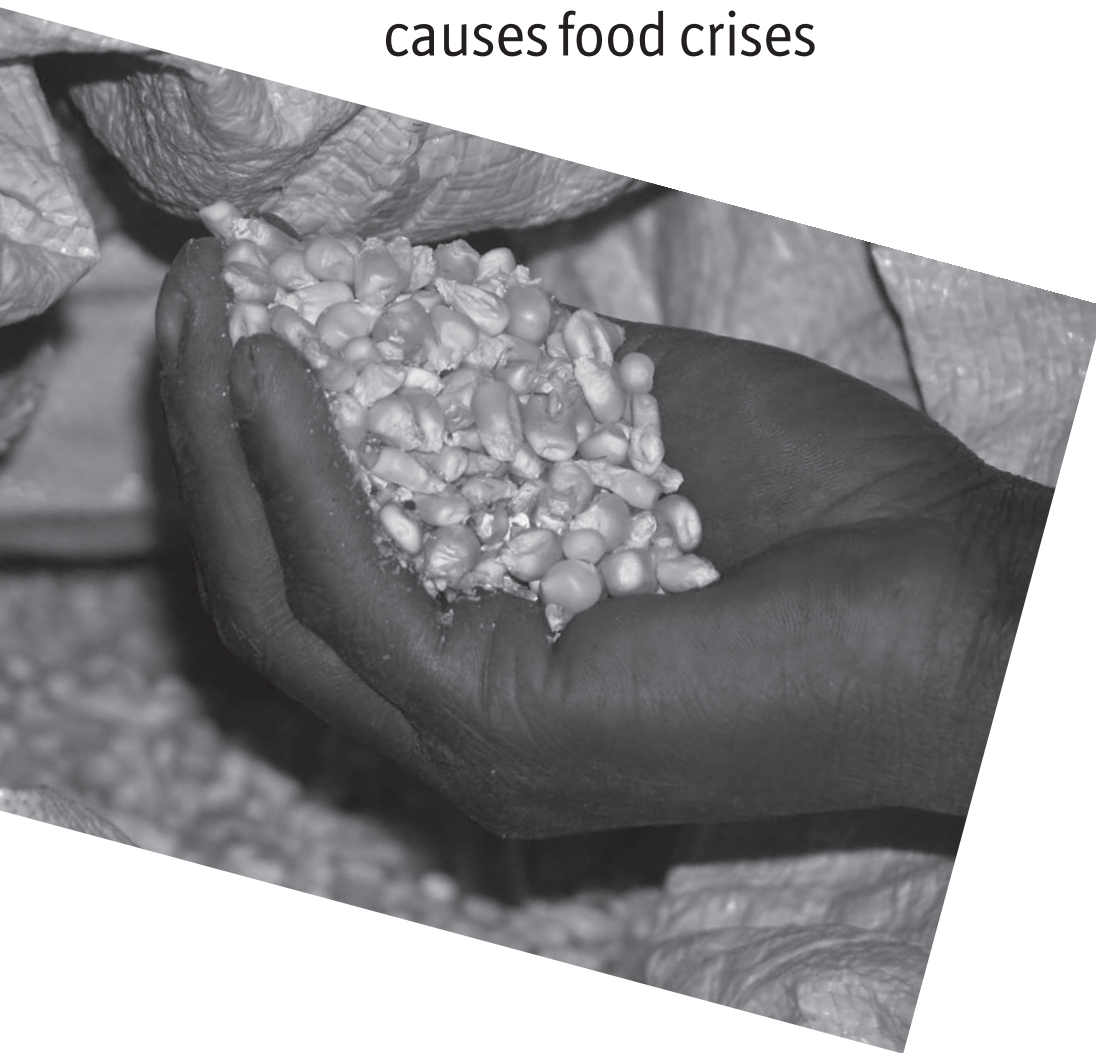


July 2010

# The great hunger lottery

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How banking speculation  
causes food crises



  
**World  
Development  
Movement**  
Justice for the world's poor

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By **Tim Jones, World Development Movement**

With particular thanks to **Tom Lines**, whose papers on food speculation and regulating speculation are available on the **World Development Movement website at: [www.wdm.org.uk/report/speculation-and-regulation-food-commodities](http://www.wdm.org.uk/report/speculation-and-regulation-food-commodities)**

With thanks to **Alex Wood** for writing section 3.2.

With thanks for comments to **Julian Oram and Deborah Doane**.

July 2010

### **About the World Development Movement**

The World Development Movement (WDM) campaigns for a world without poverty and injustice. We work in solidarity with activists around the world to tackle the causes of poverty. We research and promote positive alternatives which put the rights of poor communities before the interest of big business. WDM is a democratic membership organisation of individuals and local groups.

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# great hunger lottery

## Executive summary

**T**ake the highest stakes, riskiest economic behaviour ever devised, and marry it to the most fundamental basic need of humankind, and you have the subject of this report.

Over the past decade, the world's most powerful financial institutions have developed ever more elaborate ways to package, re-package and trade a range of financial contracts known as derivatives. A derivative is not based on an exchange of tangible assets such as goods or money, but rather is a financial contract with a value linked to the expected future price movements of the underlying asset. Derivative contracts are traded on a growing number of underlying assets, from share prices, to mortgages, bonds, commodity prices, foreign exchange rates, and even index of prices.

Derivatives trading has been one of the most lucrative parts of the financial industry, but it is the increasingly complex, opaque and disconnected nature of these and similar products that ultimately triggered the collapse of the banks and the worst financial crisis in human history.

Of course, the financial crisis has been an economic disaster of seismic proportions for millions around the world, plunging many countries into recession causing millions to be thrown out of work, soaring public debts and cuts in vital public services.

But while betting on the value of sub-prime mortgages or foreign currency values undoubtedly leads to disastrous consequences, there is another area where the speculative

behaviour of the world's largest banks and hedge funds represents a threat to the very survival of people: food commodities.

In *The great hunger lottery*, World Development Movement has compiled extensive evidence establishing the role of food commodity derivatives in destabilising and driving up food prices around the world. This in turn, has led to food prices becoming unaffordable for low-income families around the world, particularly in developing countries highly reliant on food imports.

Nowhere was this more clearly seen than during the astonishing surge in staple food prices over the course of 2007-2008, when millions went hungry and food riots swept major cities around the world. *The great hunger lottery* shows how this alarming episode was fueled by the behaviour of financial speculators, and describes the terrible immediate impacts on vulnerable families around the world, as well as the long term damage to the fight against global poverty.

In the report we describe how the current situation came to pass, the risks of another speculation induced food crisis, and what specifically can be done by policymakers here in the UK as well as in the US and EU to tackle the problem.

But at its heart, *The great hunger lottery* carries a very straightforward message: allowing gambling on hunger in financial markets is dangerous, immoral and indefensible. And it needs to be stopped before any more people suffer to satisfy the greed of the banks.

# 1. Introduction

In 2007 and 2008, there was a huge increase in the price of food and energy. The International Monetary Fund's (IMF) food price index increased by more than 80 per cent between the start of 2007 and the middle of 2008. Oil prices went to almost \$150 a barrel. The impacts were felt across the world. In rich countries, consumers were paying more for food and energy. High prices contributed towards pushing countries into recession. And high levels of inflation led central banks into maintaining strict monetary policy whilst economies went into decline. The story of commodity prices is a key part of the recent financial crisis and economic difficulties.

But across the global south, the impacts were even more serious. Households in developed countries tend to spend between 10 and 15 per cent of their income on food. While poor households in developing countries tend to spend between 50 and 90 per cent.<sup>1</sup> High food prices left households spending a lot more money on food or eating less. Combined with lower incomes due to the global economic slowdown, high food prices led to the number of chronically malnourished people increasing by 75 million in 2007 and a further 40 million in 2008.<sup>2</sup>

As well as eating less food, households have been forced to:

- Eat less fruit, vegetables, dairy and meat in order to afford staple foods.
- Reduce any savings, sell assets or take out loans.
- Reduce spending on 'luxuries' such as healthcare, education or family planning.

In this report we argue that part of the reason for the spike in food and other commodity prices was financial speculation. Speculation rides on the back of underlying changes in supply and demand, amplifying their impact on price. This speculation continues to impact on price, and as long as it remains unregulated, there is a danger it will contribute to a huge spike again.

Section 2 presents the evidence that speculation in derivatives<sup>i</sup> has influenced the real price of food. It outlines the particular role of commodity index funds. It also shows how unlimited speculation has also caused disruptions in the market, making it more difficult for farmers to use derivatives to hedge<sup>ii</sup> their risk, and made futures markets less able to predict future real prices.

Section 3 shows the impacts price swings have had. It outlines in more detail how poor households in developing countries were impacted by the high prices and volatility of staple foods in 2007 and 2008. It shows how farmers of cash crops such as cocoa and coffee also suffer from the increased volatility in the price of such crops.

Section 4 discusses the ways in which real changes in supply and demand have contributed to changes in food price in recent years.

Section 5 outlines proposed ways of regulating commodity derivative markets to limit speculation. Firstly, the extent of worldwide concern about the impact of speculation on commodity prices is shown. Two specific proposals of how to re-regulate commodity derivative markets are then presented; clearing and position limits. The current political situation and proposals in the US and EU are discussed.

Section 6 concludes by summarising the reasons why governments should re-regulate commodity derivative markets. As well as preventing speculation from amplifying movement in commodity prices, good regulation could:

- Make commodity derivatives markets more able to help producers and purchasers to hedge their risk.
- Make commodity derivatives more able to discover future real prices.
- Free up capital for use in genuinely productive investment.
- Protect against default on commodity and other derivatives, the direct cause of the recent financial crisis and economic woes across the world.

Regulating commodity derivatives is a key part of the necessary response to the global financial crisis. High and volatile commodity prices helped to precipitate and exacerbate economic difficulties. Unregulated, opaque derivatives hid major risks in the financial system which directly caused the financial crisis. Resources tied-up in unproductive commodity derivative contracts continue to increase economic inefficiency and deny resources for genuinely useful activities. This report shows how good regulation of commodity derivatives could help to tackle all of these problems.

i. A derivative is a financial contract which does not involve the trade of any real product. It is ultimately based on the trade in something real, so its value is 'derived' from a real trade. A future is one form of a derivative contract.

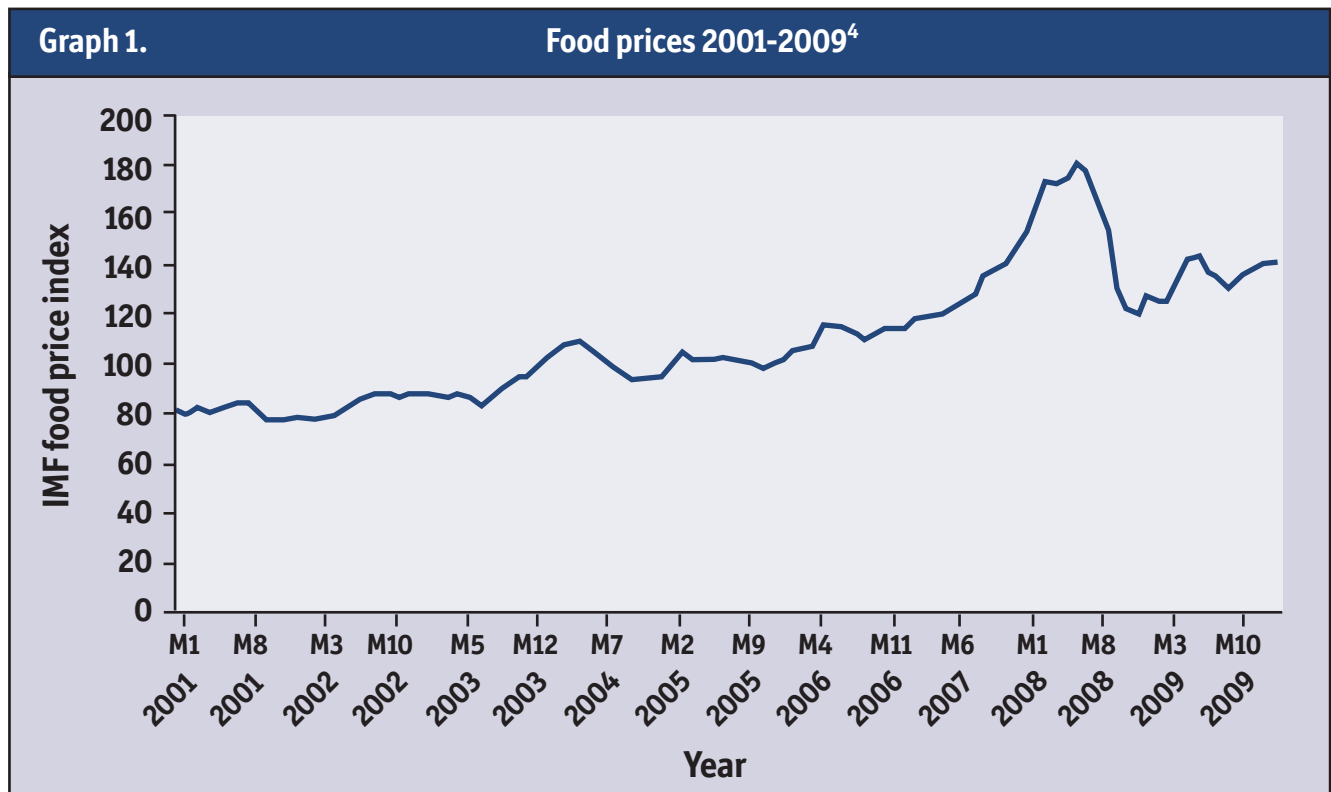
ii. A hedge is when someone reduces their risk to price fluctuations.

## 2. Playing the hunger lottery: The role of financial speculation

*“Deregulation that began in 2000 ... encouraged hyper-speculative activities by market players who had no interest in the underlying physical commodities being traded. This produced severe price swings for both oil and food in 2008-09 that destabilized business and household budgets in the US and throughout the world.”<sup>3</sup>*

**Letter from 18 US economists  
to the US Congress**

From early 2007 to the middle of 2008 there was a huge spike in food prices. Over the period there was more than an 80 per cent increase in the price of wheat on world markets. The price of maize similarly shot up by almost 90 per cent. Prices then fell rapidly in a matter of weeks in the second half of 2008 (See Graph 1 below). There are various reasons to explain a general increase in food prices over this time. But only financial speculation can explain the extent of the wild swings in the price of food





*“In the period before the outbreak of the crisis, inflation spread from financial asset prices to petroleum, food, and other commodities, partly as a result of their becoming financial asset classes subject to financial investment and speculation.”<sup>5</sup>*

**Report of the UN Commission of Experts on Reforms of the International and Monetary System (Stiglitz Commission)**

## **2.1 The impact of financial speculation on price increases and volatility**

The history of modern commodity speculation has its origins in the mid-19th century, when so-called ‘futures contracts’ were created for agricultural products traded in the United States. These contracts allow farmers to agree a guaranteed price for their next harvest well in advance, giving them greater certainty of income when planting crops. Futures contracts remain very important for farmers, although in global terms they tend to only be available to larger, wealthier farmers.

However, in the early 20th century futures contracts started to be bought and sold by financial speculators who had nothing to do with the physical production, processing or retailing of food. This activity began to affect the actual prices of foodstuffs on the daily ‘spot markets’, causing them to become more volatile and to rise and fall more sharply. Following the Wall Street crash, the Roosevelt government in the United States recognised this problem, and introduced regulations such as position limits<sup>i</sup> to prevent excessive speculation through the Securities Act of 1933, the Securities Exchange Act of 1934 and the Commodity Exchange Act of 1936.

In the 1990s and early 2000s these regulations were weakened in the face of intense lobbying by the financial industry. For instance, in 1991 lobbying by Goldman Sachs exempted many commodity speculators from the limits on trading created in the 1930s.<sup>6</sup> At the same time, new and more complicated contracts were created based on the price of food. Derivatives in food, just as in property and shares, expanded massively.

i. Position limits place a limit on the amount of derivatives which can be traded in a particular market. They were created by US regulators in the 1930s to prevent excessive speculation on food commodities, whilst still enabling farmers to use derivatives to hedge their risk.



Banks such as Goldman Sachs created index funds to allow institutional investors to 'invest' in the price of food, as if it were an asset like shares. Goldman Sachs' commodity index fund was created in 1991,<sup>7</sup> the same year it was exempted from position limits. These commodity index funds have since become the primary vehicle for speculative capital involvement in food commodity markets.

The number of derivative contracts in commodities increased by more than 500 per cent between 2002 and mid-2008. Between 2006 and 2008 it is estimated that speculators dominated long positions<sup>i</sup> in food commodities. For instance, speculators held 65 per cent of long maize contracts, 68 per cent of soybeans and 80 per cent of wheat.<sup>9</sup>

i. A long position is one where the holder owns the contract, and so profits from its price rising. In contrast, a short position is selling a contract which has been borrowed from a third party, with the intention of buying it back in the future. Short sellers profit from a fall in prices.

In a major study on the issue, another UN body, the United Nations Conference on Trade and Development (UNCTAD) concluded that: *"part of the commodity price boom between 2002 and mid-2008, as well as the subsequent decline in commodity prices, were due to the financialization of commodity markets. Taken together, these findings support the view that financial investors have accelerated and amplified price movements driven by fundamental supply and demand factors, at least in some periods of time."*<sup>10</sup>

This analysis is widely shared within the financial industry itself. As early as April 2006, Merrill Lynch estimated that speculation was causing commodity prices to trade at 50 per cent higher than if they were based on fundamental supply and demand alone.<sup>11</sup>

## Is speculation in commodities investment or profiteering?

Speculation on commodity markets is sometimes referred to as 'investment', but it is nothing of the sort. Buying commodity derivatives is attempting to skim money from a notional value of outputs from the 'real' economy. It is not investing capital to increase production.

Of money spent on commodity derivatives, not £1 is invested in increasing commodity production. But there is an opportunity cost of resources being put into commodity derivatives. Instead of being used on speculation, resources could be used on genuine assets and investment to increase production. This opportunity cost is particularly pertinent following the credit crunch, as small and medium sized businesses have struggled to secure sufficient capital. Limiting speculation on commodities could divert resources to be invested in genuinely productive activities.

The author and financial expert, Satyajit Das, who has worked in derivatives and risk management, writes: *"Proponents argue that speculators facilitate markets and bring down trading costs, thereby helping capital formation and reducing cost of capital. There is little direct evidence in support of this proposition. Recent experience suggests that in stressful conditions speculators are users rather than providers of scarce liquidity. ... A reduction in speculative activity would also arguable free up capital tied up in trading. This capital could be deployed more effectively within the economy."*<sup>8</sup>

At the start of the food price boom, one hedge fund manager told the Financial Times: *“There is so much investment money coming into commodity markets right now that it almost does not matter what the fundamentals are doing. The common theme for why all these commodity prices are higher is the substantial increase in fund flow into these markets, which are not big enough to withstand the increase in funds without pushing up prices.”*<sup>12</sup> As the food price spike reached its height in 2008, another hedge fund manager quipped that speculators held contracts in enough wheat to feed every *“American citizen with all the bread, pasta and baked goods they can eat for the next two years”*.<sup>13</sup>

Gregory Fleming, President of Merrill Lynch, said in May 2008 that commodity markets looked similar to the dot.com bubble of the late 1990s and the bubble in structured-credit products which preceded the credit crunch.<sup>14</sup>

But the situation was probably best summarised by the famous businessman George Soros, himself no stranger to financial speculation. In an interview with *Stern Magazine* published in the summer of 2008, Soros reflected on the nature of the crisis:

*“every speculation is also rooted in reality... [however] Speculators create the bubble that lies above everything. Their expectations, their gambling on futures help drive up prices, and their business distorts prices, which is especially true for commodities. It is like hoarding food in the midst of a famine, only to make profits on rising prices. That should not be possible.”*<sup>15</sup>

## 2.2 The murky world of commodity index funds

Much of the new money coming into commodity markets in recent years has been through commodity index funds. These indexes put money into derivatives across a range of commodities. They were mainly created by banks such as Goldman Sachs and Deutsche Bank. It is estimated the money in such index funds increased fivefold from \$46 billion in 2005 to \$250 billion in March 2008.

Commodity indexes are open to anyone to invest in, just as the FTSE 100 index is for shares. However, they are rarely marketed at ‘normal’ people and

instead tend to be used by institutional investors such as pension funds, insurance companies and mutual funds such as unit trusts.

Central to how index funds work are banks. Banks play two, potentially conflicting roles; arranging the buying of derivatives contracts for which they charge a fee, and selling the contract the index fund is buying. This effectively means banks are trading against their own clients. The largest commodity swap dealers are Goldman Sachs, Bank of America, Citibank, Deutsche Bank, HSBC, Morgan Stanley and JP Morgan.<sup>16</sup> Goldman Sachs on its own made around \$5 billion from commodities trading in 2009.<sup>17</sup> Following conversations with the nationalised British bank Royal Bank of Scotland, we estimate they made over \$1 billion from commodities trading in 2009.<sup>18</sup>

One commentator at the Financial Times noted in 2007 that investors in commodity index funds were losing large amounts of money and exposed that the main beneficiary was the trading arm of Goldman Sachs.<sup>19</sup>

Index funds do not actively follow supply and demand for a commodity when choosing whether to put money in or take money out. Instead they use commodities as a ‘hedge’ against their risk. For instance, money in commodities is seen to protect against losing money due to inflation. If institutional investors think inflation is due to increase, they may put more money into commodities. When inflation is expected to be low, they may take the money back out again. Because such decisions have nothing to do with the supply and demand of the actual commodity in question, it can play havoc with the commodity price.

One important driver for index funds to be used as a hedge was an influential academic paper in 2006 by Gorton and Rouwenhorst which argued that commodity prices were negatively correlated with shares and bonds, making them excellent for diversifying investments.<sup>20</sup> This paper was in turn heavily promoted by Goldman Sachs,<sup>21</sup> helping to drum-up business for its commodity derivative traders. In 2007, Goldman Sachs research was telling markets that increases in food prices were due to structural reasons and prices were

likely to continue rising;<sup>22</sup> ie. putting money into commodities would be a good idea.

UNCTAD say: "a major new element in commodity trading over the past few years is the greater presence on commodity futures exchanges of financial investors that treat commodities as an asset class. The fact that these market participants do not trade on the basis of fundamental supply and demand relationships, and that they hold, on average, very large positions in commodity markets, implies that they can exert considerable influence on commodity price developments."<sup>23</sup>

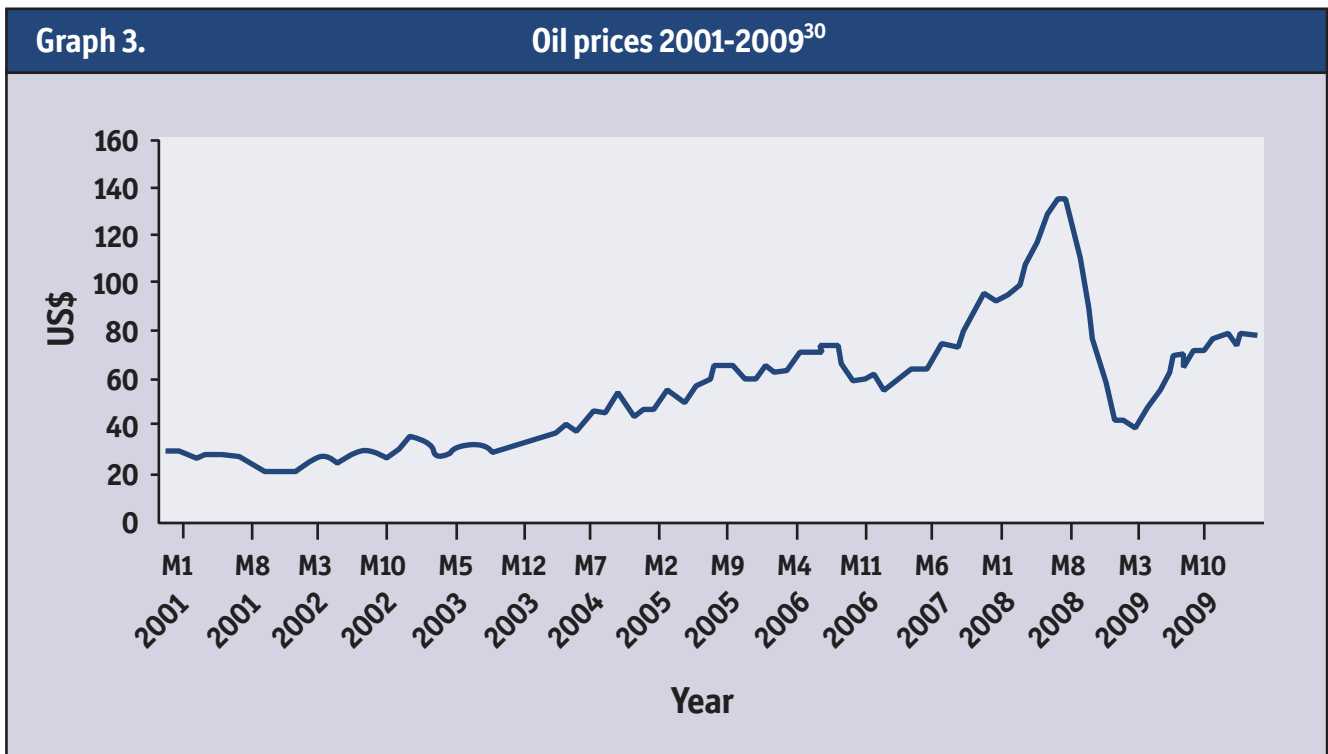
In May 2008 a Goldman Sachs research paper stated that "Without question increased fund flow into commodities has boosted prices." However, it went on to argue that commodity prices still reflected real supply and demand, saying "The so-called commodity speculator should be applauded for speeding up the message to both oil companies and consumers that energy markets are tight" and that this signalled the need for "greater investment".<sup>24</sup>

Goldman Sachs' argument seemed to be that speculators, particularly commodity index funds, had spotted what real traders of commodities had not; that the fundamentals pointed towards higher prices. Goldman Sachs accepted that the action of speculators was pushing up real prices of commodities, but this was because speculators were anticipating changes in supply and demand. In the event, prices crashed just two months later. Speculators had not anticipated supply and demand changes so well after all but created a bubble.

There is a scarcity of data on the commodity derivatives trade, particularly because huge numbers are sold 'over-the-counter' and so are opaque. There are also limitations in data on hour-by-hour and day-by-day changes. However, one estimate of contracts purchased by index funds shows a close correlation with food prices (see Graph 2. below). Whilst only using month-to-month data, the graph below shows the number of contracts held by index traders rising and falling in line with prices. Interestingly, the number of contracts held by indexes began to fall before the unusual and extreme drop in food prices in mid-2008.

**Graph 2. Index of estimated net long positions of index traders and the IMF food price index (January 2006-May 2009)<sup>25</sup>**





One way in which the movement of money into and out of index funds is seen is in the correlation between commodity index prices and heavily speculated exchange rates. The exchange rates of several currencies affected by carry trade speculation,<sup>26</sup> such as the Icelandic krona and Hungarian forint, are all highly correlated with the Reuters Commodity Price Index and Standard & Poors Goldman Sachs Commodity Price Index. There is no real reason why the movements of heavily speculated against currencies should be correlated with heavily speculated against commodities - unless speculators are moving money into and out of currencies and commodities on the same news about the general state of world markets. This speculation then impacts on the price of currencies and commodities. UNCTAD says the changes in the currency and index price "are clearly driven by factors beyond fundamentals because the fundamentals underlying the different prices cannot go in the same direction".<sup>27</sup>

Index funds can also use computer models to decide what to invest in. These models tend to be similar across funds, leading to herd behaviour into and out of commodity contracts. UNCTAD states that: "This can result in increased short-term price volatility, as well as the overshooting of price peaks and troughs."<sup>28</sup>

Jayati Ghosh, professor of economics at Jawaharlal Nehru University, New Delhi, says: "From about late 2006, a lot of financial firms - banks and hedge funds and others - realized that there was really no more profit to be made in US housing market, and they were looking for new avenues of investment. Commodities became one of the big ones - food, minerals, gold, oil. And so you had more and more of this financial activity entering these activities, and you find that the price then starts rising. And once, of course, the price starts rising a little bit, then it becomes more and more profitable for others to enter. So what was a trickle in late 2006 becomes a flood from early 2007."<sup>29</sup>

## Oil

The impact of commodity speculation is not just on food. The commodity traded most by financiers is oil. The price of a barrel of oil increased from \$60 in 2006 to almost \$150 in mid-2008, before falling rapidly to \$40 in a matter of weeks. Whilst there are underlying reasons for a rising oil price, these extreme swings strongly suggest a role for speculation.

Writing in mid-2008, Lord Meghnad Desai, emeritus professor of economics at the London School of Economics, said: *“There is a growing feeling that the latest sharp upsurge in the price of oil may be a speculative bubble rather than an outcome of market fundamentals. The US Commodity Futures Trading Commission indicated last week that there may be ‘system risk’ and George Soros, the veteran investor, in testimony on Capitol Hill on Tuesday, warned that commodity index funds, which treat oil as an asset rather than a commodity to be bought and sold for use, are creating a bubble.”*<sup>31</sup>

Goldman Sachs used its position as a financial analyst to talk-up oil markets. Most famously, in March 2008 Goldman Sachs predicted that oil prices would remain high and could reach as much as \$200 a barrel.<sup>32</sup> This talking-up of the oil price was repeated in May 2008 when Goldman Sachs energy strategist Argun Murti was reported across the world as saying the oil price could reach \$200 a barrel within six-months.<sup>33</sup> At the time, Goldman Sachs was heavily investing in oil, through its subsidiary J.Aron.<sup>34</sup>

An April 2010 survey of banks, traders and oil companies found that 70 per cent say speculation is currently increasing the price of oil, on average by \$10 to \$30 a barrel.<sup>35</sup>

A high oil price has many impacts on developing countries. For net oil importers, it increases the import bill. As with high food prices, poor people across the world have to use less energy and/or cut their expenditure on other things. Furthermore, as agriculture is an energy intensive industry, a high and variable oil price has a knock-on impact on food prices. A research paper for the World Bank estimates that higher oil and other energy prices caused the prices of US food exports to increase by 15-20 per cent between 2002 and 2007.<sup>36</sup>



### 2.3. Market servant or market master?

Two main reasons are given for why speculation is needed in commodity markets; to help producers and buyers of commodities to manage their price risk, and to help price discovery. Whilst these are valid reasons for allowing a limited amount of speculation, there is evidence that excessive speculation has actually made it more difficult for commodity markets to fulfil these objectives.

#### a) Price risk management

Producers and purchasers of food who want to use futures markets to limit their exposure to price movements (otherwise known as 'hedging') need financial traders to take on that risk. Such traders effectively act as insurers to, for example, a farmer. The farmer gets a guaranteed return. The trader gets an unknown but potentially higher return. Such traders are therefore needed to provide 'liquidity' to the futures market. Whilst such liquidity is needed, the current scale of trading by financiers dwarfs that actually needed to provide sufficient liquidity for real buyers and sellers of food.

Worryingly, the increased demand for food derivatives by speculators has actually made it more difficult for farmers to hedge their risk. With rising futures prices, more margin has been required of farmers in order to hedge. A subcommittee of the US senate found that this abnormality in the wheat market impaired the ability of farmers to hedge and aggravated their economic difficulties in 2007 and 2008.<sup>37</sup>

This finding has been echoed by Gary Gensler, Chairman of the US Commodities Futures Trading Commission, who in a statement to US legislators argued that: *"record-high volatility has impaired the ability of many farmers and other businesses to use the futures markets to manage their price risks"*.<sup>38</sup>

#### b) Price discovery

Futures contracts are seen as a way to 'discover' the price of a commodity in the future. Financial traders are expected to use information they learn about a particular commodity to influence their decisions about what price to buy and sell futures contracts at. For instance, drought in Australia means a lower wheat harvest is expected that year, and so the price of a future in wheat rises.

Policymakers and farmers can then use future prices to help make decisions.

However, in recent years, futures markets have less accurately predicted the future spot price<sup>39</sup> than just assuming that the future spot price would be the same as the current spot price. Ben Bernanke, chairman of the US Federal Reserve, says commodity futures markets have a "poor recent record" in forecasting prices,<sup>40</sup> making it more difficult to forecast inflation and so set interest rates.

This failure of futures markets to predict prices can be explained largely because index speculators often base their decision to buy contracts on information unrelated to underlying supply and demand in that commodity. They are driven by factors outside commodity markets such as the availability of cheap money, the attractiveness of other markets such as currencies, property and shares, and using commodity markets as a hedge. Furthermore, the larger the investments by financial traders the more they determine prices rather than demand and supply, as evidenced by the sub-prime mortgage crisis that led to the 2008 crash.<sup>41</sup>

All this suggests that rather than helping to discover prices, the scale of financial involvement in commodity markets is actually disrupting them, making them less able to set sustainable prices.

There is an argument as to how much the increase in futures price is passed on to the spot price. The less it is passed on, the less speculation affects the real price. However, the less it is passed on, the greater the disparity between futures and spot prices, and so the more difficult it is to use derivatives to hedge. Similarly, the greater the disparity between futures and spot prices, the less well futures markets are doing their job of discovering future prices for a commodity.

The less speculation is seen to be impacting on real prices, the more it will be creating disparity between future and real prices. This in turn disrupts the two supposed reasons for futures and derivatives in commodities. Limiting excessive speculation would help futures markets work properly, as well as preventing excessive volatility in commodity markets.

## 3. The impact of price swings

*“The excess price surges caused by speculation and possible hoarding could have severe effects on confidence in global grain markets, thereby hampering the market’s performance in responding to fundamental changes in supply, demand, and costs of production. More important, they could result in unreasonable or unwanted price fluctuations that can harm the poor and result in long-term, irreversible nutritional damage, especially among children.”<sup>42</sup>*

**International Food Policy  
Research Institute**

### 3.1 Hunger and poverty

*“The price boom between 2002 and mid-2008 was the most pronounced in several decades – in magnitude, duration and breadth. It placed a heavy burden on many developing countries that rely on food and energy imports, and contributed to food crises in a number of countries in 2007-2008.”<sup>43</sup>*

**UNCTAD**

The increase in the price of food has been disastrous for people across the world. There were 75 million more hungry people in 2007 and a further 40 million in 2008.<sup>44</sup> The latest estimate by the Food and Agriculture Organisation (FAO) in June 2009 was that over 1 billion people are now chronically malnourished due to “global economic slowdown combined with stubbornly high food prices”.<sup>45</sup>

But the impact of high prices goes well beyond not getting enough to eat. Poor households in developing countries tend to spend between 50 and 90 per cent of their income on food, compared to an average of 10-15 per cent in developed countries.<sup>46</sup> It is estimated that the food price spike increased the number living in poverty by between 100 and 200 million.<sup>47</sup> As well as eating less food, households have been forced to:

- **Eat less fruit, vegetables, dairy and meat in order to afford staple foods.** This can have drastic impacts on protein and vitamin intake.<sup>48</sup> Nutritional deficiencies particularly affect children, pregnant women and unborn children. Ethiopia suffered both from high global food prices and widespread drought in 2008. Ethiopia’s wheat imports increased from threefold from over 300,000 tonnes in 2006 to over 1 million tonnes in 2008.



But higher global prices meant its wheat import bill increased more than fivefold from \$84 million in 2006 to \$465 million in 2008.<sup>49</sup>

Nuria Mohammed farms vegetables in southern Ethiopia's Oromiya region. Drought in 2008 made Nuria dependent on buying wheat and maize from the local market. But the price of wheat and maize had more than doubled. Two of Nuria's children, Faiza Abdulmalieh and Fatima, both under five, were among 30,000 children local health workers estimated were malnourished in the region. Nuria says *"When I was nursing Faiza, I was sick, so I could not breastfeed her properly."*<sup>50</sup>

Nigeria is one of the world's largest importers of wheat. In 2006 Nigeria imported over 13 million tonnes of wheat, but by 2008 this had fallen to less than 3 million.<sup>51</sup> The price Nigeria was paying for wheat increased from just over \$100 a tonne in 2006 to almost \$300 a tonne in 2008. With rising food prices, many people have to resort to eating just staples rather than more 'luxury' foods like meat, dairy and vegetables. Shehu Bawa, a consultant for UNICEF, says: *"[With lower purchasing power] consumers use the money they would normally use for buying eggs and chicken to purchase grains which is more important to them."*<sup>52</sup> For instance, Joseph Adeleke, a resident of Lagos, said in May 2008 *"bread is the only affordable food for the common man"*.<sup>53</sup>

- **Reduce any savings, sell assets or take out loans.** This can include selling-off assets vital to future income such as land or cattle. Lesotho imports 70 per cent of its food, particularly maize, and was therefore hit hard by high global food prices in 2007 and 2008. Moheemad Farooq, a UNICEF child protection specialist in Lesotho says that many people responded by *"selling off assets - if they have any - or taking loans with high interest rates, for which they could end up in bonded labour, so the situation will get worse."*<sup>54</sup> One Lesothan, Retselisitsoe Rasetona, said in 2008: *"We have no food, so we have to borrow; that is how we survive."*<sup>55</sup>

In Ethiopia, Nuria Mohammed says: *"I sold the cattle for 200 Br (Birr) to 300 Br. They had become skinny because of lack of adequate pasture, but still they were our only family assets. Previously, they would each have been worth 1,000 Br (US\$105)."*<sup>56</sup>

Mauritania imports 70 per cent of its food. In 2004, Mauritania had spent \$15 million importing 350,000 tonnes of wheat. By 2008 it was spending \$110 million to import 260,000 tonnes.<sup>57</sup> Many had to borrow to buy food. *"Repaying the debts is more expensive this year than last,"* said Omu Mint Belel, a resident of M'beida, a village in the south, in late 2007. But she says none of this was enough to prevent hunger: *"Already some families are eating only once a day."*<sup>58</sup>

- **Reduce spending on 'luxuries' such as healthcare, education or family planning.**<sup>59</sup> Solomon Desta, director of a primary school in southern Ethiopia, said in 2008: *"This time last year we had already enrolled 2,300 students. Now we have registered 1,800. The turnout is the lowest of the last three years."*<sup>60</sup> Lema Harrisso, director of another primary school in southern Ethiopia says: *"Compared to the vastness of our kebele [ward], we expected many children [to register for school]. There are about 400 children of school age in our kebele, but only 260 of them are registered."*<sup>61</sup>
- **Women tend to manage the food budget and often bear much of the suffering.** Women may also try to increase income through taking on insecure and risky employment such as becoming domestic workers, mail-order brides and sex workers.<sup>63</sup>

High food prices affect poor farmers as well as the urban poor. A high percentage of rural households are net buyers of staple foods. In Kenya and Mozambique, around 60 per cent of rural householders are net buyers of maize.<sup>64</sup> Very few poor farmers produce a significant surplus to sell.<sup>65</sup> In Zambia, 80 per cent of farm households

grow maize, but fewer than 30 per cent sell any. The few households which make-up the bulk of maize sellers have significantly higher incomes.<sup>66</sup> In, addition any increase in income was for many producers negated by increasing costs of farm inputs such as oil and fertilizer. The cost of fertilizer almost doubled in 2007 and 2008.<sup>67</sup>

Furthermore, in general terms wild price swings make it difficult for farmers to make decisions about what crops to grow and in what they should invest precious resources. As Jayati Ghosh, professor of economics at Jawaharlal Nehru University, New Delhi, says: *“the world trade market in food, has started behaving like any other financial market: it’s full of information asymmetry... So farmers think, ‘Well, wow, the price of sugarcane is really high,’ and they go out there and cultivate lots of sugarcane. By the time their crop is harvested, the price has collapsed. So you get all kinds of misleading price signals. Farmers don’t gain.”*<sup>68</sup>

High staple food prices have been a problem at an economy-wide level, particularly across sub-Saharan Africa. Africa has gone from being a net exporter of food in 1970<sup>69</sup> to a massive net importer today. Around 55 per cent of developing countries are net food importers and almost all countries in Africa are now net importers of cereals.<sup>70</sup>

Sudden food price surges also frequently result in political and social unrest, and the crisis of 2007-2008 was no different. There were protests and riots against the rising prices in major cities across the developing world. This generated major headlines and was top of the international news agenda in the weeks leading up to onset of the bank collapses. One protestor from Cote d’Ivoire interviewed at the time, Alimata Camara, said: *“We only eat once during the day now. If food prices increase more, what will we give our children to eat and how will they go to school?”*<sup>71</sup>

## Volatility

As financial speculation increased from 2000 to 2008, the volatility of commodity prices also tended to increase. The volatility of the maize price increased by over one-third from 2002-2006 to 2007-2008. For the same period, wheat volatility increased by around 50 per cent. UNCTAD finds that positions taken by financial markets, and particularly those of index funds, were positively correlated with volatility from January 2005 to August 2008. They conclude that *“given that index traders generally follow a passive trading strategy [unrelated to market fundamentals], it is more likely that it was an increase in their activity that caused greater price volatility”*.<sup>72</sup>

The FAO says: *“The wider and more unpredictable the price changes in a commodity are, the greater is the possibility of realizing large gains by speculating on future price movements of that commodity. Thus, volatility can attract significant speculative activity, which in turn can initiate a vicious cycle of destabilizing cash prices.”*<sup>73</sup>

Widely changing prices make it difficult for farmers to make decisions about what crops to grow and what to invest precious resources in. For instance, the FAO continues: *“At the national level, many developing countries are still highly dependent on primary commodities, either in their exports or imports. While sharp price spikes can be a temporary boon to an exporter’s economy, they can also heighten the cost of importing foodstuffs and agricultural inputs. At the same time, large fluctuations in prices can have a destabilizing effect on real exchange rates of countries, putting a severe strain on their economy and hampering their efforts to reduce poverty.”*<sup>74</sup>

French finance minister Christine Lagarde has said: *“I see the problem on my radar of the volatility of price”* and has called for tighter regulation of commodity derivatives and the creation of an EU commodities trading regulator, comparable to the US Commodities Futures Trading Commission (CFTC).<sup>75</sup>

### 3.2 Cash crops

A simple assumption would be that speculation on developing country cash crop exports would be a good thing, in as much as speculation increases the price received for such goods. However, speculation on cash crops such as coffee, cocoa, and cotton is actually a large problem for farmers. Speculation can temporarily push up the prices of these crops, but this also causes the price to become more volatile with sudden decreases in price too.

In the first half of 2008 the price of cocoa hit a 28 year high. However, these rises were only temporary and in the second half of 2008 cocoa experienced a sharp decline.<sup>76</sup> This volatility in cash crop prices is a major issue as it makes it harder for farmer's to make decisions.<sup>77</sup> Cash crop farmers in developing countries lack the knowledge and money to adequately respond to confusing market signals. Changing the crops which are grown requires investment in seeds and knowledge, and farmers have few safety nets such as insurance, futures contracts or other risk reducing instruments to protect them if they respond incorrectly.<sup>78</sup> For example, banks and other lending institutions are reluctant to lend to individual cocoa-dependent producers at reasonable interest rates, since growers ability to repay is tied directly to unpredictable future cocoa prices.

Cash crop farmers, such as cocoa growers in Ghana and Côte d'Ivoire, are especially at risk to commodity price volatility as a very small quantity of these crops are consumed by farmers. Cash crops are sold in return for cash to buy food with. The price of both cash crops and food crops are critical to a cash crop farmer's wellbeing.<sup>79</sup>

The Fairtrade Foundation states of its producers: *"farmers like most smallholders, are net food buyers and as such only a minority have gained from increased commodity prices"*.<sup>80</sup> For example, in southern Malawi many cash crop farmers grow sugar cane. However, the Kasinthula Cane Growers reported in 2009 that the families of their 300 members are spending on average 80 per cent of their income on food, compared to around 50 per cent a year before, causing many families to now eat one meal less a day. This is the case even though many of these farmers still grow much of the food that they eat but even so they still buy more food than they sell.<sup>81</sup>

As farmers cannot respond to the volatile market they can be forced out of business altogether, and lose their main source of cash income.<sup>82</sup> As mentioned in section 3.1 above, one of the initial responses of cash crop farmers will be to sell any assets they hold, such as land. This can create opportunities for corporate land grabbing,

Commodity	Price increase from start 2006 to mid-2008
Maize	+180 per cent
Wheat	+110 per cent
Oil	+110 per cent
Cocoa	+90 per cent
Coffee	+70 per cent
Cotton	+30 per cent
Sugar	+10 per cent

where companies buy-up land to produce export crops. For example, in just five African countries, 1.1 million hectares (an area the size of Belgium) has been taken over by companies to grow biofuels.<sup>83</sup> Furthermore, buying-up land is seen by speculators as an alternative way of speculating in food to buying derivatives.<sup>84</sup>

Another problem caused by speculation is that more powerful middlemen can use the volatile price to take advantage of individual farmers by buying at a low price from the desperate farmers and then selling at the high international price, gaining most of the benefits of high commodity prices for themselves.<sup>85</sup> This price volatility is also a major barrier to increasing cash crop farmer's efficiency, unstable prices are one of the reasons for Africa's low level of fertilizer use as farmers can not be sure of their return from investing in fertilizers.<sup>86</sup>

Cash crop markets provide the most recent evidence that speculation continues to be a problem. Chocolate producers have identified speculation as a key reason why cocoa prices reached an all time high in April 2010.<sup>87</sup> Meanwhile, in June 2010 the spot price of robusta coffee increased almost 20 per cent in three days on the London exchange. Hedge funds had been betting on lower prices, artificially pushing the price down. However, their positions unwound when it emerged that one commodity trading house was holding a large number of future contracts and actually intended to take physical delivery of the coffee. Hedge funds were forced to buy back the contracts they had sold, triggering the sudden correction of a big increase in price.<sup>88</sup> A commodities analyst, Sudakshina Unnikrishnan, said that the coffee price spike was not linked to underlying supply and demand issues: *"There is no fundamental reason for coffee prices to have increased so much in recent weeks."*<sup>89</sup>

### 3.3 Inflation

As well as increasing food and oil prices for people across the world, speculation also impacts on the general rate of inflation. Artificially higher inflation leads to higher than necessary interest rates, and so more expensive lending. In the UK, because of high food and oil prices, the Bank of England's Official Bank Rate stayed as high as 5 per cent until October 2008, despite all the signs that Britain was heading into recession.

The fall in commodity prices from mid-2008 'allowed' the Official Bank Rate to fall to 0.5 per cent. Because they make lending cheaper, low interest rates are expected to increase demand and thereby inflation in the economy. More money is available for investment in economic activity.

In the context of speculation on commodity prices, low interest rates can also increase inflation by increasing speculation. Low interest rates make more money available which can then be put into commodity derivatives, increasing commodity prices. This is another route by which low interest rates can increase inflation. But this does nothing to increase demand and economic activity, it just ties the cheap money up in unproductive derivative contracts.

## 4. Other causes of the food price spike

Financial speculation is not the only cause of high food prices, and certainly was not the sole driver of the 2007-2008 crisis. Changes such as increased use of biofuels, changes in crop yields and the fall in the value of the dollar have all affected prices in recent years. Certainly, these factors affecting the 'fundamentals' of food prices had a significant bearing on the events of 2007-2008. But an examination of the evidence during and since the 2007-2008 crisis leads to the inescapable conclusion that speculation rides on the back of these underlying changes, amplifying their impact on price. The FAO concludes that:

At the onset of the price surge in 2007, FAO identified a number of possible causes contributing to the price rise: low levels of world cereal stocks; crop failures in major exporting countries; rapidly growing demand for agricultural commodities for biofuels and rising oil prices. As the price strengthening accelerated, several other factors emerged to reinforce the upheaval; most importantly, government export restrictions, a weakening United States dollar **and a growing appetite by speculators and index funds for wider commodity portfolio investments on the back of enormous global excess liquidity.**<sup>90</sup>

*(emphasis added)*

In June 2008, at the peak of the crisis, the IMF acknowledged that *"Purely financial factors, including market sentiment, can have short-term effects on the prices of oil and other commodities, but a lasting impact on recent oil price trends remains difficult to establish."*<sup>91</sup> Whilst they acknowledged a role for speculation in then high commodity prices, the IMF argued that real demand and supply factors were primarily responsible for the commodity spikes then taking place. They therefore predicted that *"prices are expected to ease only gradually from recent highs"*.<sup>92</sup> This prediction was shown to be incorrect the following month when prices fell rapidly.



It is the scale of the swings in price, and in particular the sudden fall in prices, which real demand and supply factors struggle to explain. Clearly there are real demand and supply factors which have been behind changes in food price. But financial speculation amplifies these changes, pushing prices higher, and making them more volatile.

## 4.1 Biofuels

Donald Mitchell at the World Bank argues that the main trigger for the spike in food prices was the increase in biofuel production from grains and oilseeds in the US and EU. He argues that without the increase in biofuel production *“global wheat and maize stocks would not have declined appreciably, oilseed prices would not have tripled, and price increases due to other factors, such as droughts, would have been more moderate.”* However, he acknowledges that speculation was part of the reason for the price spike, but that without increased biofuel use it *“would probably not have occurred”* because it was a response *“to rising prices.”*<sup>93</sup>

Biofuels have certainly increased demand, particularly for maize. The proportion of maize used for bioethanol increased from 4 per cent in 2001/02 to 12 per cent in 2007/08.<sup>94</sup> Biofuels have therefore had some impact on the general rise in food prices. Biofuels would be particularly expected to impact on the price of maize, although this would then have knock-on impacts on other foods. However, the price of wheat actually increased first in 2007 (see Graph 4 on page 22).

Demand for biofuels remained strong and continued to increase throughout 2008 and 2009.<sup>95</sup> It is therefore difficult to see how biofuels can explain the sharp fall in food prices in mid-2008, and so the sharp increase in 2007 and 2008.

Increased use of biofuels does cause food prices to rise, as well as having large negative impacts on local communities and increasing greenhouse gas emissions. But increased demand for biofuels does not explain the huge swings in food prices of recent years.

## 4.2 Low crop yields

Global grain production did fall in 2006 by 1.3 per cent, though increased by 4.7 per cent in 2007.<sup>96</sup> Shortfalls in wheat production were higher, with a fall in production of 4.5 per cent in 2006, followed by an increase of just 2 per cent in 2007. Wheat production then increased by 14 per cent in 2008.<sup>97</sup> Such changes, and their knock-on impact on grain stocks, offer some explanation for gradually increasing prices in 2006 and 2007. But they offer little explanation for the huge changes in grain price in 2007 and 2008, compared to 2006.<sup>98</sup>

The UK government argues that low wheat yields were a key factor behind the 2007 and 2008 price spike. They argue that earlier in 2008 food prices continued to rise because of uncertainty over the 2008 wheat yield. The bubble then burst in mid-2008 once it was clear wheat production was high. However, early in 2008 it was still expected that the wheat yield would be 7 per cent higher than in 2007.<sup>99</sup> There was no sudden moment which would explain the rapid fall in wheat and food prices in mid-2008. Yields offer an explanation for a general rise in price through 2006 and 2007, and a fall in 2008. But it is unclear how they explain the large spikes and fluctuations in price.

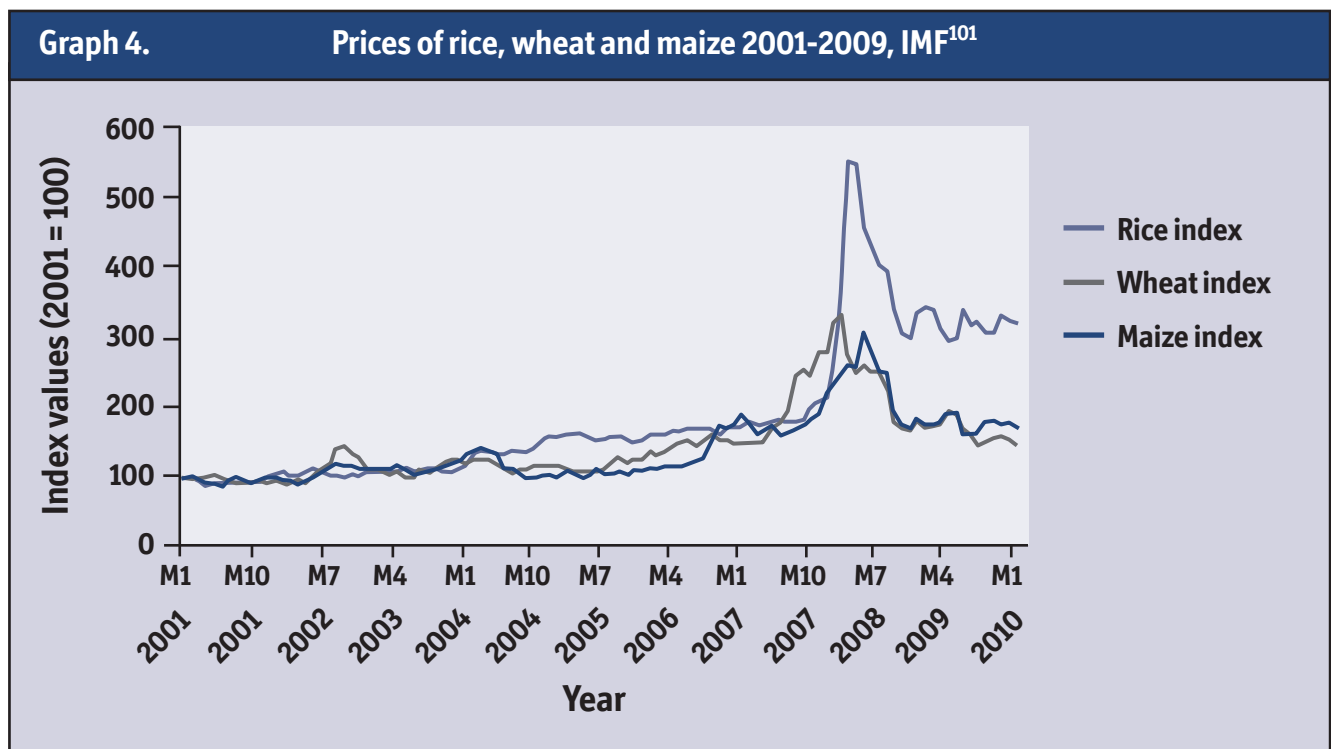
## 4.3 The future outlook for food

Outlooks for food suggest that fundamentals will continue to cause food prices to rise in the medium term. The Organisation for Economic Co-operation and Development (OECD) and FAO outlook for food commodity prices in June 2010 predicted that from 2010-2019 *“Average wheat and coarse grain prices are projected to be nearly 15-40% higher in real terms relative to 1997-2006”*.<sup>100</sup> The report highlights that this is due to factors such as predicted increased demand from emerging markets and increased demand for biofuels.

One interesting point about the report is that whilst it expects pressure on the food price to continue to increase, it predicts that food prices will not go as high up until 2019 as they did in 2007 and 2008. Given that increased demand for

biofuels and from emerging markets is continuing to increase, as will the impacts of climate change on food supply, this prediction begs the question as to why prices rose so high in 2007/08. Financial speculation provides the answer.

The more fundamentals are pushing food prices up, the more likely it is that speculators will once again ride on the back of that pressure amplifying prices. Whilst it is entirely possible to prevent food prices from rising as high over the next decade as they did in 2007 and 2008 (especially if the rush to biofuels is stopped and climate change is tackled with urgency), this will only be possible if regulations are introduced to limit excessive speculation.





## Rice: a victim of speculation by proxy

The knock-on effects of speculation can be seen through a range of commodities. Very little rice is traded on international commodity exchanges or in futures contracts. Yet the price of rice increased far more than that of wheat in 2007 and 2008. This is given as a key argument by those who argue speculation had little impact on the price of food in 2007 and 2008.

The international market for rice is very small; about 6-7 per cent of global production.<sup>102</sup> As the rice price rose, key rice exporters such as India, Vietnam and Thailand introduced export bans to protect rice availability for their own people, making the international market even smaller. The rising price also probably prompted households to buy and store more rice, in anticipation of rising prices, but also causing prices to rise further. Intervening to protect the food supply of their own people is a necessary and legitimate response from governments to wildly fluctuating global markets.

Some commentators point to rice to show that financial speculation was not a problem, but rather blame 'protectionism'. It is undoubtedly the case that the reason the global rice price went so high was due to the factors listed above. However, there is strong evidence that the extreme increase in the price of wheat triggered the increase in the price of rice.

In some countries, most importantly India, rice and wheat are substitutes for each other. India is a large net importer of wheat. The average cost of India's net wheat imports rose from \$220 a tonne in 2006 to \$255 a tonne in 2007 and \$370 a tonne in 2008. As well as causing the local wheat price to rise, this also led to India importing far less wheat in 2008. Net imports fell from 5 million tonnes in 2007 to just over 700,000 tonnes in 2008.<sup>103</sup> This rise in the price of wheat and fall in wheat imports had knock-on impacts on rice price and demand.

The global price of wheat increased particularly in late 2007, whilst the rice price increase began in early 2008. Statistical tests show that at times the price of rice is 'caused' by the price of wheat. There was a crucial period at the start of 2008 when statistical tests by a researcher for the FAO have shown that the rise in the price of rice was 'caused' by the rise in the price of wheat.<sup>104</sup>

Similarly, a research paper for the World Bank says that there was little change in production or stocks of rice, and the initial increase in world rice price was caused by the increases in wheat prices in 2007.<sup>105</sup> An FAO food outlook report says: "*The shock to demand for rice was largely generated by demand to make up shortfalls in wheat available to consumers.*"<sup>106</sup>

Financial speculation can be said to have had an impact on the rice price by amplifying the increase in the price of wheat, which in turn triggered the dramatic increase in the price of rice.

## 5. So what do we do about it? Reregulating speculation

*“Speculation in basic foodstuffs is a scandal when there are a billion starving people in the world. We must ensure markets contribute to sustainable growth. I am fighting for a fairer world and I want Europe to take the lead on that.”<sup>107</sup>*

**Michel Barnier, European commissioner  
for the internal market**

### 5.1 Worldwide concern

Whilst it has been less commented on in the UK, the impact of financial speculation on food and energy prices has received significant attention elsewhere in the world; including by governments such as the United States and France, as well as by the European Commission.

Gary Gensler, head of the US government commodity regulator, says: *“I believe that increased speculation in energy and agricultural products has hurt farmers and consumers.”<sup>108</sup>* In a separate statement before the US House Agriculture Commission, Gensler referred to the need to bring back the checks put in place by the Roosevelt administration, arguing that *“Just as we then brought regulation to the commodities and securities markets, we now need to bring regulation to markets for risk management contracts called over-the-counter derivatives.”<sup>109</sup>*

Michel Barnier, European commissioner for the internal market, told the European parliament: *“Speculation in basic foodstuffs is a scandal when there are a billion starving people in the world. We must ensure markets contribute to sustainable growth. I am fighting for a fairer world and I want Europe to take the lead on that.”<sup>110</sup>* Michel Barnier continued: *“We have to look at derivatives. Speculation is linked to derivatives which are linked to raw materials. That is something we want to regulate very carefully in order to tackle speculation in raw materials.”<sup>111</sup>*

These sentiments have been backed by a number of UN agencies and offices dealing with food and hunger issues, including the UN’s special rapporteur on the right to food, Olivier de Schutter, who has called for limits on speculation in foods such as wheat.<sup>112</sup>

Developing countries have also been calling for action on the issue. In an interview with the World Development Movement, Pedro Paez, former Minister for Economic Policy Coordination of Ecuador, said: *“international financial markets are distorting the markets in food and energy. This is increasing vulnerability day-by-day. In one-and-a-half years, the number of people in hunger has increased from 900 million to over 1 billion ... The lives of millions of people come to depend on the activities of a handful of financial speculators.”*<sup>113</sup>

Commodity speculation is therefore a live political issue, particularly in the United States and in the European Union, where a package of regulatory reforms is now under review. Together, action on both sides of the Atlantic could change the rules of the game for trading in commodity derivatives and bring markets back into line – as long as governments hold firm in their resolve.

## 5.2 Transparency

All futures contracts need to be cleared through regulated exchanges. Most contracts are currently set in private, meaning it is impossible to know how much of what is being traded. Contracts need to be brought out into the open.

There is an enormous amount of derivatives trading which takes place ‘over-the-counter’.<sup>i</sup> The European Commission says that there were \$4.4 trillion of over-the-counter commodity derivatives outstanding in December 2008.<sup>114</sup> These are private trades for which there is little information. Because such contracts are by their nature opaque, for those buying the contract they may have little information of the price similar contracts are being bought and sold at. But because all trading happens through banks, firms such as Goldman Sachs have a very good idea of what is happening in the market. They can use this ‘information asymmetry’ for their benefit, over their clients.

i. An over-the-counter derivative is a derivative traded privately between two financial traders. Banks create a derivative in a specific way for its client. Because it is created in private, the rest of the market does not clearly see what is being traded at what price.

In contrast, when derivatives are traded through an exchange it can be seen who is selling what for how much. Prices are set in transparent competition between buyers and sellers.

Exchanges also allow contracts to be ‘cleared’. This is when a clearing entity (the exchange or potentially a bank) becomes the buyer to each seller, and the seller to each buyer, of a contract. The clearing entity makes the payments to each side of the deal, covering them from the risk of the other defaulting.<sup>115</sup> This in turn provides financial stability. In contrast, over-the-counter derivatives can be defaulted on. It was non-payment of derivative contracts (not traded through clearing exchanges) which directly caused the 2007/08 financial crisis. Gertrude Tumpel-Gugerell, a member of the Executive Board at the European Central Bank, says:

central clearing of OTC derivatives is an essential part of the regulatory reform to make this market sufficiently transparent and to allow supervisors and overseers to effectively monitor the build-up of systemic risk.<sup>116</sup>

In return for being protected from default, buyers and sellers make up-front payments to clearing exchanges. Making these upfront payments protects traders from default by the other party but creates a small cost for each trade which takes place. This cost is small for real users of commodity derivatives like farmers. In fact, most farmers choose to use centralised clearing rather than over-the-counter trading, because their whole reason for using futures contracts in the first place is to protect themselves from risk.

Nobel-prize winning economist Joseph Stiglitz says *“Many economists agree that the unregulated, over-the-counter derivatives market played a key role in transforming a financial downturn into a global economic calamity.”*<sup>117</sup> Economist Nouriel Roubini, respected for predicting much of the recent financial crisis, argues that trading of all derivatives should be cleared through exchanges.

He says:

During the recent financial crisis, things that were traded on exchanges - like equities - there was tumult, there was noise, but there was never a freeze-up of these markets. But in dealer's markets, we had totally frozen markets for bonds, for derivatives, for credit derivatives, for lots of stuff. So I think market-making and dealing is actually only a source of profit for financial institutions - under the guise of market-making and dealing, they're doing a lot of proprietary trading. I would not just take that away from them, I would also move away from dealers markets altogether to exchanges where there is full transparency.<sup>118</sup>

If all trades had to go through clearing, this would impose a new cost on speculators, which would increase the more excessive speculation takes place. The small clearing charge if repeated over many transactions should have a dampening effect on speculative trading. For instance, a passive index fund would need to make a clearing payment every time they roll over from one futures contract to the next. Making all contracts be cleared through exchanges should limit the amount of excessive speculation whilst providing financial stability to real traders in a commodity and the wider economy.

### 5.3 Position limits

Position limits were first created in the 1930s in the United States to limit the amount of financial speculation possible in a particular commodity market. Whilst real producers and consumers of food, such as farmers, were allowed to buy and sell unlimited contracts, limits were placed on speculators so that prices would not be subject to financial bubbles, such as the one preceding the Wall Street Crash.

In 1991, a Goldman Sachs owned commodities trading company, J.Aron, wrote to the CFTC arguing that they were using food derivatives to hedge their risk in other markets, just as farmers use futures to hedge their risk against changing food price. Therefore they should be treated as hedgers, and the limits on number of contracts should not apply to them.<sup>119</sup>

This ran counter to the whole purpose of CFTC regulations in the 1930s; to make a distinction between real buyers and sellers of food and the financial markets. By putting money into commodity markets, Goldman Sachs was increasing its risk to changing food prices, and potentially contributing to a financial bubble.

Under heavy corporate lobbying, this bogus argument was accepted, and the CFTC issued a 'Bona Fide Hedging' exemption. This allowed Goldman Sachs and many speculators to completely bypass the limits on speculation set by the CFTC, leading eventually to the bubble in food prices of 2007 and 2008. During 2007 and 2008, far more wheat and maize derivatives were bought by financial speculators than would have been allowed if the limits had applied to all of them.

Position limits in the US failed to prevent the events in food markets of 2007 and 2008 because they were not applied to speculators, not because they do not work. However, Europe has never had a commodities market regulator or set position limits.

As the French government has suggested, the European Union should create a commodity derivatives regulator, equivalent to the CFTC in the United States. This regulator should then apply position limits to commodities traded on European markets. Position limits do not need to apply where derivatives are being used to hedge the buying or selling of real food. But all other transactions in derivatives should be limited. These limits would still allow financial markets to provide enough liquidity for real buyers and sellers of food to hedge with. But they would prevent the excessive speculation of recent years.

One single position limit needs to be set for derivatives in a commodity in all places in which it is traded. Hedge fund manager Michael Masters argues that if position limits are not set as an aggregate value covering all exchanges and over-the-counter derivatives "speculators would spread their trading between well regulated and less-regulated venues".<sup>120</sup>

As shown in section 2.2, commodity index funds present a particular problem to commodity markets because they move money into and out of derivatives due to factors unrelated to the supply and demand for a particular commodity. Position limits should fully apply to them. In addition, a more simple measure for commodity index funds would be to just ban them. Traditional speculators who follow commodity markets are best placed to provide the liquidity for hedging. Commodity index funds decisions are so detached from what is happening in commodity markets that they bring nothing to them. But they do destabilise markets, and waste resources on buying unproductive derivative contracts from banks. As Michael Masters says:

Passive investment provides no benefits to the markets while it exacts a heavy toll. Investors' desire to turn the commodity derivatives markets into something they are not (namely a valid investment vehicle) must be subjugated to the needs of bona fide physical hedgers to hedge their risks and discover fair prices.<sup>121</sup>

## 5.4 Action in the US and EU

In the United States a coalition of over 450 organisations including civil society, farmers, and businesses such as hauliers and airlines are campaigning for such regulations to be introduced. The Obama government and the commodity regulator both support re-regulation. As of June 2010, regulation being discussed in Congress could force much derivatives trading to go through regulated exchanges, and give the CFTC new powers to set position limits in food and energy.

However, regulation is needed in Europe as well; particularly London and Paris, the two main commodity exchanges outside the United States. Whilst derivatives in key staples such as wheat, maize and soybeans still tend to be traded primarily in the United States, other key commodities such as cocoa, sugar, oil, metals and carbon permits are traded in London and Paris.

There is also a danger that regulations in the US will be able to be bypassed by traders operating through London or Paris. Even if this is unlikely to happen, the threat of it is being used by corporate

financial lobbies in the US to try to weaken regulations. Joint action by the EU and US is vital to tackling the commodity speculation problem. So far, the US has been ahead of the EU in doing so.

However, Michel Barnier, European Commissioner responsible for financial markets, called speculation on food "scandalous" upon his appointment in the role. Barnier told the European Parliament: "*We have to look at derivatives. Speculation is linked to derivatives which are linked to raw materials. That is something we want to regulate very carefully in order to tackle speculation in raw materials.*"<sup>122</sup>

The European Commission is due to bring out proposals on regulating speculation in food later in 2010. Some EU member states, such as France, are strongly pushing for the EU to take strong action and set-up a regulator of financial markets in commodities.<sup>123</sup> The London Stock Exchange is preparing to launch its own derivatives exchange in anticipation of regulators forcing more over-the-counter derivatives to be traded on exchanges.<sup>124</sup>

As of June 2010, the European Commission had not published any proposals. Whilst it is likely there will be moves to increase the number of derivatives traded through exchanges, it is not clear how strong proposed regulations will be. Furthermore, the European Commission says it will "*assess the possibility of empowering the national regulators to set position limits*".<sup>125</sup> However, it would make far more sense for position limits to be consistent across Europe. They could be set by a European wide regulator, in liaison with the CFTC in the US.

Unfortunately the corporate lobby will act to maintain their ability to make vast profit out of unregulated trading in commodity derivatives. The financial services lobbyists and banks such as Goldman Sachs hold huge sway in Brussels. For instance, Corporate Europe Observatory has revealed that:

- When the European Commission set out to review its strategy on financial services in 2004, expert groups were formed on which Goldman Sachs was represented.



- Goldman Sachs was represented on a group setup by then commissioner for the internal market Charlie McCreevy to advise on reforms of the derivatives market.
- Of ten expert groups on financial services with business participation, Goldman Sachs is represented on three.
- When the commission formed a high level group on responding to the financial crisis, one of seven members was an advisor to Goldman Sachs.
- Three former Commissioners have taken up positions with Goldman Sachs at the end of their term; Peter Sutherland, Karel van Miert and Mario Monti.<sup>126</sup>

The City of London has its Brussels lobbying headquarters opposite the European Commission head office. The City has already played a leading role in campaigning against proposed EU regulations on hedge funds, including arranging visits by London mayor Boris Johnson. Yet the City of London is absent from the Commission's lobby transparency register.<sup>127</sup>

The UK government has been curiously silent on the role of speculation in influencing commodity prices. Despite the wealth of evidence to the contrary, the Treasury has been sceptical that speculation presents either a systemic risk to the economy or has been a contributing factor in food price rises. The UK government says "*Whilst theory allows for the possibility of speculation having an impact on prices*" they are "*sceptical that speculators have played a significant causal role in the [2007/08] price spikes.*"<sup>128</sup> This runs counter to much of the evidence presented in this report. But by recognising the theoretical impact of speculation, the UK government accepts that in the future speculation could have impacts on price. It should therefore recognise its responsibility to regulate, in order to prevent speculation causing huge price and volatility problems in the future.

Despite all the controversy surrounding the workings of commodity markets, the UK's Financial Services Authority has just one reference to commodities in the whole of its current business plan:

Over the coming year we will continue to review, including within the CESR and IOSCO, whether there is sufficient transparency in non-equity markets trading. The credit crisis (among other things) has prompted regulators to revisit arrangements for fixed income, credit derivatives, structured products and commodities, where a significant amount of trading takes place OTC. We are committed to ensuring that any changes to the transparency regime are justified by market failure analysis and have costs proportionate to benefits.<sup>129</sup>

Perhaps not coincidentally, London is host to the highest amount of commodity trading outside the United States. Recent opposition to EU regulation of hedge funds by the UK treasury shows that the UK government still gives a disproportionate voice to the financial sector at the expense of other sectors of the economy, and against the interests of citizens. Rather than playing an active role in setting the best regulatory standards, there is a danger the UK will continue its disastrous no-touch approach to the financial sector. Worse still, it might seek to actively block progressive reforms, making it the global pariah of derivative and commodity market reform.

Ironically, in doing so the UK government risks not only jeopardising the food security of millions around the world, but also the affordability of food and fuel to low-income consumers in this country, as well as to business end-users highly dependant on commodities such as food manufacturers, haulage companies and commercial airlines.

## 6. Conclusion

Reregulating commodity markets is a vital step in tackling hunger and reshaping the global economy to work for the benefit of people rather than profit for the small elite of bankers. This report has outlined five reasons why the UK government and European Union should support regulations to limit excessive speculation in commodities.

### **1) Higher and more volatile food and oil prices**

As outlined throughout the report, speculation in recent years has contributed to the spike in food and oil prices and made prices more volatile. The recent example of hedge funds depressing the price of coffee also shows the potential for speculation to reduce prices.

High food and oil prices have reduced the real incomes of people across the world. This has affected the poorest people the most causing hunger and malnutrition to increase, valuable assets to be sold off, spending on health, education and family planning to fall and more risky employment to be taken on. Yet the main reason for speculation is to make large profits for multinational banks. This is one of the most striking examples of the injustice of profit being put ahead of people.

Volatile prices also make it more difficult for farmers to plan and invest. At a country level, wild swings in commodity prices can destabilise the economies of commodity exporters and importers, as the FAO says: *“hampering their efforts to reduce poverty.”*<sup>130</sup>

In richer countries such as the UK, high commodity prices also reduced the real incomes of consumers, affecting the poorest in society the most. The food and oil price spikes in 2007 and 2008 helped to push the UK towards recession, and high inflation led to higher interest rates. Regulating commodity markets would benefit people across the world.



Even if the UK government remains unconvinced that financial speculation played much of a role in the 2007 and 2008 price hikes, it does acknowledge it could play a future role. If there is any chance of speculation causing price hikes and volatility in the future, regulations must be introduced now to prevent this from happening.

Furthermore, the following are good reasons to introduce regulations to limit excessive speculation regardless of any impact on the real price of food and fuel.

## **2) Help producers and purchasers to hedge their risk**

The massive influx of speculative money into commodity markets has made it more difficult for real buyers and sellers to hedge their risk. There is too much liquidity in commodity markets. This speculative money has caused derivatives to fluctuate more wildly in price, increasing rather than reducing risk. This fluctuation and higher prices have meant hedgers have had to provide money margin when buying their hedges. There is evidence that some farmers were not able to afford to do so, and so stopped hedging altogether.

## **3) Enable futures markets to better discover prices**

The havoc speculators have brought to commodity markets has also made futures markets less accurate in predicting future real prices of a commodity. This makes it more difficult for central banks to predict inflation and so set interest rates accordingly.

## **4) Free up capital for use in genuinely productive investment**

Money put into commodity derivatives by speculators is not investment. It does not provide capital for any genuinely useful activities. Since the credit crunch, governments and central banks in developed countries have sought to increase economic growth by pumping huge quantities of cheap money into financial markets, with the hope this would increase investment. However, money put into commodity derivatives and other unproductive areas such as property denies capital for real investment.

## **5) Protect against financial crises**

The credit crunch and financial crisis was caused by a huge boom in private sector debt. This boom was allowed to take place because risky loans were hidden in the world of over-the-counter derivatives, hidden from regulators, without the protections of trading through a proper clearing exchange. Making the trading of all derivatives, commodity and other derivatives such as in property, government debt and foreign exchange, is a vital step to prevent such a crisis from reoccurring. All derivatives need to be brought onto properly regulated exchanges, with regulated clearing used to prevent default on contracts and toxic debt sweeping through the financial system.

The opposition to regulating commodity derivatives comes from those in the financial industry with a vested interest in the profits they make from the unregulated market, particularly the large banks. The profits banks make allows them to throw huge amounts of resources into a behind-the-scenes lobbying effort to prevent regulation. The power of banks in the UK unfortunately makes UK authorities particularly susceptible to such lobbying.

Regulators need to resist lobbying and look to what is genuinely in the interests of people rather than the profit of a small elite. All those who have concern for justice and for less risky economies have to push for such regulations to be implemented.

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