INSTITUTE FOR **AGRICULTURE** AND **TRADE POLICY**
COMMENTARY

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Institute for Agriculture and Trade Policy works locally and globally at the intersection of policy and practice to ensure fair and sustainable food, farm and trade systems. IATP is headquartered in Minneapolis, Minnesota with offices in Washington D.C. and Geneva.

Multi-lateralizing G-20 commitments on the commodity derivatives market

Two very modest proposals

WASHINGTON D.C., APRIL 27, 2010* — First, I would like to set a broader multi-lateral governance context for the following remarks on the Group of 20 (G-20) commitments concerning commodity price volatility. The G-20 finance ministers meet this week to consider how to further commitments made to regulate commodity markets as commodity market investments hit a record peak of $412 billion in March.[1]

I will also comment on some of the commitments themselves, particularly on the clearing of standardized derivatives, i.e., practicing good credit management to prevent the cascade of counterparty defaults that triggered the global economic crisis in which we still live.

Finally, I will make two truly modest proposals about further commitments the G-20 ministers should make to enable member governments to implement commitments already made. G-20 proposals for more ambitious commitments, e.g., on contract-specific aggregate position limits to prevent excessive speculation, will require a greater degree of international regulatory cooperative and trade data transparency than currently exists.

First, let me read the G-20 commitments that affect commodity derivatives, i.e., futures, options and swaps (of the cash flows of futures or options) contracts whose value is derived from that of an underlying asset. Here are two commitments from the September 2009 G-20 Summit in Pittsburgh:

> All standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements.
>
> We have agreed to improve the regulation, functioning and transparency of financial and commodity markets to address excessive commodity price volatility. (U.S. Chair's Progress Report, 12.)

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And, here is a step made toward a commitment in the February 18–19 communiqué of the finance ministers' meeting in Paris, stating:

> We discussed concerns about consequences of potential excessive commodity price volatility and asked our deputies to work with international organizations and to report back to us on the underlying drivers and the challenges posed by these trends for both consumers and producers and consider possible actions. Keeping in mind the impact of this volatility on food security, we reiterated the need for long-term investment in the agricultural sector in developing countries.

The Pittsburgh decisions are in response to the commodity price bubble and collapse of 2008. The Paris communiqué arguably responds not only to the global commodity price spikes of 2010, but also, insofar as the French presidency is concerned, to the 60 percent increase in the price of wheat on the Paris exchange in the summer of 2010. With regard to the financial ministers concern about food security, according to a recent report by UNICEF, local food prices in 58 developing countries surveyed are up 55 percent in November 2010, relative to prices in a May 2007 survey.[2] However, reversing three decades of growing food-import dependence and corresponding neglect of agricultural investment in most developing countries to build capacity for greater self-sufficiency in national food security will take quite a bit more time than to implement the regulatory measures to reduce extreme price volatility.

I'd like to summarize the analysis of excessive commodity speculation by a few of the international organizations that have prepared reports to advise the ministers' deputies on commitments to possible actions. These actions would be in addition to the aforementioned pushing of standardized over-the-counter derivatives, "where appropriate," (a diplomatic hedge) on to exchanges and measures to improve the regulation and transparency of commodity markets and financial markets as they affect commodity prices, for example in mixed swaps between financial flows of oil contracts and foreign exchange bets.

The cascade of defaults in the fall of 2008 that resulted in taxpayer and central bank bailouts of many of the world's largest private financial institutions set into motion several multi-lateral economic governance processes, of which the G-20 is just one, however important. Due in part to the private net capital outflow of nearly $700 billion dollars from developing countries in 2009, relative to the 2007 capital inflow peak of $1.2 trillion, the United Nations has an understandable interest in analyzing both the global market and economic governance failure.[3] Despite food- and energy-price riots in at least 30 countries in 2008 alone, the Stiglitz Commission of experts advising the President of the United Nations General Assembly did not view commodity derivatives markets as systematically important financial institutions. However, the commission did recommend that the scope for trading unregulated over-the-counter derivatives be radically reduced.[4] The U.S. and EU delegates to the General Assembly contended at a June 2009 summit that the United Nations had no competence or mandate for economic governance.[5] That competence and mandate would be self-arrogated to the G-20 and the international financial institutions, despite their widely recognized regulatory failures that helped enable the derivatives price bubbles and subsequent insolvency of many large and politically well-connected financial institutions.

Nevertheless, in 2009, the U.N. Conference on Trade and Development (UNCTAD), began to publish research on the "financialization of commodity markets" that began to shift the analytic framework from a "fundamentals only" explanation of commodity price formation to a more comprehensive understanding of price formation factors.[6] This understanding included an attempt to analyze the consequences of the $13 trillion of over-the-counter, i.e., unregulated, off-exchange, commodity derivative trades in 2008 reported by governments to the Bank for International Settlements (as of June 2009).[7]

There has been considerable reluctance, even outright denial, to acknowledge as valid any research that documents the extent to which excessive speculation has become a significant price driver in commodities. For example, on the basis of 2008 U.S. futures contract data, the International Organization of Securities Commission (IOSCO) cautiously affirmed that there was no evidence that excessive speculation had a "systematic" effect on commodity prices.[8] Shortly before the June 2010 U.S. Senate vote on the Dodd-Frank Act, the Organization for Economic Cooperation and Development (OECD) published a study that denied excessive speculation had played any role in agricultural futures price formation.[9] More recently, the authors of an International Food Policy Research Institute (IFPRI) study declared that they were "ultimately agnostic" about the effect of excessive speculation on agricultural prices.[10] Given the conflicts among the intergovernmental agencies analyzing the extent of the effect of excessive speculation on commodity prices, it will not be surprising if the interagency paper to advise the minister's deputies does not present the ministers with clear policy options to serve as the basis for the ministers' recommendations to their Heads of State at the G-20 summit in November.

Group of 20 commitments thus far on commodity price volatility

The G-20 commitment to trade previously unregulated over-the-counter standardized derivatives on exchanges and other regulated platforms, "where appropriate," is not as big a commitment as it might appear. The commitment leave a lot of room for regulatory exemptions from clearing concerning special pleading for derivatives claimed to be "customized" or "bespoke." So, a swap whose counterparties are a major swaps dealer, such as Goldman Sachs, and a derivatives end-user might be claimed as "customized" because, for example, the contracts are traded outside exchange hours or because the end-user wants to hedge a volume of a commodity that the exchange doesn't offer in a standardize contract. While the individual exemptions from clearing granted to the commercial hedger do not pose systemic risk, regulators are concerned about aggregate exemptions from clearing for the major swaps dealers. Even with "too big to fail" capital reserves bolstered by access to the discount window of the Federal Reserve Bank[11], as well as other forms of bailout, the question remains whether a commitment to clear standardized OTC derivatives will suffice to prevent another blowup.

Given the resistance to position limits by major swaps dealers and many of their largest corporate derivative end-users, what is to prevent a trickle of regulatory exemptions from becoming a flood of liquidity that will distort the market's price discovery process for commercial hedgers? In the best of all possible worlds, regulators would set position limits that would prevent excessive liquidity. However, both in the United States and in Europe, rule-making to set robust position limits faces enormous financial services industry opposition.[12] In advance of resolution to the position-limits fight, G-20 ministers could usefully signal a commitment to the rule of law. Here is my first proposal for one formulation of such a commitment:

> We commit to ensuring that the competent authorities with responsibility to regulate commodity markets have sufficient budgetary, technical and human resources to enforce all commodity market rules in their jurisdictions and to be able to cooperate with competent authorities in other jurisdictions to prevent regulatory arbitrage among jurisdictions.

This may seem like an exceedingly modest proposal. What government wouldn't want to ensure that its competent authorities were sufficiently well-resourced to carry out their statutory duties? However, as the recent budget debate over the CFTC demonstrated, sufficiency of resources to carry out those duties should not be taken for granted.[13] Yet, without those resources to prevent violations of commodity market statutes, governments may find themselves again in the position of being warned that they must not prosecute apparent major violators, lest investor confidence be damaged by action taken to restore market integrity.[14]

If my first proposal for a G-20 ministers' commitment seems too ambitious, here is an even more modest proposal:

> We urge member governments of the International Organization of Securities Commissions to present a resolution to enable intergovernmental organizations with responsibilities for the analysis of commodity markets, trading practices and prices to become accredited IOSCO observer organizations, with the obligations and privileges that are customary for observer organizations.

To the extent that there is global economic governance for commodity markets, IOSCO's commodity market technical committee is it. Insofar as the G-20 ministers' commitments can be implemented on a multi-lateral basis, it will be done through the IOSCO best-practice recommendations agreed by member governments and exchanges. However, IOSCO sits in splendid isolation not only from the United Nations system but from the international financial institutions and the World Trade Organization. As noted above, intergovernmental agencies advising the G-20 ministers had distinct views on the extent to which commodity price volatility resulted from new financial instruments and actors in commodity markets. However, both IOSCO's government and exchange members could benefit by the various expertise that U.N. agencies, IFIs and the even WTO could bring to IOSCO. Conversely, regular interaction of exchange representatives and market regulators with officials who are mandated to analyze the real-world consequences of market "innovations" and compensate for market failures could provide a periodic reality test of the economic theories according to which markets run. Theories, such as the efficient markets hypothesis and comparative advantage that interpret markets as "they should be," could be evaluated in light of the empirical analysis brought by IOSCO observer organizations.

In sum, if you know a deputy to a finance minister who is looking for a very modest proposal, or two with which to show G-20 progress on reducing extreme commodity price volatility, I'm in town until April 17 and otherwise available electronically.

**These comments were delivered April 13 at the Carnegie Endowment for Peace at a symposium on commodity market reform and the G-20.*

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