Speculation undermines the right to food

"Speculators create a bubble which covers everthing. With their expectations, and bets on the future they push prices and their deals distort prices particularly of commodities."
-George Soros

"Do you enjoy rising prices? Everybody talks about commodities – with the Agriculture Euro Fund you can benefit from the increase in value of the seven most important agricultural commodities." With this advertisement the *Deutsche Bank* tried in spring 2008 to attract clients for one of its investment funds.

At the same time, there were hunger revolts in Haiti, Cameroon and other developing countries, because many poor could no longer pay the exploding food prices. In fact, between the end of 2006 and March 2008 the prices for the seven most important commodities went up by 71 per cent on average, for rice and grain the increase was 126 per cent. [1]

The poor are most hit by the hike in prices. Whereas households in industrialised countries spend 10 -20 per cent for food, in low-income countries they spend 60 - 80 per cent. As a result, the World Bank forecasts an increase in the number of people falling below the absolute poverty line by more than 100 million. Furthermore, the price explosion has negative macroeconomic effects: deterioration of the balance of payment, fuelling inflation and new debt. High food prices are also a threat to the basic human right to food.

Speculation boosts price increases

The price increase has several explanations. There are long term factors, such as increases in demand, insufficient agricultural productivity in several developing countries, structural adjustment programmes crowding out local food production in favour of cash crops and bio-fuels, as well as short term factors such as bad harvests and the depreciation of the dollar. But these factors alone cannot explain the dramatic increase in such a short time.

Speculation comes in, as some people and institutions "*enjoy rising prices*" like in the Deutsche Bank advertisement above. Speculation is boosting the prices for food. This is now acknowledged by the mainstream of the financial community, among others the World Bank, the IMF and the Commodity Futures Trading Commission – CFTC in the US.[2]

How speculation influences food prices

Speculation is a bet on the future price of a commodity or financial asset. Speculation occurs on a range of items from currencies and equities to bonds and all kinds of derivatives. Speculators have no intention to really deliver or buy a product. They have no link to production and consumption; they enter the market because they expect that they can profit from changing prices. For the recent price explosion speculation contributes in several manners.

A large part of international trade in agriculture is made with the help of derivatives, especially *futures*. For example, in a futures contract, a farmer agrees in January to sell his not yet existing July harvest to a trader at a fixed price. The risk of price volatility lies with the trader. If the prices in July are higher, the trader makes a profit, if they are lower he makes a loss, whereas the farmer no longer has worry about the price in July. For him this deal has the character of insurance. This is why this type of speculation is called *hedging*. Of course, the trader wants a risk premium for this future contract, which at the end increases the overall price of the commodity. This procedure is not without alternatives. For instance, it would be possible to organise a mutual insurance among the farmers or to have state guaranteed prices. But under the given conditions, this type of speculation is reasonable as long as it is made by specialised and experienced traders and if there is no external market disturbance.

However, the US-subprime crisis and the crash at Wall Street have pushed hedge funds and other institutional speculators to enter the commodity markets. As business opportunities in the financial markets are drying up as a consequence of the crisis, they desperately seek for new areas to make profit. Thus, they have discovered the commodity markets, particularly oil and agricultural commodities. This has boosted demand and, consequently the prices. In 2007 trade in agricultural derivates increased by 32 per cent.[3] Between June 2005 and June 2007 the face value of commodity derivatives traded *over the counter*[4] increased by 160 per cent although real production did not increase. The price increases developed in the futures market first.

The bubble in the futures markets also influences the spot markets.[5] Under the influence of increasing prices in derivative trade, producers or traders hold back delivery, as they expect higher prices at a later stage. In other words, the bubble in derivative prices seduces them to behave as speculators.

> "oil in itself is a commodity, whose price is very much driven by speculation"

The oil price is a strategic price, i.e. its price gets included into the prices of all other products. This is also the case for agricultural commodities. Their production and distribution requires oil for tractors and other machines, for fertilizers and transportation to the markets. As oil in itself is a commodity, whose price is very much driven by speculation, the speculative boost of the oil price comes on top of the price of the agricultural commodity. Experts estimate, that approximately 25 per cent of the oil price is determined by speculation.[6] Thus, speculation in oil works as an indirect factor for the increase in prices of agricultural commodities.

Dollar depreciation – another indirect factor

Beside "old" imbalances of the US-economy, such as the trade and fiscal deficit, the bursting of the speculative bubble in the financial system of the United States has contributed to the depreciation of the dollar. Given, that most of international trade is billed in dollars, the depreciation leads to a loss of revenues in the producing countries. Therefore they increase the price in order to compensate the exchange rate losses.

Is speculation on falling prices good?

Since the climax of the commodity prices in July/ August 2008 commodity prices have fallen again. By mid September the oil price had fallen by 30per cent from its peak. This highlights the impact of speculation. This drop within a few weeks has absolutely nothing to do with fundamentals, such as new supply, a slow down of demand, "*peak oil*" etc. It is largely due to speculation on falling prices. In particular hedge funds have engaged in *short selling*. Short selling means, that you sell an asset which you don't own. Generally you borrow the asset from someone who owns it before you sell it. Then if the price of the asset goes down, you buy it back at the lower price and return it to the original. In the first eight months on 2008 the revenues of short selling have increased by 10per cent.[7]

Although short selling contributes to falling prices, there is no reason to welcome it as good speculation, because it can increase volatility by making prices overshoot downwards, just as speculation can do upwards. In both cases financial transactions effect the prices of items in the real economy apart from fundamental changes in supply and demand.

Short selling on certain items was banned by in the US, the UK, Germany and other countries in September 2008. It had accelerated the fall of the share price of financial institutions such as *Lehman Brothers*.

Furthermore, the falling prices from short selling follow on from rising prices and speculation. Therefore, short selling is not positive but an integral part of the financial system that creates volatility and insecurity. That volatility is what enables speculators to continue to profit. However development projects and agriculture in particular requite a stable and predictable economic environment, as they need long-term investment.

Banning speculation

Technically it is easy to prevent the speculation on food commodities and prices. It can be achieved through the combination of the following measures:

- Introducing a trade register where only traders who are hedging are allowed;
- Preventing hedge funds and other institutional speculators which are not listed from trading;
- Requiring that all trade be conducted on exchanges and transparently rather than over the counter;
- Creating regulation that can take action to prevent and bubbles that hedging might produce.

It is only a question of political will, whether speculation on agricultural commodities is allowed to contribute to undermine food security and increase hunger and misery. The casino has to be closed.

- by Peter Wahl, WEED

The views expressed are those of the author.

Endnotes

1. FAO Food Price Index; http://www.fao.org/docrep/010/ai470e/ai470e07.htm.
2. World Bank (2008): *Double Jeopardy: Responding to High Food and Fuel Prices*, Memo for the G8 summit in Hokkaido-Toyako, 2008 International Monetary Fund (2008): *Food and Fuel Prices—Recent Developments, Macroeconomic Impact, and Policy Responses*, Washington.
Commodity Futures Trading Commission (2008): Remarks of Commissioner Michael V. Dunn before the Swiss Futures and Options Association, Bürgenstock Meeting, September 5, 2008.
3. UNCTAD (2008): *World Trade Report 2008*, Geneva, p24.
4. Ten per cent of trade in derivatives goes through stock or commodities exchanges and is therefore standardized and under supervision. The remaining 90 per cent, not traded through an exchange is called "over the counter". This trade is completely unregulated and intransparent.
5. In the spot market, a deal is settled within at maximum three days.
6. Kemfert, Claudia, Deutsches Institut für Wirtschaftsforschung (DIW), FAZ NET, September 28, 2008.
7. Credit Suisse/Tremont Hedgefonds Index, Benchmark Performance Summary www.hedgeindex.com/hedgeindex/de/default.aspx?cy=USD,

For More Information Contact:

Eurodad Contact: Marta Ruiz - mruiz@eurodad.org
www.eurodad.org
WEED Contact: Peter Whal - peter.wahl@weed-online.org
http://www.weed-online.org
Campagna per la Riforma della Banca Mondiale Contact:
Andrea Baranes - abaranes@crbm.org
http://www.crbm.org
Bretton Woods Project Contact:
Peter Chowla - pchowla@brettonwoodsproject.org
http://www.brettonwoodsproject.org

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