high share, no bubble is detected in beef and pork prices. Nevertheless, it is doubtful that index fund investments would have a direct impact on meat markets, through strengthening the demand for inventories (herds) in a period of high feed prices. The specificities of each food market, in conjunction with the wide diversity of traders, both non commercial and commercial, and their complex trading behaviour over a short period of time, makes the analysis of the role of futures markets in the 2007-08 price episode difficult and beyond the scope of this article.

## **Conclusions**

Recently there has been a rise in agriculture products price volatility which has had a wide range of implications. A number of tests and dating algorithms have been developed and used to identify rapid increases in prices followed by a collapse, also known as explosive bubbles (Phillips, Wu and Yu, 2011; Phillips, Shi and Yu, 2012; Gilbert, 2009). We apply the GSADF test for explosive bubbles to monthly time-series for food, beverages, agricultural raw material, cereals, dairy, meat, oils and sugar indices and a total of 28 agricultural commodities between 1980-2012.

These tests identified that price bubbles occurred for some commodities within food markets. Such rapid changes in agricultural commodity prices may have important immediate effects on the income and welfare of producers, agents along the food chain and consumers as well as the trading positions of countries (Balcombe, 2009). Two important questions arise, a) are the price bubbles found in food commodities of speculative origin?; b) are some commodities more prone to suffer price bubbles than others

Looking forward, on question a) there is need for further analysis of trading positions of commercial and non commercial participants in the futures markets. A price bubble was identified in the wheat market, where the share of open interest was held by non-commercial

traders. However, maize, as well as other commodities are traded in futures markets and further research based on disaggregated data on the composition of both commercial and non commercial positions and their behaviour during price surges is necessary to unravel their potential role in determining price movements. Regarding b) specifically we conclude that a number of agriculture commodities are prone to suffer price bubbles and therefore efforts in both identifying and tackling price bubbles should focus on those commodities that have shown bubble behaviour in the past. For example, the global rice market is quite thin, with major producers and exporters managing domestic markets through export controls combined with buffer stocks. Our results show that export restrictions can exacerbate or even cause severe disruption and a collapse in confidence on international markets. Increased international trade policy coordination in times of crisis can also reduce volatility and ensure that global markets can be still a reliable source of food. Enhanced trade policy harmonization through more predictable and less discretionary policies would convey clearer information and render panic and hoarding less likely, resulting in less uncertainty.

From the methodological point of view, an important issue also highlighted by Gilbert (2010) is the data frequency (e.g. daily, monthly) used in the analysis may be important in detecting bubbles. The fact that we have not found more price bubbles may be precisely because of the data frequency used (i.e. using higher frequency data such as daily data may have detected bubbles that are disguised under lower frequency data).

Therefore, high frequency data of agricultural prices, particularly data of commodities that have shown bubble behaviour in the past, should be used to detect emerging trends of price spikes. Cereals, such as wheat and rice, staple crops, and vegetable oils such as soybean and rapeseed oil have shown bubble behaviour in the recent years and close attention should be paid to their price evolution. On the other hand, fruits meat, seafood and to a large extent

beverages have not shown evidence of bubble behaviour and therefore the relative risk of bubble behaviour may be low.

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Table 1. GSADF model results for agricultural commodities

<b>Commodities</b>	Max	90% critical value	Lags	n
<b>Index</b>				
Food and beverage index	2.00	1.87	1	254
Food Index	2.09	1.87	1	254
Beverages Index	0.88	2.11	1	386
Agricultural Raw Material Index	1.41	2.11	1	386
Food Price Index – FAO	3.10	1.93	1	271
Cereals Price Index – FAO	2.98	1.93	1	271
Meat Price Index – FAO	-0.04	1.93	1	271
Dairy Price Index – FAO	1.97	1.93	1	271
Oil Price Index – FAO	2.28	1.93	1	271
Sugar Price Index – FAO	1.06	1.93	1	271
<b>Cereals</b>				
Wheat	2.24	2.11	1	386
Maize	1.13	2.11	1	386
Rice	4.09	2.29	2	386
Barley	0.85	2.11	1	386
<b>Vegetable oils and protein meal</b>				
Soybean	1.28	2.11	1	386
Soybean meal	0.68	2.11	1	386

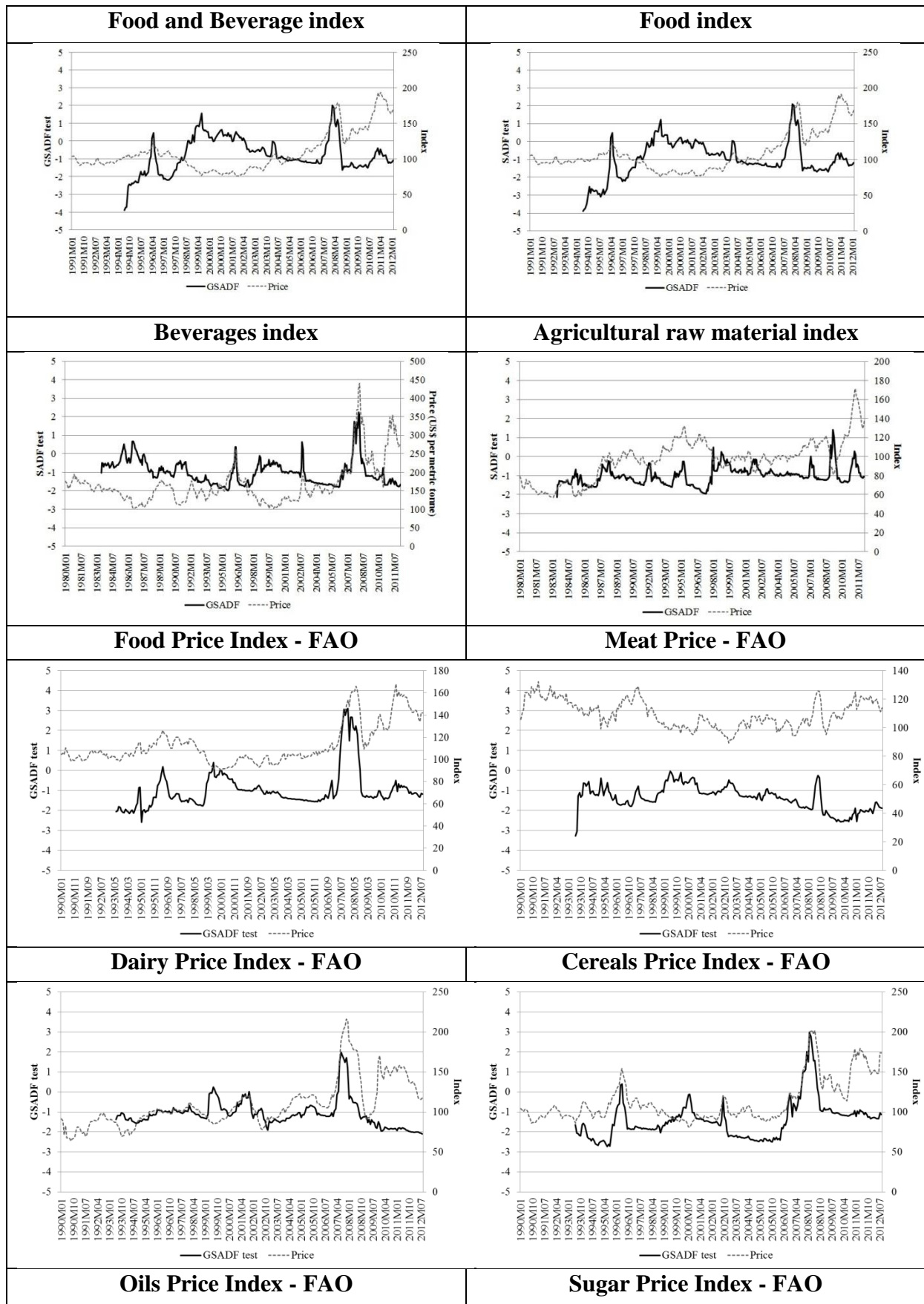
Soybean oil	2.60	2.11	1	386
Palm oil	1.90	2.53	4	386
Fishmeal	2.01	2.11	1	386
Sunflower oil	1.11	2.29	2	386
Olive oil	1.89	2.29	2	386
Groundnuts (peanuts)	0.80	2.11	1	386
Rapeseed oil	2.09	1.96	0	386
<b>Meat</b>				
Beef	1.36	2.29	2	386
Lamb	0.34	2.29	2	386
Swine (pork)	1.51	1.96	0	386
Poultry (chicken)	0.89	2.11	1	386
<b>Seafood</b>				
Fish (salmon)	0.80	2.71	6	386
Shrimp	0.00	2.29	2	386
<b>Sugar</b>				
Sugar, free market	1.56	2.11	1	386
Sugar, European import price	1.53	1.87	1	254
Sugar, U.S. import price	3.50	2.11	1	386
<b>Fruit</b>				
Bananas	-1.44	1.96	0	386
Oranges	-0.61	2.11	1	386
<b>Beverages</b>				
Cocoa beans	2.07	2.29	2	386

Coffee, other mild arabicas	1.70	2.11	1	386
Coffee, Robusta	2.15	2.11	1	386
Tea	0.38	2.11	1	386

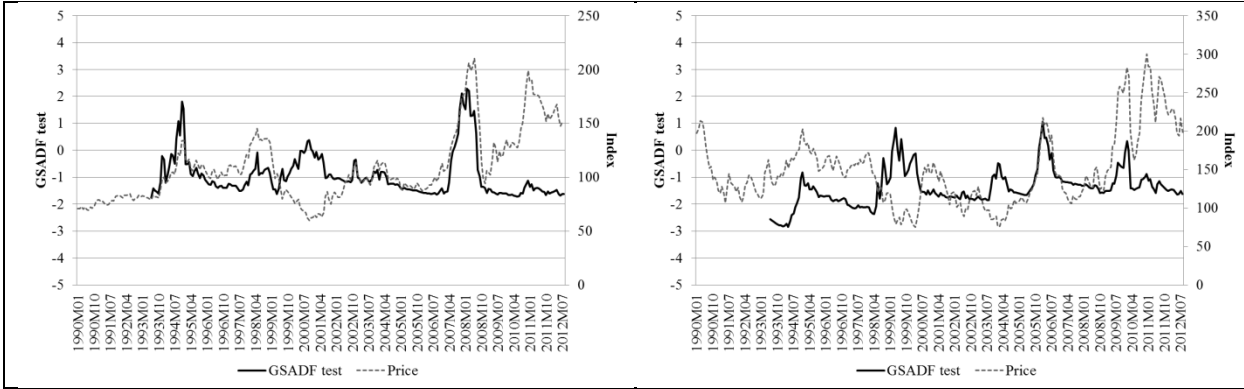
**Figure 1. FAO Food price index**



Figure 2 Price trends and GSDAF test statistics







## Appendix

Tables A.1, A.2 and A.3 show the critical values at 90, 95 and 99% level, respectively. Tables show the critical value by lags (0 to 12) and number of observations (100 to 500).

Table A.1

Number of lags	Number of observations								
	100	150	200	250	300	350	400	450	500
0	1.145	1.449	1.593	1.723	1.814	1.892	1.957	2.009	2.045
1	1.267	1.567	1.753	1.868	1.970	2.028	2.111	2.160	2.208
2	1.415	1.748	1.926	2.056	2.153	2.236	2.289	2.343	2.384
3	1.462	1.775	2.004	2.154	2.239	2.331	2.396	2.451	2.501
4	4.607	1.987	2.159	2.311	2.397	2.473	2.534	2.577	2.631
5	1.628	1.988	2.210	2.335	2.435	2.539	2.620	2.688	2.728
6	1.691	2.089	2.317	2.457	2.571	2.678	2.750	2.785	2.841
7	1.768	2.162	2.382	2.514	2.639	2.733	2.800	1.875	2.930
8	1.834	2.258	2.502	2.639	2.733	2.834	2.891	2.961	3.024
9	1.838	2.263	2.465	2.659	2.763	2.855	2.925	2.988	3.051
10	1.953	2.389	2.613	2.763	2.877	2.962	3.037	3.126	3.182
11	1.985	2.439	2.671	2.806	2.930	3.046	3.092	3.161	3.220
12	2.093	2.477	2.749	2.916	3.039	3.132	3.215	3.273	3.325

Table A.2

Number of lags	Number of observations								
	100	150	200	250	300	350	400	450	500
0	1.455	1.709	1.863	1.992	2.061	2.140	2.203	2.266	2.308
1	1.589	1.836	2.039	2.163	2.251	2.310	2.374	2.423	2.458
2	1.780	2.061	2.209	2.347	2.426	2.520	2.567	2.618	2.662
3	1.783	2.131	2.331	2.474	2.566	2.649	2.715	2.759	2.789
4	2.015	2.335	2.496	2.605	2.695	2.765	2.836	2.873	2.923
5	2.000	2.334	2.517	2.659	2.759	2.852	2.923	2.974	3.003
6	2.083	2.484	2.664	2.806	2.896	2.992	3.037	3.097	3.138
7	2.168	2.492	2.735	2.881	2.985	3.058	3.109	3.157	3.185
8	2.280	2.645	2.874	2.990	3.061	3.144	3.212	3.260	3.317
9	2.235	2.659	2.869	3.007	3.127	3.218	3.305	3.359	3.418
10	2.350	2.761	2.970	3.127	3.239	3.311	3.378	3.438	3.490
11	2.418	2.821	3.008	3.122	3.250	3.349	3.424	3.476	3.514
12	2.452	2.870	3.103	3.259	3.358	3.445	3.564	3.601	3.654

Table A.3

Number of lags	Number of observations								
	100	150	200	250	300	350	400	450	500
0	2.048	2.229	2.381	2.493	2.639	2.716	2.766	2.791	2.803
1	2.160	2.440	2.641	2.738	2.848	2.917	2.968	2.994	3.033
2	2.484	2.667	2.787	2.916	2.993	3.093	3.173	3.222	3.232
3	2.488	2.849	3.003	3.059	3.159	3.241	3.281	3.330	3.346
4	2.751	3.072	3.216	3.254	3.325	3.352	3.431	3.472	3.517
5	2.778	2.977	3.144	3.281	3.377	3.498	3.539	3.576	3.629
6	2.885	3.179	3.296	3.424	3.529	3.589	3.660	3.688	3.736
7	2.972	3.272	3.411	3.539	3.663	3.712	3.786	3.825	3.835
8	3.061	3.325	3.441	3.559	3.684	3.815	3.829	3.864	3.977
9	3.084	3.508	3.678	3.788	3.842	3.890	3.994	4.065	4.086
10	3.225	3.452	3.621	3.752	3.864	3.937	4.025	4.078	4.105
11	3.088	3.545	3.692	3.811	3.893	3.934	3.957	4.017	4.063
12	3.253	3.575	3.792	3.937	4.054	4.162	4.243	4.243	4.307

### **List of agriculture commodities price definitions**

1. Bananas, Central American and Ecuador, FOB U.S. Ports, US\$ per metric tonne
2. Barley, Canadian no.1 Western Barley, spot price, US\$ per metric tonne
3. Beef, Australian and New Zealand 85% lean fores, CIF U.S. import price, US cents per pound
4. Cocoa beans, International Cocoa Organization cash price, CIF US and European ports, US\$ per metric tonne
5. Coffee, Other Mild Arabicas, International Coffee Organization New York cash price, ex-dock New York, US cents per pound
6. Coffee, Robusta, International Coffee Organization New York cash price, ex-dock New York, US cents per pound
7. Rapeseed oil, crude, fob Rotterdam, US\$ per metric tonne
8. Fishmeal, Peru Fish meal/pellets 65% protein, CIF, US\$ per metric tonne
9. Groundnuts (peanuts), 40/50 (40 to 50 count per ounce), cif Argentina, US\$ per metric tonne
10. Lamb, frozen carcass Smithfield London, US cents per pound
11. Maize (corn), U.S. No.2 Yellow, FOB Gulf of Mexico, U.S. price, US\$ per metric tonne
12. Olive Oil, extra virgin less than 1% free fatty acid, ex-tanker price U.K., US\$ per metric tonne
13. Oranges, miscellaneous oranges CIF French import price, US\$ per metric tonne
14. Palm oil, Malaysia Palm Oil Futures (first contract forward) 4-5 percent FFA, US\$ per metric tonne
15. Swine (pork), 51-52% lean Hogs, U.S. price, US cents per pound.
16. Poultry (chicken), Whole bird spot price, Ready-to-cook, whole, iced, Georgia docks, US cents per pound

17. Rice, 5 percent broken milled white rice, Thailand nominal price quote, US\$ per metric tonne
18. Fish (salmon), Farm Bred Norwegian Salmon, export price, US\$ per kilogram
19. Shrimp, No.1 shell-on headless, 26-30 count per pound, Mexican origina, New York port, US cents per pound
20. Soybean Meal, Chicago Soybean Meal Futures (first contract forward) Minimum 48 percent protein, US\$ per metric tonne
21. Soybean Oil, Chicago Soybean Oil Futures (first contract forward) exchange approved grades, US\$ per metric tonne
22. Soybeans, U.S. soybeans, Chicago Soybean futures contract (first contract forward) No. 2 yellow and par, US\$ per metric tone
23. Sugar, European import price, CIF Europe, US cents per pound
24. Sugar, Free Market, Coffee Sugar and Cocoa Exchange (CSCE) contract no.11 nearest future position, US cents per pound
25. Sugar, U.S. import price, contract no.14 nearest futures position, US cents per pound  
(Footnote: No. 14 revised to No. 16)
26. Sunflower oil, Sunflower Oil, US export price from Gulf of Mexico, US\$ per metric tonne
27. Tea, Mombasa, Kenya, Auction Price, US cents per kilogram, From July 1998, Kenya auctions, Best Pekoe Fannings. Prior, London auctions, c.i.f. U.K. warehouses
28. Wheat, No.1 Hard Red Winter, ordinary protein, FOB Gulf of Mexico, US\$ per metric tonne