UN Pleads for Curbing Speculation in Food Commodities

By IDN Global Economy Desk

BERLIN (IDN) - The UN Special Rapporteur on the right to food has criticised the European Union (EU) for not acting as boldly as the U.S. and striving to keep in check speculation in food commodities that led to the 2008 global food price crisis, which affects many developing countries to this day.

An unmistakable sign of "no lessons learnt" is the fact that London continues to be the world's largest agricultural commodities market outside the United States. "Denkste various calls denouncing the impact of speculation in foodstuffs, such as the demarche by the French government to the European Commission, European regulation of commodities trading remains insufficient," Olivier De Schutter, the UN Special Rapporteur, points out in a "briefing note".

In July 2010, for example, Andrew Ward, the manager of Armajaro, a London based hedge fund, purchased US$ 1 billion (€770 million) worth of futures contracts for 241,000 tons of cocoa. This represented about 7% of the world's annual output of cocoa, and is enough to supply Germany for an entire year, states the note published on the eve of an emergency meeting of the Food and Agriculture Organisation (FAO), on September 24.

"Even more amazingly, the contracts were for delivery, which means that Armajaro owned almost all the cocoa beans sitting in warehouses all over Europe. Although the announcement of good harvests ensured that the spot prices did not rise as Armajaro had hoped, that such hoarding is permitted in this day and age stretches belief." The paper examines the impact of speculation on the volatility of the prices of basic food commodities, and the possible solutions forward.

It draws attention to the fact that the 2008 global food price crisis, from which many developing countries continue to suffer, arose because a deeply flawed global financial system exacerbated the impacts of supply and demand movements in food commodities.

Reforming the global financial system should therefore be seen as part of the agenda to avert another food price crisis and achieve food security, particularly in poor net food-importing countries, says the UN Special Rapporteur on the right to food.

A significant portion of the increases in price and volatility of essential food commodities can only be explained by "the emergence of a speculative bubble". In particular, a significant role was played by the entry into markets for derivatives based on food commodities of large, powerful institutional investors such as hedge funds, pension funds and investment banks, all of which are generally unconcerned with agricultural market fundamentals.

COMMODITY DERIVATIVES

Such entry was made possible because of deregulation in important commodity derivatives markets beginning in 2000. These factors have yet to be comprehensively addressed, and to that extent, are still capable of fuelling price rises beyond those levels which would be justified by movements in supply and demand fundamentals, cautions Olivier De Schutter.

"Therefore, fundamental reform of the broader global financial sector is urgently required in order to avert another food price crisis," the briefing note rightly points out.

De Schutter makes a strong plea for subjecting previously unregulated Over the Counter (OTC) derivatives to rules requiring registration and clearing on public exchanges. Exemptions to these rules must be highly restricted, he says.

As regards commodity derivatives trading in particular, he urges States to ensure that dealing with commodity derivatives is restricted as far as possible to qualified and kissedged investors who deal with such instruments on the basis of expectations regarding market fundamentals, rather than mainly or only by speculative motives.

These measures would enable States to fulfil their legal obligations arising under the human right to food, says De Schutter. He finds the recent Dodd-Frank Act on financial reform passed by the U.S. Congress "encouraging" in regard to achieving food security, particularly in poor net food-importing countries.

With specific relation to agricultural commodities, the Dodd-Frank Act sets out a new Section 4a(c) of the Commodity Exchange Act (CEA), which requires the U.S. Commodity Futures Trading Commission (CFTC) to establish, within 270 days of the passage of the Act, limits on the number of agricultural commodities that can be held by any one trader, as well as on energy related commodities and futures, says the UN Special Rapporteur.

The Dodd-Frank Act also requires the CFTC to establish limits on the aggregate number or amount of positions in certain contracts based upon the same underlying commodity that may be held by any one person, including any group or class of traders, for each month. De Schutter hopes that the CFTC does not set those limits so high as to be meaningless.

On the other hand, he regrets that the Dodd-Frank Act has not brought about the structural changes in the financial markets many had hoped for: in particular, the "Volcker rule" announced by President Obama in January 2010, which was intended to prevent banks from using taxpayer-backed funds to speculate on financial markets and give up their stakes in hedge funds and private equity funds, has been severely watered down in the Act.
EU'S PROPOSED REGULATION

In the European Union, Michel Barnier, the EU Commissioner for the Internal Market and Services, announced on September 15, 2010 a Proposed Regulation on OTC derivatives, central counterparties and trade repositories.

This proposed regulation imposes mandatory reporting and clearing (where possible) of OTC derivatives, and stipulates that "nonfinancial actors" will be subject to the same rules as "financial actors" if they meet certain thresholds.

More specifically, an information threshold is proposed, which will allow financial authorities to identify non-financial actors that have accumulated significant positions in OTC derivatives, and a clearing threshold, which, if exceeded, will render a nonfinancial actor subject to the clearing obligation.

Moreover, the proposal draws a distinction between commercial and financial actors by stipulating that "in calculating the positions for the clearing threshold, derivatives contracts should not be taken into account if they have been entered into to cover the risks from an objectively measurable commercial activity."

The proposed regulation will place obstacles in the path of index speculators' participation in commodity index funds. However, these obstacles do not appear to be insurmountable: the CME group, which describes itself as "the world's leading and most diverse derivatives marketplace", for instance, has already successfully developed cleared commodity index swaps.

Moreover, there may be a difference between the "position limits" imposed by the Section 737 of the Dodd-Frank Act, and the "concentration limits" imposed by Article 44 of the proposed regulation. The former provision sets out clear restrictions, while the latter appears to set out more variable, individualized limits that could be subject to dispute, argues the briefing note.

"The goal of commodity derivatives reform is not to inconvenience financial speculation in commodities, but to limit, control, or even prohibit it outright. As such, it cannot be said that the proposed regulation tackles the subject of speculation in commodities directly," it adds.

RECOMMENDATIONS

De Schutter offers a set of recommendations to mend the present situation.

1. Given the numerous linkages between agriculture, oil, and other financial markets, comprehensive reform of all derivatives trading is necessary. The very first step would be to require registration, as well as clearing to the maximum extent possible of OTC derivatives, so that there is real time reporting of all transactions made, without information privileges for OTC traders, and in order to allow for effective supervision. The small minority of derivatives that cannot be cleared must nevertheless be reported without a time lag.

2. Regulatory bodies should carefully study and acquire expertise in commodity markets, instead of regulating commodity derivatives and financial derivatives as if they were the same class of assets. It may be appropriate to assign the task of regulating commodity derivatives to a specific institution staffed with experts in commodity regulation, rather than have a single body regulating both financial and commodity derivatives.

3. Access to commodities futures markets should be restricted as far as possible to qualified and knowledgeable investors and traders who are genuinely concerned about the underlying agricultural commodities. A significant contributory cause of the price spike was speculation by institutional investors who did not have any expertise or interest in agricultural commodities, and who invested in commodities index funds because other financial markets had dried up, or in order to hedge speculative bets made on those markets.

4. Spot markets should be strengthened in order to reduce the uncertainty about future prices that creates the need for speculation. However, these markets must also be regulated in order to prevent hoarding. Spot markets must be transparent, and holdings should be subject to strict limits in order to prevent market manipulation.

5. Physical grain reserves should be established for the purpose of countering extreme fluctuations in food price, managing risk in agricultural derivatives contracts, and discouraging excess speculation, as well as meeting emergency needs. Such measures and the abovementioned reform of commodity derivatives markets should be seen as complementary. (IDN-InDepthNews/24.09.2010)