Commodity market deregulation and food prices

The view from the US

STEVE SUPPAN takes a hard look at the relationship between big business and US Government, and asks whether the 'revolving door' of American politics will ever allow effective regulation of commodity markets.

The 200 million person increase in global food insecurity since 2006 – over one billion according to UN Food and Agricultural Organization (FAO) – did not result from global production failure or a shortage of supply. Global food production increased on a per capita basis throughout the past decade and 2008 saw a record global cereal harvest.[1] The trigger for food riots in at least 30 net food import dependent developing countries in 2008 was extreme spikes in food and energy prices. A major driver of these price spikes was rather the overwhelming market domination of financial firms over traditional traders in commodity futures markets.

In March 2008, US Commodity Futures Trading Commission (CFTC) rules limited commercial users of commodities to owning 11 million bushels of Chicago Board of Trade (CBOT) maize futures contracts, while Goldman Sachs and Morgan Stanley investors, exempted from contract limits, controlled 1.5 billion bushels. Futures contracts provide short term (generally 90 days for agricultural contracts) protection against abrupt prince increases for commodity users (such as bakeries or cereal manufacturers) and against abrupt price decreases for commodity producers (such as farmers). However, investment bank "weight of money" drove prices up and then down, as they "rolled out" of contracts and bought new ones.

CBOT and other US agricultural futures market prices are globally influential, not only because futures and cash contracts are denominated in dollars, but because US prices are used by policy makers in agricultural export and import planning. Futures contracts became ineffective price risk management tools not only for developing country importers, but also for commodity users in developed countries.[2]

In orderly and transparent markets, futures contract prices should converge to set a predictable cash price based on supply and demand fundamentals. Explaining what the UN Conference on Trade and Development calls the "financialisation of commodity markets"[3] is a necessary first step in understanding how the deregulation of commodity and financial markets led to a food price crisis. Without strict regulation and enforcement, spikes in food prices could be repeated in the near term.

> What do oil and gold prices have to do with agriculture?

Disorderly markets: some origins and consequences

Following the global decline in agricultural futures prices from their June 2008 peaks, the FAO Food Index has risen each month since August 2009. FAO notes that agricultural markets remain structurally susceptible to price volatility originating from non-agricultural markets.[4] What do oil and gold prices have to do with agriculture prices?

On June 24, 2009, the US Senate Subcommittee on Investigations published "Excessive Speculation in the Wheat Market." The report concludes that price volatility in wheat futures contracts in 2007-2008 could not be explained by supply, demand and other fundamental factors. The Senate investigators found that commodity index fund traders had driven up wheat futures prices from US$3/bushel in 2006 to over US$11/bushel in mid-2008, collapsing to US$3.50/bushel by the end of 2008.[5] Investors in commodity index funds, such as those of Goldman Sachs or Morgan Stanley, bet on the price movements of indices bundling up to 24 commodity futures contracts, including energy, agricultural, base metal and precious metal contracts. Bush administration CFTC waivers exempted index traders and other financial institutions from rules governing how many contracts could be held in a given commodity for a given time period. The rules governing contract position limits were designed to prevent any trader or group of traders from inducing price volatility or otherwise manipulating markets.

Furthermore, under the "Enron Loophole" successfully defended during the Bush administration, the CFTC exempted financial service energy trades from reporting, so CFTC regulators couldn't effectively monitor dominant market forces. Most index fund contracts are traded "Over the Counter," (OTC) in "dark markets" not subject to commodity exchange regulation. As a result, the oil futures dominant Goldman index fund and other index funds induced price spikes in wheat and other agricultural commodities until June 2008, when the investment bubble burst and aggregate commodity prices fell

about 60% by mid-November 2008.[6]
On January 14, the CFTC proposed a rule, which if approved, would impose the first position limits on energy futures contracts. Two of the five CFTC commissioners who voted to release the rule for public comment expressed US financial industry warnings that even the generous position limit rule would drive energy trades overseas, especially to their London branches.[7] It almost goes without saying that proposals to regulate European markets are met with industry threats that trades will be executed in US markets.[8]

Won't get fooled again?

What have investors, legislators and regulators learned since the financial market crisis following the mid-September 2008 bankruptcy of Lehman Brothers? Market analyst John Authers writes, "Usually after such an excessive episode, investors stay away for a while. But this time, they are rushing back into the same places where bubbles burst barely a year ago."[9]
In January, Goldman reversed more than a decade of advice to clients, when it wrote "we do not recommend a strategic allocation to a commodity futures index."[10] Although the analysts charted price data going back to 1845 and cited academic analysis, their climb down from recommending index investments was more plausibly dictated by the withering analysis and Congressional testimony about this massively destructive financial instrument.[11]
Nevertheless, Goldman recommends continued investments in commodities, above all in oil, the underlying asset of their lucrative energy trades, which will affect agricultural prices indirectly in production and transportation costs, even if investors avoid index trading.[12]
However, the economic and political dominance of the "too big to fail" banks hardly resides in trading commodity derivatives, which include using futures contracts, e.g. oil, to hedge various financial instrument risks. The value of OTC (off-exchange) commodity derivatives contracts is less than one% of the estimated US$592 trillion 2009 global market of OTC derivatives, which include trades in interest rate, foreign currency exchange, debt and other financial instruments.[13] The new CFTC chair Gary Gensler, formerly a Goldman manager, said that OTC commodity and financial derivative trades were at the heart of the financial crisis, and called for their strict regulation.[14]
Preventing effective regulation of the OTC derivatives market is crucial to the banks' power. Some corporate commodity end users have played the role of "useful idiots" in the banks' strategy.
On December 11, the US House of Representatives passed financial services reform legislation that includes provisions to regulate OTC trades. Financial markets analyst Adam White estimates that legislative loopholes will exempt at least 40-45% of OTC trades from clearing on exchanges or other regulated venues. Prominent among these exemptions is one for trades between banks and non-bank derivatives "end-users."[15] Signatories to a Coalition of Derivatives End User letter in support of the exemption include agribusiness firms such as Bunge, Cargill and John Deere.[16] The exemption would allow banks and non-banks to gain competitive advantage from commodity exchange price information while maintaining their own trades in dark markets and part of their debt in off-balance sheet financing vehicles. Déja vu - unless the US Senate closes the House loopholes.

The coming financial crisis and food security

The outlook for a sustainable and transparent financial system to underwrite trade dependent food security is not good. First, the US needs to know why the system failed, in order to fix it. Consonant with the Obama administration's stated interest in the future, not the past, the budget for the just launched congressional Financial Crisis Inquiry Commission, scheduled to report December 15, is just $8 million.[17]
The Wall Street lobbying budget for defeating financial reform legislation is thus far $344 million, a tiny investment for protecting $35 billion revenue from derivatives trades.[18]
Given the thus far successful resistance of Wall Street and its revolving door of government allies to reform, Simone Johnson, former chief economic of the International Monetary Fund, predicts another financial crisis within twelve months. [19] If half of all derivatives continue to trade in dark markets, Wall Street self-regulation is unlikely to prevent another US financial crisis, and a consequent repatriation of capital flows from developing countries, leaving their treasuries bare of hard currencies to pay for food imports.
Two thirds of all developing countries remain import dependent for a critical margin of their food security. Twenty years ago, Solon Baraclough wrote on how an unstable global monetary system intensified commodity price volatility to the detriment of food security.[20]
Since then, new "financial innovations" have only exacerbated this instability. Advocates of yet greater dependency on trade liberalisation for food security can only hope that the global financial services industry is regulated before it destroys what remains of the liberalisation project.

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