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Betting Against Food Security: Futures Market Speculation

Setting the table[1]

According to the United Nations Food and Agricultural Organization (FAO), the food import bill of developing countries rose from $191 billion in 2006 to $254 billion in 2007. Due to sharp commodity price increases until July 2008, FAO projects a global $1 trillion food import bill for 2008, a 23 percent increase over 2007 and a 64 percent increase over 2006.[2] The fall in commodity prices after July has not yet been transmitted to supermarket prices and it is unlikely that there will be a corresponding food retail price decrease in 2009. In October, a survey of 27,000 persons in 26 countries reported that 43 percent of those polled had reduced their food consumption. To the very conservative estimate of 850 million food insecure people, in 2007 FAO estimated another 75 million had joined this agonizing and scandalous statistic. The popular protests around the world against the sharp increase in food prices are more than well known.

Commodity price speculation has been recognized as a factor in these price increases. For example, a marketing consultant estimated that of the July price of a yellow corn Chicago Board of Trade contract, about 31 percent was due to financial speculation, irrespective of the supply and demand factors affecting prices.[3] Despite the harmful effects of financial speculation for food security, the use of speculative instruments is universal in commodities exchanges, including those in Chicago, New York and London. These exchanges are the most influential in determining international agricultural prices, often referred to by developing country governments in their national agricultural planning.

In traditional price risk management, the fundamental instrument is a contract that obliges the purchase or sale of an agreed quantity of a commodity at an agreed price and date, usually 90 days from the contract date for agricultural commodities. Investors in futures contracts lock in prices to avoid sharp price falls (if they are sellers) or abrupt price increases (if they are commodity users)—for example, food processors using wheat. The purchase and sale of these contracts are regulated in public exchanges. There are regulatory limits to the number and value of futures contracts that are set in relation to the quantity and value of a given commodity traded in the exchange over a defined period.

New forms of speculation

To avoid regulatory limits on speculation, proponents of financial services liberalization got an exemption on speculative position limits in 2000 so that financial speculators could buy and resell futures contracts to exchange price risks ("swaps"), as if "swaps" were insurance contracts against price risk. (In mid-December, then-President-elect Barack Obama nominated the main author of the swaps loophole, Gary Gensler, presently a Goldman Sachs partner and a Treasury Department official in 2000, to be chair of the Commodities Futures Trading Commission (CFTC).[4] According to *The Wall Street Journal*, commodities speculation contributed $1.5 billion to Goldman's bottom line in 2008, about a third of its estimated net income. Average estimated bonuses for commodity trading directors in 2008 are $3 to 4 million, down 25 percent from 2007.[5]) Furthermore, instead of "betting" on this or that commodity, some financial institutions created commodity index funds to diversify price risks and, supposedly, to reduce them for investors.

Instead of buying and selling contracts according to supply and demand factors, the index funds bought or sold a group of commodities packaged as a financial instrument, according to a proprietary mathematical formula. For example, the most traded index fund, set up by Goldman Sachs/Standard and Poors, with nearly two thirds of the commodity index fund market in 2007, bundles up to 24 commodities. Each fund has an average weight of about 30 percent agricultural and 70 percent non-agricultural commodities, mostly oil. Instead of managing price risk on commodities commercialized by the investors themselves, the purely financial speculators in the new funds drove prices up until the moment when they took profits by selling the index fund contracts to other investors.[6]

A large share of the commodity exchange price volatility resides not so much in supply and demand of the commodity traded as in the fund formulas for buying and selling the bundled futures contracts. In July, there were an estimated $318 billion invested in such funds, the large majority of them in private, Over-The-Counter contracts over which governments lacked regulatory authority and verified information.

According to *The New York Times*, in 2004 Henry Paulson, the chief executive officer of Goldman Sachs, and future U.S. Treasury Secretary, petitioned the Securities and Exchange Commission (SEC) for a key regulatory exemption on behalf of the banks that traded in the new speculative contracts. Paulson contended that his bank, Lehman Brothers, Morgan Stanley, Bear Stearns and J.P. Morgan were so well capitalized and sophisticated in their price risk management that they should be exempt from SEC capital reserve rules required of other banks to cover their trading losses.[7]

Once this exemption was granted, the beneficiary banks were able to release billions of dollars of reserves for speculation. When the commodity prices inflated by the new forms of speculation collapsed, the lack of reserves in those banks left them insolvent. Except for Lehman Brothers, these banks have been the major beneficiaries of $350 billion of the taxpayer-funded Troubled Asset Relief Program championed by Secretary Paulson and passed by Congress in the heat of the U.S. election campaign.

U.S. legislative response and the possibility of international regulation of speculation

There is no intergovernmental agreement to regulate commodity exchanges. Indeed, the World Trade Organization agreement on financial services restricts the capacity of governments to regulate those services, of which commodity exchanges are one service category.[8] However, already in April, the U.S. Congress began to investigate the sudden rise in commodity prices, not so much because of their effect on food security as because of the disruptive effects of speculative price spikes on the agribusiness financial system.

One result of the legislative initiatives was the House of Representatives' approval on September 18 of "The Commodity Exchange Transparency and Accountability Act of 2008" (H.R. 6604).[9] The Senate has prepared a companion bill, "The Derivatives Trading Integrity Act of 2008," that will be debated in early 2009. Following compromises between the House and Senate bills, a final bill could be presented for President Obama's signature in 2009. However, there is strong financial services industry opposition to such a bill.

One way to derail, weaken or at least delay regulation of the commodities exchanges is proposed legislation to merge the CFTC and the SEC. The proposed legislation is supported by former Secretary Paulson and SEC chair nominee, Mary Shapiro, a champion of industry self-"regulation."[10] The Senate hearings to approve the CFTC and SEC nominees should ask tough questions about why a merger of the SEC and CFTC, two agencies that failed to prevent the financial services debacle igniting the present global economic crisis, would result in a successful agency, after the long delays that typically accompany any government agency merger.

The major provisions of HR 6604 are important but not comprehensive steps toward regulating excessive speculation in the commodity markets. These measures include: 1) the setting of the same commodity specific speculative position limits for all investors, i.e., closing the "swaps" exemption; 2) required reporting of all speculative contracts, including Over-The-Counter contracts, to the CFTC so regulators can understand the size and working of the market; and 3) financial and human resources sufficient for the CFTC regulators to implement and enforce HR 6604 and its corresponding regulations. (The Bush administration was notorious for cutting funding to agencies so they would be unable to enforce laws and rules it opposed.)

There are many regulatory loopholes within agencies and among other financial regulatory agencies, and even more defenders of the "Swaps Loophole," the "London Loophole," the "Dubai Loophole," and so on. To reduce the capacity of financial institutions to evade or pervert new U.S. laws, however comprehensive they may be, it is important to negotiate an intergovernmental agreement to regulate or at least harmonize national regulatory frameworks for commodity markets. To prepare such negotiations, the members of the United Nations should authorize and finance research into commodities exchanges and existing regulatory regimes. The UN Conference on Trade and Development could be appointed as the lead agency for a research team to prepare discussion papers for negotiators. The team should publish reports on national commodity exchanges, their participants, their current rules and the effects of excessive speculation in those exchanges, particularly as regards sustainable food and energy security. Policy options for reforming commodity exchanges should support realization of UN objectives, e.g., the Millennium Development Goals.

Conclusion

The statutory purposes of the Commodity Exchange Act are currently two: 1) enable market participants to manage price risk volatility; and 2) enable market participants to "discover" the price of a given commodity at a given time through the buying and selling of commodity contracts. However, new legislation and regulation could be designed to add to these purposes the protection of food and energy security against excessive speculation. The urgent need for such protection is evident in the ongoing vulnerability of both U.S. consumers and developing countries to price spikes in their import food and energy bills, with consequent increased food and energy insecurity.

Agricultural production and price volatility are likely to increase under current agricultural, trade and investment policies, particularly as climate change and natural resource depletion affects production in vulnerable countries. Rather than reduce the regulatory criteria of commodities exchanges to mathematical models for measuring whether financial speculation is excessive, new legislation should provide additional criteria for measuring the effects of price volatility on food and energy prices.

Legislation could provide for a public ombudsperson to receive information and report to regulators and annually to Congress on the food and energy price impacts of price volatility in the regulated commodities. Both the inspector general of the CFTC and its enforcement officers would use these criteria in carrying out their duties.

Notes

[1]This is a summary and update of the longer paper on commodity speculation: http://www.iatp.org/iatp/publications.cfm?accountID=451&refID=104414. This summary is based on a Spanish language summary: http://www.iatp.org/iatp/publications.cfm?accountID=451&refID=104748.

[2]FAO, *Food Outlook*, November 2008, http://www.fao.org/docrep/011/ai474e/ai474e15.htm.

[3]The consultant estimated that of the $8 per bushel CBOT yellow corn price for December delivery, about $2.50 was due entirely to financial speculation by non-users of commodities.

[4]Aliya Sternstein, "CFTC Pick Worked to Exempt Credit Swaps," *Congressional Quarterly Politics*, December 19, 2008, http://cqpolitics.com and "Did Speculation Fuel Oil Price Swings?" CBS News, January 11, 2009, http://www.cbsnews.com/stories/2009/01/08/60minutes/main4707770.shtml.

[5]Ann Davis, "Top Traders Still Expect the Cash," *The Wall Street Journal*, November 19, 2008, http://online.wsj.com/article_email/SB122705339535539245-lMyQjAxMDI5MjI3OTAyNTkzWj.html.

[6]Michael W. Masters and Adam K. White, "How Institutional Investors Are Driving Up Food and Energy Prices," July 31, 2008, http://www.accidentalhuntbrothers.com.

[7]Stephen LaBaton, "Agency's '04 Rules Let Banks Pile Up New Debt and Risk," *The New York Times*, October 3, 2008.

[8]Ellen Gould, "Financial Instability and the GATS Negotiations," Canadian Centre for Policy Alternatives. Trade and Investment Series, Vol. 9, No. 4. July 2008. http://www.policyalternatives.ca.

[9]http://agriculture.house.gov/inside/Legislation/110CMTAA.pdf

[10]Paul West, "Marylander Gensler to head Commodity Futures Trading Commision," *The Baltimore Sun*, December 19, 2008, http://www.baltimoresun.com/news/nation/politics/bal-te.gensler-19dec,0,181821.story and Sarah N. Lynch, "Obama Nominates Gary Gensler To Head CFTC," Dow Jones Newswires, December 19, 2008.

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