

Rebutting the sceptics

Briefing for local groups, January 2012

This briefing is designed to supplement the questions and answers briefing, and addresses questions you might get from someone who is sceptical of the role of food speculation in contributing to food price spikes, or that the policies we are calling for are the right response to the problem.

Speculation and food prices

How does speculation impact on farmers if most of them don't use these markets themselves?

Farmers, whether in the global south or north, often sell their produce to firms which are part of large (sometimes multinational) companies. These companies are most able to benefit from high prices through trading internationally in large volumes and have greater power to determine prices. This means that producers often fail to benefit from higher prices on international markets.

In addition, in developing countries poor farmers are also affected by high food prices because very few produce a significant surplus to sell and a high percentage of rural households are net buyers of staple foods.

Africa has gone from being a net exporter of food in 1970 to a massive net importer. Around 55 per cent of developing countries are net food importers and almost all countries in Africa are now net importers of cereals. This means that they are hugely reliant on the world food prices of their staple foods and higher prices have a direct impact on their ability to feed themselves.

Finally, as well as affecting producers financially, the volatility caused by speculation also makes it difficult for producers, particularly small scale farmers, to plan because it gives them less confidence that a crop that they plant will retain its value by the time they come to harvest it.

How can speculation affect food prices when speculators aren't creating a shortage in physical supply?

According to the supply and demand model of price determination, the amount of a particular good or service that consumers want to buy and producers are willing to sell depends on its price, with prices settling

at a level where the amount demanded by consumers equals the amount being supplied by producers.

Under this model, an increase in price would be expected to occur only if there was a reduction in supply or increase in demand. However, data from the US on global levels of wheat and maize does not show a shortage of supply or excessive demand that could explain the price fluctuations we've seen in recent years. And financial speculators aren't trading in physical supplies of food, only contracts linked to its value.

But futures prices do affect the price of food in the physical markets. This can happen in three ways. First, futures prices influence the expectations for buyers and sellers of food who look to the futures markets for information as there is relatively little information available from the physical market. Second, future prices are sometimes incorporated directly into contracts for physical deliveries of food. Finally, high futures prices increase demand for food because buyers look to avoid future price rises. (Conversely, low futures prices could increase supply and lead to a drop in price if those holding food in storage rushed it to market in an attempt to sell it before prices decreased.)

How can speculation affect food prices when there are an unlimited number of contracts that can be traded?

In order for a transaction to take place, the trader buying a contract must agree a price with a willing seller. If there is huge demand on one side of the market, traders on the other side will be influenced, resulting in a change in price. For example, if there are lots of traders wanting to buy contracts, sellers of contracts will increase the price they demand, causing the price to increase.

Price ‘bubbles’ can only exist in the very short term. Even if there can be ‘bubbles’ in food prices created by speculation, they will always burst very quickly and return to the level that would be expected based on supply and demand in the physical market. How do you explain this?

According to market theory, any trading based on prices which don't reflect supply and demand (i.e. a bubble) would fail to make a profit and the trader would be quickly driven out of the market, causing the bubble to burst.

However, in futures markets for food this often doesn't happen, due to a number of factors. First, there is limited reliable data about supply and demand in the physical markets, with some traders (such as grain giants like Cargill) having more information than others. This lack of accessible and reliable information means that trading can move away from the market price.

In addition, if a bubble does emerge, informed traders are needed for the market to correct itself. Speculators have an increasing influence over the market, resulting in incidences of herding where informed traders who do know about the supply and demand are unable to 'correct' the market back to pricing based on supply and demand. This is because the majority of trading is based on an expectation about how other participants will behave, not the levels of supply and demand.

Finally, food production and food consumption does not respond quickly to changes in food prices. For example, if prices increase, producers can't suddenly grow more food (this takes months), and consumers can't suddenly stop eating. Similarly, if prices decrease, there is a limit to how much more food people can consume, and crops that have already been planted will continue to grow. So supply and demand can't change quickly or dramatically in response to prices.

All these reasons mean that bubbles in the food markets (changes in price that aren't reflected in the supply and demand) don't burst straight away, meaning they can have real human impacts.

If supply and demand for food doesn't respond quickly to prices, small changes in supply or demand could result in big changes in price. Isn't this the real reason for the big food price spikes we've been seeing?

Although this is part of the reason for price volatility in food markets, this explanation cannot fully explain why volatility has increased so much since

deregulation in the 1990s and 2000s, in parallel with the growth in financial speculation.

There are also examples in which price changes have been the opposite of those that would be expected. For example, in 2007 prices for maize were rising fast during a period where supply was exceeding demand. If this argument was correct, we would instead have seen prices falling sharply at this time.

If speculation is pushing up food prices, wouldn't we see stocks of food (inventories) increase as sellers withhold food from the market in expectation of getting a better price later? But inventories haven't increased.

An argument like this assumes that futures prices only influence the behaviour of producers, and not buyers of food. If future prices increase, not only might it seem attractive for sellers to hold on to their supplies, but buyers of food will look to make purchases then, even at a higher price, rather than pay an even higher price later.

Because food consumption and production cannot respond quickly to price changes (as explained above), only significant and long lasting changes in prices could be expected to lead to a change in food stock or inventories.

In any case, there is very poor data on inventories globally, so we cannot definitively say whether or not they have changed.

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 during the global food crisis in 2007 and 2008. How do you explain that?

The international market for rice is very small; about 6-7 per cent of global production. 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, which caused prices to rise further.

Some commentators point to rice to show that financial speculation was not a problem. It is undoubtedly the case that export bans and hoarding fuelled rice price increases. However, there is strong evidence that the extreme increase in the price of wheat triggered the increase in the price of rice as consumers and importers substituted rice for wheat.

The global price of wheat increased particularly in late 2007, whilst the rice price increase began in early 2008. 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. A UN Food and Agriculture Organisation (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." So 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.

Aren't poor harvests and India and China's increasing demand the real reason for rising prices?

There are many factors driving the movement of food prices. Growing use of biofuels diverts food from humans to fuel for cars. Changes in crop yields from year to year affect food supply, and such changes are likely to get more extreme as climate change worsens. Increases in oil and fertiliser prices also make farming more expensive, and so increase the price of food.

Rising demand from emerging economies such as China, India and Brazil is a gradual phenomenon, and cannot explain the dramatic increases in food prices in 2007-08, and again in 2010-11. Net wheat imports for India and China combined accounts for an average of just 0.17 per cent of global production over the period from 2007 to 2010.

The reality is that changes in supply and demand cannot explain the dramatic fluctuations in food prices of recent years. In 2010, the third highest food prices were seen amidst the third highest global wheat harvest on record.

No one campaign or policy can tackle all the complexities which cause hunger in our world. Governments need to support smallholder farmers who produce most of the world's food and should invest in food reserves to help promote stable prices. But excessive speculation is a perversion, amplifying price movements and making them worse. It can be regulated simply and painlessly. Doing so would also have other benefits – for example freeing up money to be invested in genuinely productive activities.

Aren't food prices falling at the moment? Doesn't this mean that food speculation isn't really a problem?

Global food prices, based on the UN Food and Agriculture Organisation (FAO) food price index, fell slightly at the end of 2011, however average food prices for 2011 reached the highest level (in both

nominal and real terms) since the FAO started measuring international food prices beginning in 1990. In particular, cereal prices in 2011 overall were 35 per cent higher than in 2010. In the UK, figures from January 2012 showed that food prices have continued to increase, although the rate of increase has slowed.

While record cereal harvests, a strong US dollar and reduced demand linked with a troubled global economy are likely to be contributing factors in the recent decline, the 2007-08 food price spike was followed by a sharp decline in prices which could not be explained by levels of supply and demand, and which has been attributed to speculative activity.

Food speculation is exacerbating the natural volatility in food markets, with price spikes and crashes making it difficult for consumers and governments to budget. As long as it continues to be allowed, there is a risk of future food price spikes like those seen in 2007-08 and 2010-11.

Regulating food speculation

How would position limits work?

Individual position limits cap the amount of the market that can be held by an individual trader. Such limits can be useful in preventing influence on the market through holding excessive positions. However, the limitation of *individual* position limits is that while they can help prevent individual traders having too large an influence on the market, they do not tackle the influence of a category of traders, such as financial speculators, on the market. To address this *aggregate* position limits are needed. Aggregate position limits cap the amount of any market that can be held by any category or group of traders in total, ensuring there is not an excessive concentration of such a group.

Position limits require active analysis, oversight and intervention by regulators. If a category of traders reach their aggregate position limit, regulators would intervene to require the largest market participants within that category to reduce their positions until that category fell below the aggregate limit.

Given the lack of transparency in UK and EU markets in terms of composition, liquidity and trading volumes it is very difficult to independently assess the exact levels at which they should be set. However, data from the US markets in the 1990s suggests that commodity markets worked effectively for commercial participants, without a lack of liquidity, and with relatively stable prices, with as little as 25 per cent of the market being held by financial speculators. In setting aggregate position limits regulators should

use this historical data, together with ongoing market analysis, as the reference point for setting limits.

Position limits reduce liquidity. Don't farmers need liquidity to stabilise prices and in order to be able to use the markets for their intended purpose of hedging their risk?

Liquidity refers to the number of trading opportunities in a market, which depends on factors such as the number of willing buyers and sellers in a market at any one time.

Traders looking to hedge their risk through the futures markets need certainty that someone will be able to enter a contract with them to do so. Enough liquidity helps to ensure that large trades can happen without disrupting the market, and can therefore reduce volatility. It also helps with price discovery as more trading means that more price signals are generated. However, liquidity is not just about the volume of trading in a market, but also relies on the opinions of market participants – if they are concerned that the trading opportunities might be withdrawn, this can reduce liquidity. So ensuring sufficient liquidity is not as simple as making sure there is lots of trading going on.

In addition, while ensuring sufficient liquidity can reduce volatility in these markets, more liquidity (above the level necessary) doesn't necessarily reduce volatility – in fact recent evidence suggests that the current high levels of liquidity are *increasing* volatility. As Adair Turner, chair of the UK's Financial Services Authority (FSA) has said: "It does not follow that more liquidity is limitlessly beneficial since beyond some point there must be diminishing marginal returns to additional liquidity. It is also possible that more liquidity while in some ways beneficial to end users, could also by facilitating pure speculation, produce more variable medium term price trends".

Position limits are designed to keep liquidity at a level that allows for price discovery and for commercial participants in the market to hedge their risk, without there being so much liquidity that volatility is increased.

Position limits are very inflexible. Wouldn't using a more flexible position management system be a better approach for modern markets?

The UK government are backing a system called position management instead of position limits. Position management does not involve the setting of strict, clear limits on traders' positions but instead gives responsibility to exchanges for ensuring that traders do not disrupt markets by holding an excessive share of the market. Such a system relies on the

judgement of the exchanges and creates a significant conflict of interest as exchanges have a strong incentive not to intervene in the market as they profit from the trading volume.

In the UK, position management is the norm for regulating commodity markets and analysis of its implementation shows its clear failure in ensuring sufficient regulatory oversight. The UK regulator, the FSA, did not exercise its powers to intervene in commodity markets at all in 2010, delegating responsibility to the commodity exchanges and admitting that it was not aware how often the exchanges themselves intervened in the markets. The failures of this system are all too apparent. For example, in July 2010 the hedge fund Armajaro bought up almost all of the European cocoa market through the London based cocoa exchange – pushing prices to a 33 year high. Again, in May 2011 Frontier Agriculture, one of the UK's major grain marketing businesses, bought all the futures contracts available on the London feed wheat market, effectively buying up the whole market. Had position limits been in place, these incidents would simply not have been possible.

Position management by exchanges hands control of the market over to those with the greatest motivations not to intervene. Without the strict, transparent and objective rules of position limits, position management effectively results in deregulation, with little or no action taken. In order to provide certainty that markets are properly managed, regulators cannot hand their powers over to the judgement of exchanges but must set clear limits that can provide confidence amongst market participants and the public that these markets are being regulated effectively.

Won't regulation cost too much?

The proposals to regulate food speculation need to be overseen by regulators. These regulatory bodies already exist, but it is vital that they are properly resourced. In the US there is a dedicated commodities regulator, the Commodity Futures Trading Commission (CFTC), which has a staff bigger than the whole of the European financial regulator, European Securities and Markets Authority (ESMA). It is therefore likely that additional resources will be required.

However, the costs of failing to regulate also need to be considered. The financial crisis, a result of a deregulated global financial sector, has resulted in enormous cost to individuals, governments, and the global economy. This suggests that it could therefore be too costly *not* to regulate.

Exchange trading requires traders to pay a small margin to the exchange. Usually speculation is done

with borrowed money, but a margin requires that some of their own money is put forward, so this helps to reduce risk because it means that they effectively pay a deposit or have a 'hand in the bet'. Currently, commercial hedgers such as farmers and food companies are being pushed out of the markets because increased volatility is leading to increased margins. Regulation to curb speculation and reduce volatility, including bringing commodity derivative trading onto exchanges, would actually be beneficial to these traders. However, it would increase costs to financial speculators – so it's not hard to see why they're raising this concern.

Why do we need European regulation? Surely the UK government would be best placed to regulate the City of London?

There is a danger that different regulation in different parts of the world could lead to regulatory arbitrage, where traders move their activities to a jurisdiction where the rules are weaker in order to carry on the practices that were meant to be restricted. So the fact that legislation to regulate food speculation is being agreed for the whole of Europe as part of wider efforts at global financial reform helps to reduce this risk.

However, part of the proposals will be implemented as a directive, meaning that the UK government will interpret the legislation into UK law according to particular circumstances in the UK.

As one of the largest economies in the EU, the UK has a strong voice in the European legislative process. With numerous well-paid financial lobbyists, there is no danger that the interests of the City of London will be under-represented in the decisions about the regulation of food speculation.

However, this is not the only voice that needs to be heard in the debate. WDM is working with other organisations across Europe to ensure that the public interest is represented. The UK government's ideological commitment to 'light touch' financial regulation has had disastrous consequences, contributing to the financial crisis and exacerbating hunger and poverty around the world, and it should not be allowed to continue to push for this approach unchallenged.

WDM's campaign

Is it just the regulation of speculation on food that you're calling for?

Our campaign focuses on food as it is a fundamental human need and right. In 2007-08, and again in 2010-11, food price spikes exacerbated by food speculation have resulted in increasing numbers of

people being unable to access an adequate diet, or having to make other compromises in order to do so.

However, other commodities like energy (such as oil and gas) and raw materials (such as metals) are also speculated on, often in contracts which bundle different commodities, including food, together. It is therefore impossible to separate speculation on food commodities from speculation on other commodities. The review of the EU's Markets in Financial Instruments Directive (MiFID) legislation which our campaign is focusing on includes provisions to regulate all commodity derivative trading, not just food derivatives.

In fact, the commodity that is most traded by financiers is oil, and oil prices have seen similar wild swings to food, suggesting speculation is also affecting oil prices. Since agriculture in many parts of the world is heavily based on oil and other energy inputs, a spike in oil prices has a knock-on impact on food prices. A World Bank research paper estimated that higher oil and other energy prices caused the price of US food exports to increase by 15 to 20 per cent between 2002 and 2007.

High commodity prices also affect developing countries in other ways. Many countries are net importers of oil and other raw materials, and so increased prices increase countries' import costs. As with food prices, the result is that poor people have to use less energy, or cut back on other areas of expenditure. Volatility in commodity prices also makes it harder for developing country governments to plan their economies.

WDM is just calling for limits on speculation, not a complete ban. Does this mean some speculation is OK?

Because some producers and users of food and other commodities rely on these markets to hedge their risk, some speculation is useful as it means that there are other traders prepared to take on the risk. For this reason we are not calling for a complete ban on speculation, or the elimination of these markets. However, as described above, while a certain level of liquidity is needed for these reasons, the amount of speculation we are now seeing is far more than is needed for these purposes, and is actually disrupting the markets, making them more volatile and less able to fulfil their intended functions. This is why position limits are needed.

The big picture

Don't we need an international approach to tackle food speculation?

The majority of trading in food and other commodities derivatives takes place in the US and EU. The US has already passed the Dodd Frank Wall Street Reform Act, which has provisions, including position limits, to tackle food speculation. It is therefore vital that similar regulation is passed in the EU, otherwise trading will move to less well regulated markets in Europe where it can continue to have such devastating impacts on the poor.

Actions to tackle food price volatility will also be on the agenda for the G20 in 2012, giving the opportunity for a more joined-up international approach. But as part of this, the EU needs to act.

Don't we need the investment from financial institutions to help improve agriculture?

Money put into food speculation is not invested in improving agriculture since it does not provide resources for genuinely productive activities. Instead food speculation effectively creates an opportunity cost through reducing the amount of money available for investment in the real economy.

Other development groups are calling for a financial transaction tax (FTT) or Robin Hood Tax. Would this help to tackle food speculation?

WDM supports the Robin Hood Tax campaign for a FTT. An FTT on all commodity derivative transactions could increase costs for short term speculators who increase volatility in the market. However, it would only achieve this if it was set at a high enough level. In addition, it would do little to improve transparency or prevent longer-term financial speculators from flooding the markets. For this reason we are campaigning for improved transparency and position limits through the review of MiFID.

How does the MiFID legislation fit in with other efforts at financial reform?

The review of MiFID is part of wider efforts at financial reform within the EU. Proposals for the European Market Infrastructure Regulation (EMIR) which included some provisions to address opaque 'over the counter' (OTC) derivative trading have already been considered in the European parliament, with efforts by the financial sector to water down the rules being stymied so far. Alongside the proposals for MiFID, a draft of the Market Abuse Directive was published. This legislation aims to avoid market manipulation by particular companies. However, MiFID has the potential to properly regulate food speculation as it covers all commodity derivative trading in Europe (not just OTC trading) and stop excessive speculation by the financial sector. This is why our campaign is focussing on MiFID.

