FOOD ETHICS COUNCIL

Food and finance

Commodity trading, speculation and food prices

A report of the Business Forum meeting on 16th November 2010

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About the Business Forum

Ethical questions around climate change, obesity and new technologies are becoming core concerns for food businesses. We have launched the Business Forum to help senior executives gain expert insights into the big issues of the day. Membership is by invitation only and numbers are strictly limited.

The Business Forum meets six times a year for in-depth discussion over an early dinner at a London restaurant. The forum members shape the meeting agenda.

To read reports of previous meetings, visit foodethicscouncil.org/businessforum.

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Introduction

Since food prices rose in 2007-8, the trade in food commodities has become a focus for growing public scrutiny. Debate has centred on the part that speculation played in the price rises. Sweeping reforms of financial regulation under way in the USA under the Dodd-Frank Wall Street Reform and Consumer Protection Act include measures to increase transparency in agricultural commodities trading. Similar moves have been mooted in Europe by Internal Markets Commissioner Michel Barnier, leading to a proposed regulation on 'over-the-counter derivatives, central counterparties and trade repositories'. NGOs are supporting this clampdown, with the World Development Movement campaigning to 'stop gambling on hunger'.

The November 2010 meeting of the Business Forum explored the impact on the food consumption and production of commodity trading and speculative activity, and the prospects for regulation.

We are very grateful to our speakers, Javier Blas, commodities editor at the Financial Times, and Julian Oram, head of policy and campaigns at the World Development Movement. Helen Browning OBE, chair of the Food Ethics Council, chaired this event.

This report outlines points raised during the meeting. Contributions are not attributed. The report was prepared by Tom MacMillan. It does not represent the views of the Food Ethics Council, the Business Forum or their members.

Key points

- The food price rises of 2007-8 are estimated to have pushed an additional **150 million people** into hunger globally.
- As well as price increases harming consumers, volatility can exacerbate **inequalities among producers** and other businesses in food supply chains.
- Some argue that deregulation of trading in commodity derivatives opened the way to a large **influx of speculative investment**, which has contributed to price volatility.
- Others contend that speculation has **only played a minor role**, and that volatility can be explained by factors including biofuels expansion, high oil prices, bad harvests, underinvestment in agriculture, diminishing food inventories and export bans.
- The nature of the issue and the evidence – a series of historical events and behaviours, with the explanations resting on competing correlations, experiences and insider anecdotes – **defy definitive resolution** of this debate.
- Behind the disagreement is consensus that many **complex** factors affect food prices, that futures markets can **dampen volatility** compared with cash markets, and that futures markets have become **less reliable predictors of price**.
- Furthermore, there is some agreement that it could be beneficial – or at least increase public confidence in financial markets – to regulate the trade in commodity derivatives in ways that **increase transparency**.
- Underpinning this debate are divergent views on the effectiveness of financial markets in **channelling agricultural investment** where it will best tackle food insecurity.

Why food prices matter

Food prices affect global hunger. When prices of foods traded on world commodity markets spiked in 2007-8, 150 million more people were pushed into food insecurity. The number of hungry people in the world rose to almost one billion.

In the autumn of 2008, prices began to fall again, and food insecurity eased somewhat. However, 2010 has seen renewed rises and concerns that these will exacerbate hunger.

When food costs more it clearly hurts any consumers who spend a large share of their income on food. That includes the urban poor in the world's fastest-growing cities. However, it does not follow that farmers all win. Many of the people most at risk of hunger live in rural areas, some as small-scale farmers, pastoralists and fisherfolk, and they are poorly placed to benefit from higher global prices because of their weak bargaining position compared with input suppliers, creditors or even customers. An short-term boost in global prices does not offset smallholders' entrenched political and economic marginalisation.

Within the UK, the poorest fifth of consumers spend on average 16% of their household income on food and non-alcoholic drinks. Increases in world commodity prices have been reflected in retail prices by rises that are relevant to low-income households. However, farm gate and global commodity prices account for only one component of the price consumers pay: others include the costs of processing, distribution and marketing, and the margins charged by retailers and other businesses. So the influence of commodity prices on retail prices is mediated by strategic decisions and negotiations.

The fortunes of UK farmers and food manufactures are more closely linked to world prices. Some farmers have been able to benefit from the bullish market. However, they have not generally gained in proportion to the price rises. That is partly because their input costs have gone up – for example, nitrogen fertiliser prices depend on the oil price, which also rose in 2008. Furthermore, the weak bargaining position of farmers and food manufacturers compared with retailers limits their capacity to pass higher costs up the chain.

Power

Thus, the price spikes have prompted concern on two counts: first, the affordability of higher prices to consumers; second, the effects on producers of volatility – of the downs as well as the ups. Asymmetries in information and bargaining power mean that volatility has a regressive effect, increasing inequalities among those with a stake in the food sector.

Among farmers and food producers, for example, the expected response to volatility is to hedge. Yet the capacity to do so is unevenly distributed across the sector. Larger US farmers hedge on futures markets from laptops in their tractor cabs, while their machinery runs on autopilot. Global food and drink manufacturers also hedge on global markets – indeed this is being treated as a increasingly serious strategic issue.

Smaller manufacturers and many UK farmers hedge mainly through contractual arrangements rather than financial markets, their participation limited by financial skills and knowledge, or by the transaction costs of getting involved. For small-scale producers on the margins of global markets – directly vulnerable to food insecurity and often indebted – hedging options are profoundly limited.

Along the supply chain, a different dynamic applies. Large retailers occupy a strategic position and generally have a bargaining advantage over their suppliers. Suppliers are expected to drop prices when commodity prices fall, but to hold steady when they rise. For example, suppliers may agree a contract with a supermarket nine months ahead for a fixed price, yet be obliged to rebate the difference in the event that prices drop. Suppliers seek to mitigate this pressure by maintaining close dialogue with the businesses who are their customers.

The concentration of power within the retail part of the supply chain places a downward pressure on prices in commodity markets and at the farm gate. This has contributed to underinvestment in agriculture.

Speculation...

Back in 2008, as world leaders met in Rome to address the food crisis, the finger pointed at a 'perfect storm' of factors driving higher food prices. These included a surge in the price of oil, higher demand for feed and food from India and China, harvest failures, and US and European policies to promote biofuels. These were seen as changes in the 'fundamentals' of supply and demand in the food sector, expected to invert the long-term downward trend in food prices.

That narrative persists. Since then, however, analysts have called into question the influence of expanding markets in India and China. Meanwhile, new attention has focused on the role that speculation in commodity markets may have played.

The fall-off in prices following the Rome food summit was among the factors that prompted scrutiny of speculation. Within weeks, prices were back nearly to 2007 levels. If the 'fundamentals' had caused the price rise, what explained this nose-dive? By 2009, the problem looked less like high prices, and more like volatility.

Critics then turned attention to the correspondence between the collapse of the sub-prime mortgage market in the US and the increase in food commodity prices. As investors jumped ship from the sinking sub-prime market, commodity derivative funds boomed and over-the-counter derivatives trading (outside of commodities exchanges) accelerated. Could this influx of capital have driven a bubble?

Looking back further shows a period of relative stability in food commodity prices between previous spikes in the 1970s and the early noughties, when prices began to rise. The US Glass-Steagall Act, introduced in part to curb speculation, had been repealed by the Clinton administration in 1999, following lobbying by the financial sector. This removed restrictions preventing financial institutions from hedging in commodity futures, and opened these markets to an influx of new investment later in the decade.

So trading in food commodity derivatives has grown and, during the 2007-8 price spike, saw large-scale involvement by financial institutions that had no involvement in farming or the food sector. Critics, including the World Development Movement, contend that this has exacerbated the volatility in food prices. They argue that the involvement of financial institutions – banks, pension funds and hedge funds – means that the level of investment in food commodities depends increasingly on factors that are otherwise unconnected to food, such as the performance of competing financial instruments.

As long as there has been a market there has been some financial participation and speculation in the food sector. It was based on price movements, with traders basing their long and short positions on their expectations of agricultural supply and demand. However, critics argue, the increased weight of capital from managed money is moving prices in an upward direction – financial institutions are now betting on long-only positions.

This has prompted the World Development Movement to launch a campaign to 'stop gambling on hunger'. But they are not alone in their concern over commodities. On a recent visit to the UK Jayati Ghosh, professor of economics at Jawaharlal Nehru University, argued that the market fundamentals matter, but what is happening to food prices is not driven as much by financial activity. In the US, meanwhile, new rules to curb speculation are being introduced under the Dodd-Frank Act. The World Development Movement is among the organisations pushing for such measures in Europe, and for the UK to take an active role in promoting them.

... or not?

Few would deny that some speculation is taking place in food commodity markets, or even that is the cause of some 'exuberance' in prices. However, the notion that speculation has been a major cause of price volatility is hotly contested. Rather, counter its detractors, the influx of capital through financial institutions is correcting a long-term underinvestment in agriculture, responding to real changes in the fundamentals of supply and demand.

By this view, the factors concerning critics of speculation can be otherwise explained. For example, that many investors are taking long-only positions reflects their expectation that supplies are under pressure and global demand – driven by changes in food consumption, the biofuels market and population growth – is set to rise long-term.

The 2007-8 spike in commodity prices follows spikes not only in the 1970s, but also in the 1940s, with periods of stability in between. The periods of stability and lower prices have come from increased investment in production supporting the introduction of new technology. The latest spike is attributed principally to the factors that were the focus of attention in 2008 – the 'perfect storm' of biofuels expansion, high oil prices, bad harvests and so forth, underpinned by the stronger global presence of 'emerging markets'.

If that explains the rises, what about the volatility? The downturn in food prices from autumn 2008 may owe something to the global recession, which has seen the biggest drop in oil prices since reliable records began and has dented the demand for meat. The recent upsurge in 2010 was prompted by Russia's poor wheat harvest and similar problems elsewhere.

On top of these events, according to this view, three other factors have been more influential than speculation in creating volatility – in understanding why small steps up or down in supply or demand can lead to giant leaps in prices. The most basic is that investment in agriculture had collapsed. Farming has been neglected for at least a generation. Whereas around a fifth of international development aid used to go to agriculture, that has dwindled to about 5%. The consequence of this and wider underinvestment has been that global annual yield increases for key crops have declined several fold. Production is being pushed onto marginal land and relentless double-cropping is eroding fertility.

Previously, the squeeze on yields had been hidden by large food inventories – grain mountains and milk lakes, for example. As these stocks have been eaten away, we have become more exposed to volatility in agriculture, caused by factors such as bad weather hitting increasingly stretched and vulnerable production systems. This is the second factor. India and China have built up inventories, but these do little to dampen volatility as they are unavailable to the global market.

A third factor is that as prices have risen, fuelling concerns about national food security, exporting countries have introduced restrictions on exports. Since only a small share of foods is traded globally (for example 7% of rice), restricting exports results in exaggerated swings in traded prices, which act as the benchmarks on which other prices depend. At one point over the past couple of years, 45 countries had export bans in place. When countries depending on imports could get the volumes, those who could afford it erred on the safe side: Oman in 2008 bought two years' supply of rice, for instance. When the panic recedes, prices plummet. So volatility is exacerbated by hoarding, by exporters and importers alike.

In short, the counterargument to concern over speculation is that financial markets mirror physical markets. That volatility exists in markets that are not subject open to hedging by financial institutions lends credibility to this thinking. Tea, traded in Mombasa, is an example. In 2008, a drought in Kenya cut supply by 10% and saw prices jump five-fold.

Tension and agreements

At their simplest, these different perspectives on speculation are directly at odds: one says speculation is a big problem; the other says it is not. The nature of the issue and the evidence at hand – a series of historical events and behaviours, with the explanations resting on competing correlations, experiences and insider anecdotes – defy definitive resolution.

Behind this disagreement, however, there is considerable consensus. Both sides of this argument agree that:

- The fundamentals of supply and demand influence food prices.
- Futures markets can dampen volatility compared with cash markets, and can support investment in agriculture.
- Speculation can increase volatility, and that the large-scale entry of financial institutions into food commodity markets dilutes their capacity to provide a price discovery mechanism.
- Other aspects of finance affect food prices, including fluctuations in currency, notably the dollar.
- Many other issues besides speculation are crucial to reducing hunger, including the need to channel a greater share of UK development aid into sustainable agriculture.

Furthermore, there is some agreement that it could be beneficial to regulate the trade in commodity derivatives in ways that increase transparency and reduce the risk that speculation increases volatility. For critics who are convinced speculation is a problem, such regulation is one important component of improving global food security. For those who are argue that the role of speculation in food price volatility has been overstated, regulation has the advantage of increasing public confidence in the financial sector and then shifting the focus of efforts to dampen volatility towards the other factors that they consider more influential.

Regulating finance

The US is in the process of implementing new rules affecting commodity trading. These rules were included under the Dodd-Frank Act regulating the finance sector. The legislation, passed during the summer of 2010, covers four areas of finance, of which derivatives are one. Unusually, whereas the weaker House of Representatives version of legislation generally gets passed into US law, the stronger Senate version of the new rules on derivatives was approved. Regulators are currently consulting on the detail of how the rules will be implemented.

The new US rules make three main changes to derivatives trading:

- Requiring that a larger proportion of derivatives contracts are made through exchanges than over-the-counter within financial institutions. This is intended to increase transparency.
- Placing and enforcing strict 'position limits' on the number of derivatives contracts that market participants can hold.
- And increasing capital requirements, meaning that participants need to invest more in the trading system in

order to be able to trade – a worthwhile cost for farmers and others seeking to hedge but a deterrent against speculation.

The European Commission is making noises about following suit, including by placing similar restrictions on over the counter trading. While some member state governments say they are in favour of such regulation, the UK government is concerned that it may damage the City of London.

Some commentators contend that the regulatory reforms will make little difference, arguing that:

- Reducing over-the-counter trade will change the terms on which derivatives are exchanged but not the volume of trade.
- Hard position limits have previously existed yet have not dampened volatility.
- Margin requirements will not affect trading.

Trade and investment

For commentators sceptical about the difference that regulatory reforms would make to food price volatility, the higher priorities are to reduce trade barriers and increase investment in agriculture. Export bans are seen to make a direct contribution to volatility, and investment is expected to reduce the pressure on agricultural supplies over the longer-term. The practical solutions are therefore seen to be to regulate to prevent export bans and ensure there is a strong political consensus against them within the international community, and to encourage the level of political stability needed to ensure investment is channelled towards fertile areas such as the Black Earth region of Russia.

While there is wide agreement that export bans exacerbate volatility on international markets, others question whether it is plausible for global food security to premised on national governments honouring free trade commitments in circumstances when domestic food price hikes are causing severe political instability and potentially exacerbating hunger. It puts governments in a serious quandary, akin to the prisoners' dilemma.

This hints at a deeper divide underlying debate over the importance of commodity speculation in causing price volatility: how effective are financial markets at channelling agricultural investment where it will best tackle food insecurity? Well-functioning financial markets should channel capital to address shortfalls in supply against demand, signalled by price rises. However, people who are hungry are also poor – their demand is barely felt and little heeded by the market. Protecting their entitlements – strengthening their effective demand – remains the top priority for improving the lot of food insecure people worldwide.

Speaker biographies

Helen Browning OBE runs a 1350 acre organic livestock and arable farm in Wiltshire which supplies organic meat to multiple retailers. She is currently Director of External Affairs at the National Trust, where she contributes to debates on issues including CAP reform. Helen has been appointed Director of the Soil Association and will take up that post in the spring 2011. She was chair of the England Animal Health and Welfare Implementation Group throughout its life (2005-09), a member of the Government's Policy Commission on the Future of Farming and Food ('the Curry Commission'), a member of the Agriculture and Environment Biotechnology Commission (AEBC) until it disbanded in April 2005, and a member of the Meat and Livestock Commission until its end.

Javier Blas is the Financial Times' commodities editor, leading a team of reporters in London, New York and Beijing covering commodities. He reports on raw materials markets, investment and regulation trends in commodities and the geopolitics of natural resources. Previously, he reported on international economy for both the Financial Times and the Spanish business daily, Expansion. He has covered commodities and macro economics since 1999. Javier Blas was born in Spain and received a BA / MA in journalism from the University of Navarra, Spain, where he also studied economics. He also studied political communication at Sheffield University, United Kingdom. He is bi-lingual in English and Spanish and speaks French.

Dr. Julian Oram is Head of Policy and Campaigns at the World Development Movement, leading their advocacy work on global justice issues, including food commodity speculation. Prior to this role, Julian was head of the trade and corporates team at ActionAid, specialising on international trade, food rights and corporate accountability. Julian previously headed the 'transforming markets' programme at the New Economics Foundation, developing practical proposals for delivering a more sustainable economic system. Before that he led a research programme on globalisation and food security at the International Famine Centre, in Ireland. Julian has a doctorate in Geography from University College Cork, and has lived and worked in the UK, Ireland, the Philippines and the US.

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