Financial Speculation, Commodity Prices and the Food Crisis

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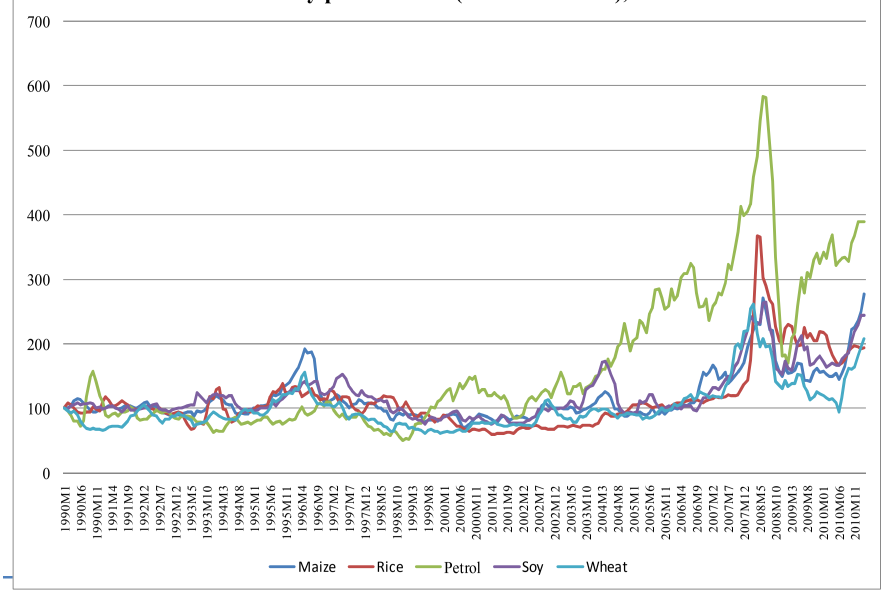
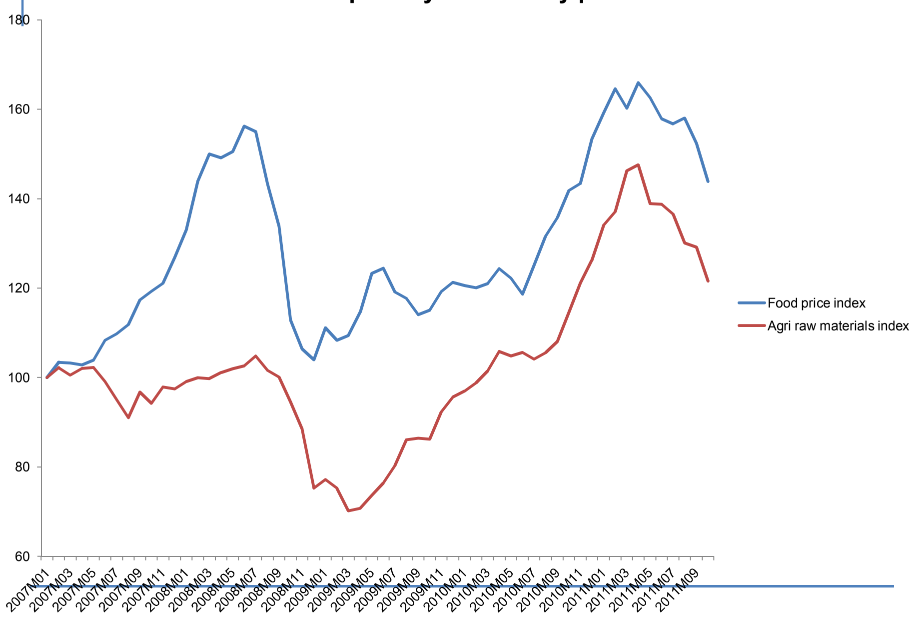
The global food crisis

- Revival of concern after global food prices started rising again from early 2010 in particular.
- Intimately connected with financial speculation which affected global trade prices.
- Massive – and unprecedented – changes in global trade prices of basic food grains and important cash crops especially over past four years.

Global commodity price indices (Jan. 1990 = 100), 1990 to 2011



Global primary commodity prices



Price movements could not have been created by real supply and demand changes

- Scarcely any change in global supply and utilisation over this period
- output changes were more than sufficient to meet changes in utilisation in the period of rising prices, while supply did not greatly outstrip demand in the period of falling prices.
- Stock holding has remained stable at around 23 per cent of utilisation.
- Claim that increased demand from China and India has led to rising prices is completely unjustified, because both aggregate and per capita consumption has fallen in both countries.

Some supply factors are and will continue to be significant

- Short-run factor
  - diversion of both acreage and food crop output for biofuel production
- Medium term factors
  - rising costs of inputs
  - inadequate credit to cultivators
  - falling productivity because of soil depletion
  - inadequate public investment in agricultural research and extension
  - impact of climate changes on harvests

Speculation and commodity futures markets

- Function of speculators is to predict future market patterns and thereby reduce the intensity of change - that is, reduce volatility and stabilise prices!
- Similarly, commodity futures markets are supposed to reduce risk for cultivators and purchasers:
  - allow better risk management through hedging by different layers of producers, consumers and intermediaries;
  - enable open-market price discovery of commodities through buying and selling on the exchanges;
  - and therefore lead to lower transaction costs.

Financial deregulation and commodity speculation

- In 2000, the Commodity Futures Modernization Act deregulated commodity trading in the United States, by exempting over-the-counter (OTC) commodity trading (outside of regulated exchanges) from CFTC oversight.
- Unregulated commodity exchanges allowed all investors, including hedge funds, pension funds and investment banks, to trade commodity futures contracts without any position limits, disclosure requirements, or regulatory oversight.
- The value of such unregulated trading was around $9 trillion at the end of 2007, more than twice the value of the commodity contracts on the regulated exchanges.

Financial deregulation and commodity speculation

- "Swap-dealer loophole" in the 2000 legislation allowed traders to use swap agreements to take long-term positions in commodity indexes.
- Emergence of commodity index funds that were essentially "index traders" focused on returns from changes in the index of a commodity, by periodically rolling over commodity futures contracts prior to their maturity date and reinvesting the proceeds in new contracts.
- Such commodity funds dealt only in forward positions with no physical ownership of the commodities involved.

Financial deregulation and commodity speculation

- As US housing finance market imploded, finance searched for other avenues of investment to find new sources of profit, like commodity speculation .
- By around June 2008, when the losses in the US housing and other markets because intense, it became necessary for many funds to book their profits and move resources back to cover losses or provide liquidity for other activities.
- Commodity markets became like other financial markets, prone to information asymmetries and associated tendencies to be led by a small number of large players.

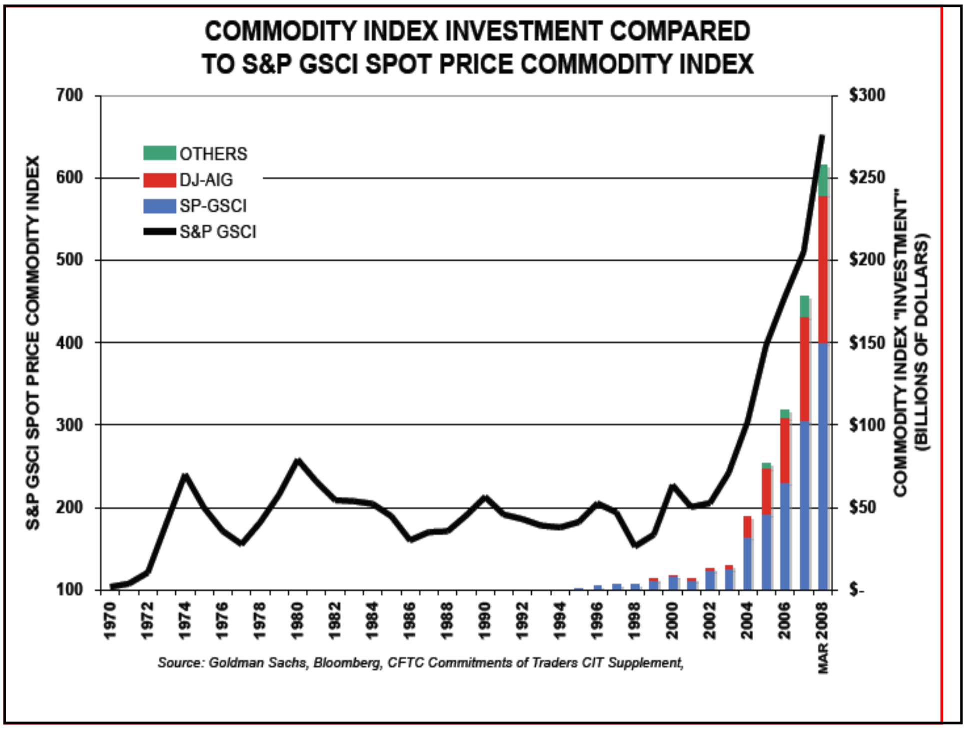
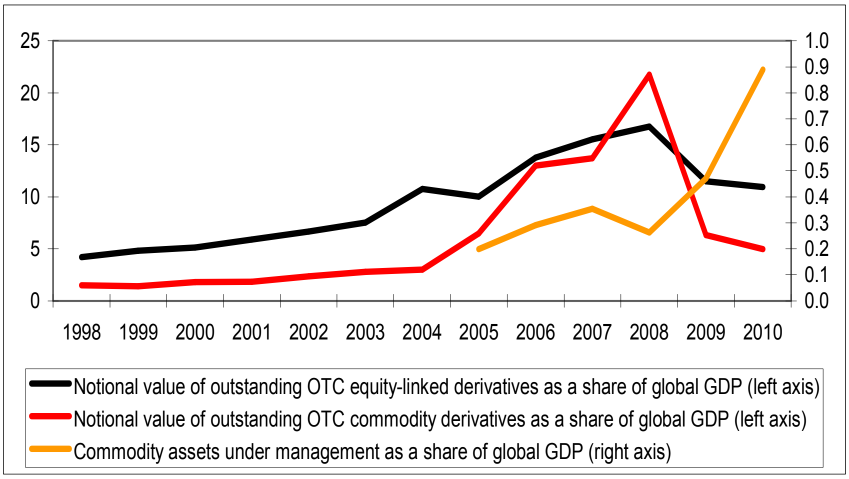
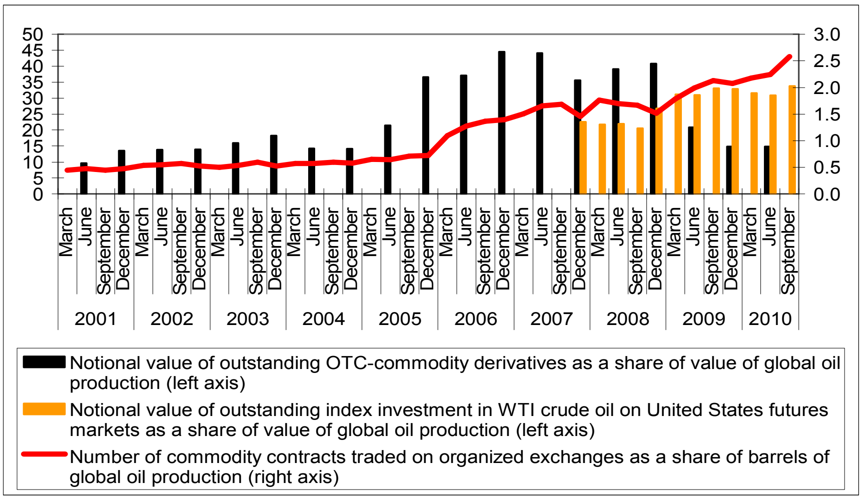


Figure 1
Financial investment in commodities and global GDP, 1998–2010



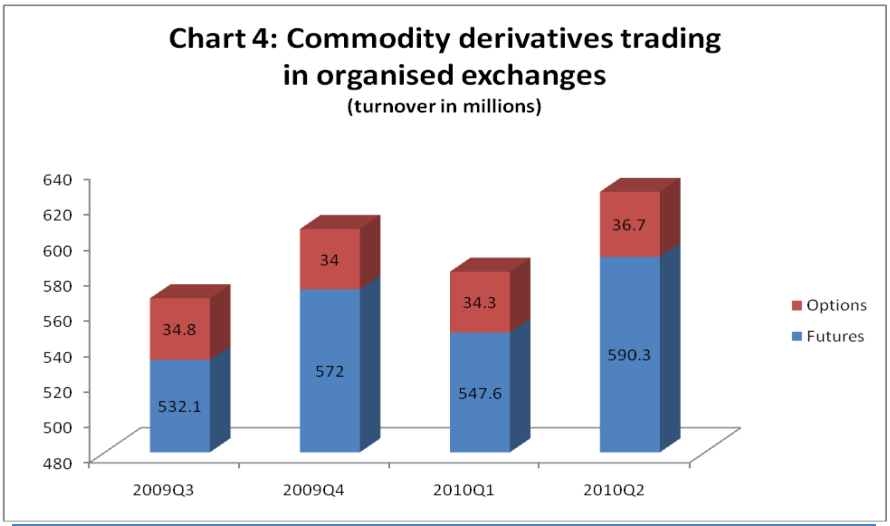
Source: UNCTAD secretariat calculations based on BIS, Barclays Capital and UNCTADstat database.

Figure 2
Financial investment in commodities and global oil production, 2001–2010

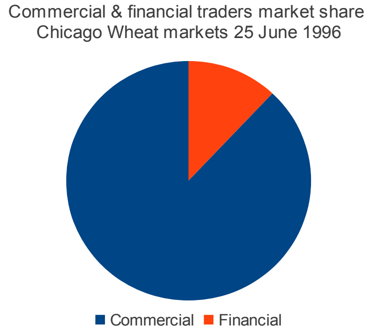


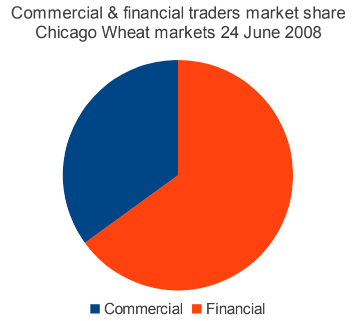
Source: UNCTAD secretariat calculations based on BIS, CFTC, IEA and UNCTADstat database.

Very recent tendencies in commodity derivatives markets are of concern once again



Assets of financial speculators in commodity markets have increased from $65 bn in 2006 to $126 bn in March 2011





Implications of financial speculation on global food markets

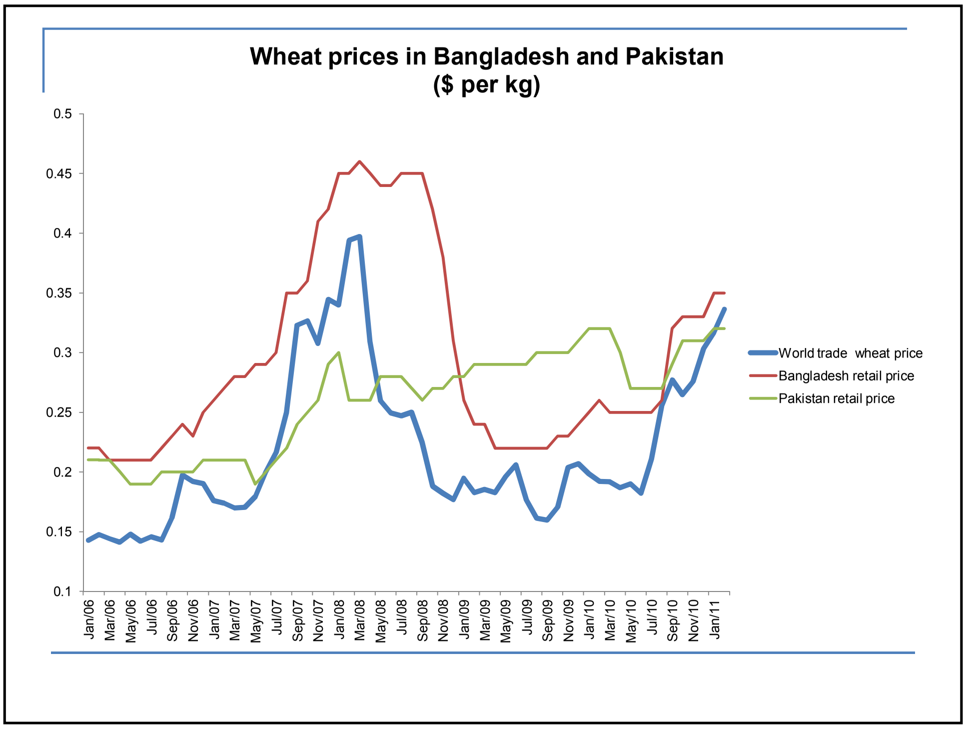
- Inherently "wrong" signalling devices became very effective in determining and manipulating market behaviour.
- The result: excessive price volatility of commodities over 2007-10 – not only the food grains and cash crops, but also minerals, metals and oil.
- Continuing denial among the international institutions that "count" like OECD, IMF – but UNCTAD and FAO have noted significance of financialisation of commodities markets, and even World Bank now accepts it.
- Report to G24 highlighted concerns and need to regulate finance.

This had very adverse effects on both cultivators and consumers of food

- Confusing, misleading and often completely wrong price signals to farmers that caused over sowing in some phases and under cultivation in others.
- High pass through of rising global prices on consumer prices in developing countries, but low pass through of falling prices on consumers.
- So both cultivators and food consumers lost out through extreme price instability. The only gainers were the financial intermediaries who were able to profit from rapidly changing prices.

Continuing food crisis in developing world

- In March 2011, FAO estimated that 29 countries are experiencing food emergencies (all in Sub Saharan Africa and developing Asia) . Conditions in at least 17 countries are worse compared to October 2008.
- The cereal import volume in LIFDCs as a group will decline in 2010/11 but their cereal import bill is forecast to increase by 11 percent because of higher international prices
- Many developing countries in which widespread and persistent hunger was already a problem, experienced significant increases in the prices of staple foods in the past four years, and with only upward pass-through (increasing with global prices but hardly any decline when global trade prices have fallen).


Wheat prices in Bangladesh and Pakistan
($ per kg)
0.5
0.45
0.4
0.35
0.3
0.25
0.2
0.15
0.1
Jan/06
Mar/06
May/06
Jul/06
Sep/06
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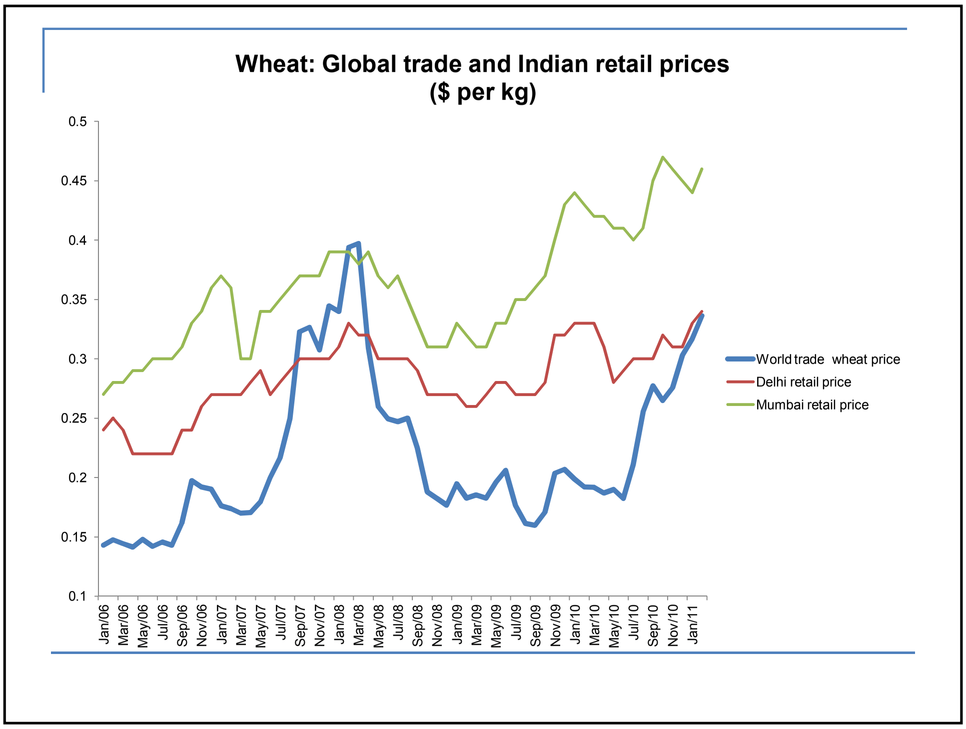
World trade wheat price
Bangladesh retail price
Pakistan retail price


Wheat: Global trade and Indian retail prices
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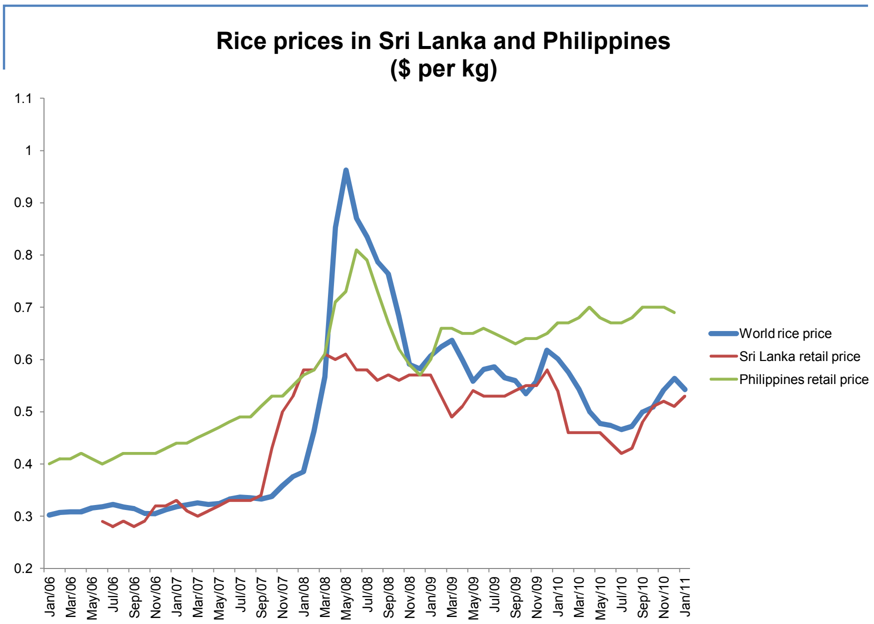
World trade wheat price
Delhi retail price
Mumbai retail price



Differential performance

- Some countries (e.g. China) have managed food situation much better than other.
- Domestic food production critical factor in this.
- Countries with high import propensity for food have been very badly affected, especially if they export cash crops.
- **Lesson:** No country, however small and open, can afford to neglect domestic food production and must ensure at least some domestic supplies or regional arrangements to ensure food, if it does not want to get caught in a vortex of price volatility that can dramatically affect national food security.
- Unfortunately, some countries are responding with "land grabs" of farmland in Africa and elsewhere, which is a counterproductive response.

National policy issues

- Effective state intervention for food price stability and food security requires fiscal resources – but developing countries already have large fiscal deficits as outcome of financial crisis.
- They are crowded out of international capital markets by US and other developed economies, as they guarantee their own private debt and expand fiscal deficits.
- Private capital moving out also causes currency devaluation, so food imports become more expensive in local currency.
- So developing countries caught in pincer movement between volatile global prices and falling exports on the one hand, and reduced fiscal space and depreciating currencies on the other hand.

Control of finance to stabilise food prices

- Bring all commodity transactions into regulated exchanges, with strict imposition of capital requirements, margin requirements and position limits, and limits on exemptions.
- Improve transparency and disclosure of positions, and ensure disclosure on physical stocks held.
- Impose strict limits on the entry of financial players into commodity futures markets, through Volcker rule on commodity trading etc.
- Eliminate the "swap-dealer loophole" that allows financial players to enter as supposedly commercial players.
- Ban futures markets for grain trade in countries where public institutions play an important role in grain trade.
- Institute capital controls of different sorts on short-term capital flows in developing countries, particularly to prevent their destabilising impact on domestic food prices.

Other required measures for open and food-importing developing countries

- Rebuild stocks and create strategic grain reserves, focus on public distribution systems for basic food items.
- International arrangements and co-operative interventions, such as strategic grain reserves, commodity boards and other measures to stabilise world trade prices.
- Demand compensatory IMF financing for food and fuel importing countries
- Stress more domestic food production and improved agricultural productivity, based on greater viability of small holder cultivation and enhanced role of public investment