



Institute for Agriculture and Trade Policy

A Better Future for Food and Energy: Reforming Commodity Futures Markets

Many factors have contributed to rising and falling food and energy prices (price volatility) in recent years. Perhaps the least understood factor is financial speculation in the commodity futures markets. During the last decade, these markets have been deregulated, allowing the entry of new financial players who have profoundly changed the way these markets operate and whom they serve.

Traditional functions and players in the futures market

Commodities are the agricultural and non-agricultural raw materials from which products and services (e.g., electricity) are made. Commodities derivatives are financial contracts derived from the value of the underlying commodity. The fundamental building block of all commodities derivatives is the futures contract. The traditional contract brings together buyers and sellers in a market, e.g., the Chicago Board of Trade (CBOT), to bid, offer and finally settle on a price for the delivery of a certain quantity of a commodity (say, wheat) at an agreed time and place. The contract enables commodity sellers, such as grain elevator operators, to avoid sudden price drops and commodity users or traders to avoid sudden price increases, e.g., due to tight supplies, crops failures or logistical bottlenecks. Both buyers and sellers use futures contracts to “hedge” their price risk. Futures prices are usually benchmarks for cash commodity prices (for example, what the farmer is paid at the elevator) and therefore affect the price of agricultural and non-agricultural goods and services. U.S. exchanges are so globally dominant in most agricultural commodities that many countries use U.S. exchange prices to set not only their export prices for a given commodity, but even their national market prices.

Commodity Index Funds: increased price volatility and food insecurity

After a decade of regulatory exemptions, exclusions and waivers, big financial institutions—not commodity users—now dominate the commodities markets. For example, in March 2008, the two unregulated biggest players, Goldman Sachs and Morgan Stanley, owned 1.5 billion bushels of CBOT corn futures contracts, while all the regulated hedgers could own only 11 million bushels.¹ These firms dominate the market through commodity index funds that bundle up to 24 agricultural and non-agricultural commodities (such as oil and gold) in a single investment instrument that usually “bets” on prices to increase. As the component contracts near their expiration (usually 90 days for agricultural futures, six months for non-agricultural commodities), the firms resell the contracts to take profits, creating price volatility in the wake of reselling.

These unregulated funds controlled 33 percent of all U.S. agricultural futures contracts in 2006-2008.² The funds’ “weight of money” both increased commodity prices and made them so volatile that many physical hedgers (e.g., wheat importers), particularly from developing countries, could not use the futures markets to manage price risk for their imports or exports. According to the UN Food and Agriculture Organization, the developing country food import bill soared from \$191 billion in 2006 to \$254 billion in 2007. In FAO’s conservative estimate, the number of those without enough to eat soared from 850 million in 2006 to nearly one billion in 2008. The fall of agricultural futures prices has yet to translate to a comparable decrease in retail food prices.

Investment banks play the market not to manage inherent commodities price volatility (e.g., weather related), but to induce volatility through huge “bets” allowed by financial services deregulation. Commodity prices rose with their bets until July 2008. When aggregate commodities prices fell from their July peak by 60 percent in mid-November, these banks could no longer cover their bets and asked the government for taxpayer bailouts.



Two possible futures for commodity futures markets: stringent vs. light regulation

In May, newly appointed chair of the Commodities Futures Trading Commission (CFTC) Gary Gensler (a former Goldman Sachs partner), announced proposals to close some of the loopholes and end some of the regulatory exemptions that allowed the investment banks to so intensively influence commodity futures markets—and profit so handsomely. For example, according to *The Wall Street Journal*, commodities speculation contributed \$1.5 billion to Goldman, about a third of their net income in 2008, as their traders bet on prices to fall after prices peaked in July.³

Gensler's proposal attempts to tackle two areas of concern: unregulated over-the-counter (OTC) trades and capital reserve requirements to cover losses. Over-the-counter trades take place between private parties and are not reported, nor are they cleared on a public and regulated exchange. Under Gensler's proposal, OTC trades would still be allowed, but the criteria for allowing unreported "customized" price risk management between private parties will be tightened. Capital reserve requirements to cover losses will be increased so that another payment default, such as the one that triggered the Lehman Brothers collapse in September 2008, will not be repeated. (A handful of banks, including Goldman and Lehman, were exempted from prudential reserve requirements in 2004 by the U.S. Securities Exchange Commission, leading to extremely high debt ratios relative to reserves and other equity.⁴)

Because U.S. commodity markets are global price setters for many commodities, the proposed rules will affect the price and availability of a huge array of products and services, including, of course, food and energy. But commodities markets are global—will OTC traders carry out their threat to move their money to a less regulated London futures market? OTC traders in both London and New York claim to their respective regulators that one financial center will lose market share and lucrative employment to the other if OTC trades are tightly regulated.

The issue of posing one regulatory jurisdiction against another ("regulatory arbitrage" is the technical term) has led the International Organization of Securities Commissions, formed by representatives of more than 200 financial and commodity exchanges, to recommend closer cooperation among government regulators. However, due to the damage to food and energy security under industry self-regulation, the UN Conference on Trade and Development has gone one step further, calling for an international agreement to prevent excessive speculation in commodities markets. Such an agreement would form part of an "enforcement pyramid" with national government exchange authorities that would oversee exchange implementation of government rules. The agreement could be financed by a Financial Transactions Tax, which if applied by national exchanges to the commodities futures share of all financial transactions in 2007 at a rate of .01 percent, would have generated about \$10 billion. An FTT would have an added benefit of reducing the frequency of trading, one of the drivers of price volatility.⁵

There is much at stake for everyone in the appropriate regulation of commodity exchanges. Commodity prices are beginning to rise again. Governments, particularly the U.S., should reassert their power to regulate markets and coordinate those efforts to prevent traders from playing off one government against another in search of the weakest link in the enforcement chain.

This fact sheet was authored by Steve Suppan, Ph.D., Senior Policy Analyst, Institute for Agriculture and Trade Policy.

Notes

¹"A big move lies ahead," *The Brock Report*, May 23, 2008.

²Christopher L. Gilbert, "Commodity Speculation and Commodity Investment," Unpublished Paper, Sept. 2008.

³Ann Davis, "Top Traders Still Expect the Cash," *The Wall Street Journal*, November 19, 2008.

⁴Stephen LaBaton, "Agency's '04 Rules Let Banks Pile Up Debt and Risk," *The New York Times*, October 3, 2008.

⁵Steve Suppan, "Regulating commodities speculation: normative and fiscal means," Institute for Agriculture and Trade Policy, May 2009.