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Food speculation: the unacceptable “normal”

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Food speculation: the unacceptable "normal"

Bonn, 15 April 2013. In the *Food Price Watch* report that appeared in late March 2013 the World Bank points out that, despite a slight decline, the prices of basic foodstuffs remain very high, just nine percent below the record high levels of August 2012. The previous *Food Price Watch* report in November 2012 had already referred to a "new normal" in the food markets, characterised by high and yet volatile prices.

According to the World Bank, persistently high and volatile food prices are causing not only hunger and malnutrition, but also obesity. Many people find themselves forced by the high prices to opt for cheaper, less nutritious foodstuffs for their families. People on low incomes are particularly hard hit by the price rises, because they spend an extremely large proportion of their income on food. Following the food price crisis in 2007/2008 – which led to social unrest in such countries as Egypt, Bangladesh, Indonesia, Mexico, Morocco, the Philippines, Senegal and Tunisia – the World Bank estimates that the number of people living in extreme poverty rose by some 130 to 155 million. The prices of basic foodstuffs at that time reached a 30-year high. They have since continued to rise.

Although the food price crisis has meanwhile become the unattractive "normal", the causes are still disputed. To some extent, the price trends can be put down to fundamental factors relating to the "real" economy, including the growing demand for food in the emerging economies, the production of biofuels and the specific supply and demand conditions applicable to individual agricultural commodities. Another factor is the weak US dollar, in which most commodities, including foodstuffs, are traded.

The high volatility of prices cannot, however, be ascribed to these factors alone. Even though representatives of the finance industry and some economists, still prone to the illusion of perfectly efficient markets, vehemently deny it, it is no accident that the price rises and the increase in price volatility have coincided with the measures taken to deregulate the commodity markets, like the US Commodities Futures Modernization Act passed at the turn of the millennium. Liberalisation led to an increase in the volumes of financial transactions with a speculative background. The signs that the price developments in the food markets are associated with the financialisation of the commodity markets – meaning the increasing dominance of financial transactions in relation to transactions driven by fundamental supply and demand conditions – are becoming more numerous. The significant increase in the volumes of agricultural commodity futures transactions in recent years has been accompanied by both a sharp price rise and extreme price fluctuations.

Speculation is not bad *per se*. A market operator less willing to take risks, such as a farmer soon to harvest his crop and wanting to protect himself against the unpredictable trend in the price of his wheat, comes to an agreement in the futures market on the future sale of his harvest at a fixed price. The food producer, who is dependent on the farmer's harvest and is equally unable to predict the development of prices, will come to an agreement in the futures market on the purchase of the wheat and its delivery at the price agreed today. However, both need a partner with whom to sign a contract, a speculator who accepts the price risk. Speculators thus provide a market for all those who want to protect themselves. This form of speculation is based on fundamental supply and demand conditions and helps to preclude intense and frequent price fluctuations.

The strategy of the index funds in the food and commodity markets is, however, completely different. Their aim is not physically to acquire the

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underlying asset, such as a tonne of wheat from the farmer, but to map price trends. To this end, commodity futures contracts, for example, are bought on futures exchanges, their accumulation leading to pressure on spot market prices. A transaction on a spot market, unlike a futures contract, is effected once agreement is reached. Now, it may justifiably be argued that this tracking of the price trend provides the markets with a significant proportion of the liquidity they need. But if excessive demand results in constantly rising prices on the futures market that systematically exceed the spot price, those markets tend to overheat and send out erratic price signals. Speculation in which the volumes traded in futures markets greatly exceed the quantity which has actually been harvested and for which there is real demand consequently stimulates price movements in one direction or the other. Rises in the prices of foodstuffs traded virtually in the financial markets may therefore influence the prices of foodstuffs that are actually traded. The resulting high volatility sends the farmer signals that he finds hard to interpret and may lead to underproduction in one phase and overproduction in another and possibly encourage hoarding and stockpiling, which may, in turn, have the added effect of distorting prices.

The problem is not futures trading in itself, but rather the volumes and the concentration of the market in this segment. The more the market in basic foodstuffs becomes an area for financial speculation, the further pricing distances itself from its fundamental determinants – and the greater the impact on the prices of foodstuffs, which ultimately concerns us all. Even though speculative transactions cannot be identified as the sole cause of the price hikes in the food markets, it is clear that they exacerbate price fluctuations and increase uncertainty. Alleged market efficiency and the promise of a high return must not be allowed to undermine the protection of the resources on which human life depends. The new "normal" is unacceptable. Unbridled food speculation should be banned.

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