

Building Markets or Building Society:

Responses to Food Speculation

by

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There are 154 million reasons why speculation via the commodity markets needs to be stopped – and stopped fast.

154 million, as I'm sure you know, is the number of people in poorer developing countries who were reportedly driven further into poverty as a result of speculation-induced food price hikes in 2007-08, or who became malnourished as a result.¹

Previous speakers have explained why speculation – not food shortages – was responsible for the food crisis that resulted. I have been asked to explore some of the possible measures that might be taken to curb such speculation.

I'd like to start with some major inroads that have already been made in the United States, due in large part to the work of a very broad coalition of farm groups, unions, faith groups, environmentalists and development groups, and then to look at some of the deeper structural changes that peoples movements around the world are already struggling for and to which we might lend our solidarity.

Regulatory Demands and Opportunities

A key regulatory change agreed under the recent Dodd-Frank Financial Reform Act in the US is to require the Commodity Futures Trading Commission (CFTC), the regulatory body that oversees commodity trading, to set limits for *all* commodities across *all* markets on the number of derivatives contracts that can be controlled by

any one entity and its affiliates during a trading contract period.² Setting limits is key to reducing the extent to which traders can conduct “virtual” hoarding, to reducing the volume of trading, and to reducing the amount of money sloshing around the system.

Just as important, the Act requires that most derivative instruments are traded openly and publicly via exchanges, rather than privately, behind closed doors in bilateral trades, known as “over the counter” transactions. This is important for a number of reasons. Trading on public exchanges would add to the cost of transactions, and so reduce their number. It would make transparent who was holding what contracts, making it easier for regulators to spot speculative plays and who was behind them.

But what is to stop US traders avoiding these new regulations by simply moving to European exchanges? Not much at present, so it is critical that the EU bring in similar legislation as well – and there is political support at the EU member state level for such changes, France being a leading supporter.

But there is still more than could be done. Some investment vehicles could – and, in my view, should – be banned because of the role that they play in pushing up food prices. Exchange Traded Funds (ETFs), which gamble on the prices of a basket of commodities going up, are a case in point.³ Commodities – particularly food – are simply too important to allow retail investors to speculate on them. Similarly, the right to trade on exchanges should be restricted to genuine food producers and genuine processors, processors and traders. At the very least, the creators of exchange traded instruments should be forbidden from generating indexes based on baskets of agricultural and non-agricultural commodities (energy and carbon lumped in with food stuffs, for example) where the price rise of one has a knock on effect on the price of the others, thus creating the risk of food prices being suddenly inflated.

I would also argue for the need to screen all new and existing derivative-based instruments for their social utility. Do they contribute to the public good? And how, and by whom, is the public good to be defined? Simply arguing that a new instrument helps in “price discovery” or in making markets more efficient is no longer credible (if it ever was). With efficient market theory now widely discredited, the public needs assurance that the instruments used in financial markets serve the wider interests of

society. What mechanisms might be evolved to ensure that citizens, rather than just financiers, are involved in this process? Had such a public interest test been in place, Exchange Traded Funds might not have gained the prominent (and highly destructive) role they now play in commodity markets. As financial news wire Bloomberg has documented,⁴ savvy commodity traders immediately recognised the possibilities of speculating with Exchange Traded Funds when they were first introduced. Regulators should have been empowered to act on this widely shared knowledge.

Other forms of speculative investments, such as land grabs, that affect agricultural production and access of poorer people to land also need to be addressed. In some cases, such investments are not motivated by commodity speculation per se, but by speculation in other spheres. In the mid-2000s, for example, hedge funds lent heavily to banks in Kazakhstan so they could invest in dairies and farmland, not because the hedge funds saw huge profits to be made out of milk and farming but because it was the only way they could get exposure to the local currency whose value they were betting on to rise against the dollar as Kazakhstan's oil revenues piled up.⁵ Elsewhere, private equity firms, hedge funds, mutuals, pension funds and sovereign wealth funds are rushing to grab land in the South as a hedge against inflation. Often the land is not even farmed, even though landlessness may be acute.

The Limits of Regulation

But regulation can only achieve so much. And regulation has its own dynamic, which may lead to outcomes that are very different from those intended.

For example, requiring all derivatives to be traded on public Exchanges – as opposed to privately through “over the counter” (OTC) deals – though entirely welcome from the point of view of transparency, may lead to Exchanges that are simply “too big to fail”.

Other undesirable consequences may also follow. Where contracts are traded through Exchanges, traders are required to make a down payment of collateral (known as a “margin”) to cover the risks of default. The added costs of posting such margins (which over the counter deals avoid) may create pressures for hedge funds and the

like to merge with each other, creating new giant entities with all that this implies in terms of market (and political) power.

High frequency trading – and the sheer volume of deals that have to be recorded – may make it easier for hedge funds to get around the rules, simply by overwhelming regulators with data.

And each new regulation inevitably creates the opportunity to make money by exploiting loopholes, or spaces where the law is not clear or by devising yet more financial instruments that remain within the law but get around its intentions.

None of these potential consequences of regulation should be regarded as reasons not to regulate. I would stress again: the opportunity exists with the current proposed EU legislation to put a stop to many opportunities for speculation in commodity markets and those opportunities should be seized right now.

But I draw attention to the potential downside in order to caution us against becoming *too* focussed on regulation alone as the response to the food crisis and in order to invite a wider discussion on *other* mechanisms that have historically been used by farmers and consumers to protect themselves against price volatility.

The Exception rather than the Rule

Proponents of derivative-based hedging of agricultural commodities often like to cast such practices as both having a long history and of being widely practised by farmers. Both premises are untrue.

Seventeenth century Japanese rice farmers, 13th century monks, 16th century Dutch herring fishers, and even biblical figures such as Joseph and Jacob routinely pop up in the stories about derivatives being used to protect livelihoods against the ups and downs of the market. They're all portrayed as “motherhood and apple pie” ancestors of Goldman Sach's commodity traders.

But what is rarely mentioned is that, for by far the greater part of history, including recent history, derivatives-based commodity trading has been banned in most countries or has been insignificant because farmers are not just not interested in them:

- In the USA, until the late 1970s, derivatives trading was considered gambling unless a futures contract could be settled by physical delivery of the underlying commodity, for example grain.
- In India, the use of options, which had been encouraged under colonial rule, was banned in 1956, a ban that was only lifted in 1995.
- Most African countries have no derivative markets, with the exception of South Africa, Morocco, Egypt and Tunisia – and even here the volume of derivative transactions is tiny. Where derivative markets exist, they are in their infancy and mostly focused on foreign-exchange derivative contracts. Other agricultural commodity exchanges in Africa, including operations in Kenya, Nigeria, Ghana, Ivory Coast and Uganda, have struggled to take off or to achieve appropriate scale.⁶
- In Malaysia, a recently launched agricultural futures market closed because of lack of interest.⁷
- In the EU, agricultural futures markets (including markets for derived products) were barely used by farmers until the early 1990s.⁸ The vast bulk of agricultural products were not even traded on the futures market, in sharp contrast to the USA (*see* Table 1), where the majority of trading was carried out not by farmers but by grain merchandisers.⁹ The reason? European farmers' risks were largely hedged not through financial markets but through price support under the Common Agricultural Policy. Critically, as the European Commission itself records, this was a period in which there was "relative price stability for the major commodities" and where agricultural commodities attracted "little interest" from speculators.¹⁰

Volume traded on selected exchanges relative to production in the respective country 1990-99 (in %)

Commodity	Exchange	Country	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Wheat	CBOT	USA	527	795	709	630	780	1135	1182	1019	1115	1427
Wheat	KCBT	USA	208	357	272	281	324	357	402	390	394	504
Wheat	LIFFE	UK		23	45	49	63	71	72	86	64	67
Wheat	MATIF	France								2.0	5.2	5.8
Wheat	WTB	Germany										2.0
Wheat	SFE	Australia							1.1	1.3	1.6	1.4
Barley	LIFFE	UK								20	17	10
Corn	CBOT	USA	720	726	546	904	574	1021	1063	922	809	833
Rape-seed	WCE	Canada	427	386	431	354	323	334	530	434	408	372
Rape-seed	MATIF	France						95	105	109	139	156
Rape-seed	WTB	Germany										1
Soybeans	CBOT	USA	2674	2269	2054	3115	2137	2440	2990	2704	2268	2361
Potatoes	AEX	Netherlands	40	28	28	50	81	56	23	24	35	21
Potatoes	LIFFE	UK								7.2	7.7	4.5
Potatoes	WTB	Germany									1.2	0.8
Hogs	AEX	Netherlands	26	36	30	26	25	19	31	42	27	25
Hogs	WTB	Germany									1.1	3.5

Source: Directorate-General Economic and Financial Affairs, European Commission (2000)

This is not to say that speculation did not take place during the era of price controls. It is simply to underline the lack of opportunities that existed for speculation through futures markets.

It is also to point out that the financialised form that speculation in food takes today (involving virtual hoarding of contracts rather than physical hoarding of actual commodities) was the result not only of deregulation in the financial markets but also, critically, of the withdrawal of price support for farmers.

Consumers, too, have seen the protection previously provided by emergency food stockpiles – now down to just 57 days supply worldwide¹¹ – and price intervention to keep prices of basic foodstuffs within a range affordable by poorer citizens abandoned under the tutelage of the World Bank. This, too, has also created yet more opportunities for speculators, as has the freeing up of capital controls aimed at preventing speculative flows of capital.

Even today, with direct price support for farmers largely scrapped (indirect farm subsidies are another matter), the vast majority of farmers in the EU and elsewhere

show little interest in using financial markets to hedge against price fluctuations. Smaller farmers have neither the time nor the cash¹² nor the appetite for the risks involved, preferring other hedging strategies, the majority of which do not involve financial markets. As one Oklahoma producer recently remarked when asked why he did not use futures markets, “I used futures once a few years ago, but the market went against me and I had to sell one of my farms just to meet my margin calls.”¹³

Indeed, the main users of derivative-based commodity markets remain large corporate farms, processors, commodity traders, and other intermediaries. And their use of options and futures has increased in the last three years. Bankers now estimate that up to one third of the world’s largest food companies launched new derivative-based hedging programmes in the aftermath of the 2007-08 crisis. Cereal processor Kellogg now hedges 90 per cent of its transactions.¹⁴ Other avenues – such the use of better-stocked inventories, through which many processors have historically hedged against price rises – do not appear to be pursued.

I said that farmers continue largely to rely on other means of hedging. These include:

- Directly-negotiated forward contracts with processors;
- Diversification of both crops and of farm incomes;
- The use of crop insurance policies to protect against losses due to weather;
- Participating in co-operatives to share risks;
- The development of new models of risk-sharing, such as community-supported farms, where farmers sell directly to community members, who provide the farmer with working capital in advance, thus lowering farmers’ risks and ensuring they receive better prices for their crops.

Indeed, the reluctance of farmers to use derivative-based hedging is a cause of major frustration to the European Commission, which confidently predicted that the stripping back of price support would lead to increased use of financialised hedging

by farmers.¹⁵ Such hedging is central to the neoliberal agenda for agriculture. Indeed, the existence of such futures markets are being used to justify the further stripping back of farm support.¹⁶

Conclusion

So, to conclude, and to emphasise once more: in the short-term, there is an urgent need to plug the obvious loopholes and inadequacies in existing regulations. The opportunities exist to do this. We should seize them.

But, for the longer-term, we need to ask some questions:

Should our long-term collective efforts be focussed on reforming derivative-based commodity futures markets that primarily service corporate power?

Or on building up the many other socially-based mechanisms available to protect farmers and consumers, particularly poorer consumers from volatile food prices?

On pressing for price support and price intervention through programmes that do not pit Northern farmers against their Southern counterparts?

On rebuilding food stocks?

On requiring processors to hold adequate inventories?

On supporting and encouraging co-operatives that bring farmers and consumers together, without the need for financial intermediaries?

In effect, on building society rather than markets?

Agriculture is too important to be left to the markets. It must be protected by society for society. Mechanisms exist to do this. Building on them, improving them and making solidarity links to those already doing so is the challenge that faces us.

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- 1 “Current world food crisis”, undated, <http://www.grida.no/publications/rr/food-crisis/page/3558.aspx>.
 - 2 IATP, “Wall Street Reform Bill Signed today will limit excessive speculation in agriculture: New rules to curb Wall Street’s influence over food and farming”, <http://www.iatp.org/iatp/press.cfm?refid=107616>
 - 3 In early 2010, ETFs accounted for 80-85 per cent of investments in commodities.

For analysis of how ETFs have pushed up prices, see:

“Are ETFs to blame for Over-speculation, record correlations and a potential crash?”, *Seeking Alpha*, 19 October 2011, <http://seekingalpha.com/article/300500-are-etfs-to-blame-for-over-speculation-record-correlations-and-a-potential-crash>

Lines, T., *Speculation in Food Commodities*, Report Commissioned by World Development Movement, April 2010, http://www.makefinancework.org/IMG/pdf/lines_2010_speculation_in_food_commodity_markets.pdf.

World Development Movement, *Broken Markets*, <http://www.wdm.org.uk/sites/default/files/Broken-markets.pdf>
 - 4 *Bloomberg Businessweek*, “Amber Waves of Pain”, 26 July-1 August 2010, http://hotfile.com/dl/56873785/de840c6/Bloomberg_Businessweek_26_07_01_08_2010.pdf.html.
 - 5 Mallaby, S., *More money than God: Hedge Funds and the making of the new elite*, Bloomsbury, 2010.
 - 6 Making finance work for Africa, “Derivatives”, undated, <http://www.mfw4a.org/capital-markets/derivatives-derivatives-exchanges-commodities.html>
 - 7 “Pros and cons when tapioca is traded through the system”, Food Market Exchange.com, accessed 19.9.10, http://www.foodmarketexchange.com/datacenter/product/feedstuff/tapioca/detail/dc_pi_ft_tapioca_14.htm
 - 8 France’s agricultural futures exchange, MATIF, only introduced corn, rape-seed and rape-seed meal options in 1999.

See: European Commission, “Working Document: Risk Management Tools for EU Agriculture with a special focus on insurance”, January 2001, p.21, http://ec.europa.eu/agriculture/publi/insurance/text_en.pdf.
 - 9 Mark, Brosen, Anderson and Small quote a 1994 study which found that only 11 per cent Kansas producers who were interviewed hedged any of their grain using futures.

See: Mark, D.B., Brosen, W., Anderson, K.B., Small, R.M., “Price Risk Management Alternatives for Farmers in the Absence of Forward Contracts with Grain Merchants”, undated, accessed 19.9.10, <http://www.choicesmagazine.org/magazine/print.php?article=27>.
 - 10 European Commission, “Working Document: Risk Management Tools for EU Agriculture with a special focus on insurance”, January 2001, p.21, http://ec.europa.eu/agriculture/publi/insurance/text_en.pdf
 - 11 Vidal, J., “Global food crisis looms as climate change and fuel shortages bite”, *The Guardian*, 3 November 2007, <http://www.guardian.co.uk/environment/2007/nov/03/food.climatechange>.

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- 12 As Mark, Brosen, Anderson and Small note, the capital outlays needed to hedge via financial markets are considerable:

“Capital requirements created by margin calls, however, can be a major drawback for many producers. At \$1,500 per contract for the initial margin requirement, establishing a position in the corn futures market requires \$0.30/bu. For soybeans, the initial margin requirement is \$3,250 per contract or \$0.65/bu. While initial margins are essentially a performance bond rather than a payment, there is an opportunity cost associated with committing that capital to the margin account. For a producer hedging new crop corn or soybean sales on April 1 and holding the futures positions until October 1, interest expenses amount to slightly more than \$0.01/bu for corn and nearly \$0.03/bu for soybeans at an 8.5% interest rate. For a farmer growing 1,000 acres each of corn and soybeans with yields of 160 and 50 bushels per acre who decides to hedge 50% of the production using futures, the initial margin requirements for the corn and soybean futures trades would be \$24,000 and \$16,250, respectively. The interest costs to fund these margin requirements would total \$1,023 and \$693, respectively. Thus, the total committed money for this producer hedging half of expected production would total nearly \$42,000. Capital needs to fund the margin account would increase further if the futures position(s) lost money and margin calls resulted.”

See: Mark, D.B., Brosen, W., Anderson, K.B., Small, R.M., “Price Risk Management Alternatives for Farmers in the Absence of Forward Contracts with Grain Merchants”, undated, accessed 19.9.10, <http://www.choicesmagazine.org/magazine/print.php?article=27>.

- 13 Quoted in Mark, D.B., Brosen, W., Anderson, K.B., Small, R.M., “Price Risk Management Alternatives for Farmers in the Absence of Forward Contracts with Grain Merchants”, undated, accessed 19.9.10, <http://www.choicesmagazine.org/magazine/print.php?article=27>.
- 14 Blas, J. and Farrell, G., “Hedging helps foodmakers through uncertainty”, *Financial Times*, 12 August 2010, <http://www.ft.com/cms/s/0/88d1f506-a63b-11df-8767-00144feabdc0.html?ftcamp=rss>.
- 15 “As price-volatility on the European market has risen in the wake of the 1992 CAP-reform and is further expected to rise with the implementation of Agenda 2000 and further trade liberalisation, the conditions for the development of futures markets and other market-based risk management tools are improving.”

See: European Commission, “Working Document: Risk Management Tools for EU Agriculture with a special focus on insurance”, January 2001, p.21, http://ec.europa.eu/agriculture/publi/insurance/text_en.pdf.

- 16 In the US, for example, it is argued that state-supported crop insurance should be stripped back in favour of farmers using derivative-based instruments.

See: Babcock, B., “Should government subsidize farmers’ risk management?”, *Iowa Ag Review on line*, Vol 15 No 2, Spring 2009, http://www.card.iastate.edu/iowa_ag_review/spring_09/article1.aspx