Institute for Agriculture and Trade Policy

"Regulating commodities speculation: normative and fiscal means"
UNCTAD Public Symposium Paper
May 2009

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> *What we face now could, in fact, be worse than the Great Depression—because the world is now so much more interconnected and because the banking sector is so big.*
> —Simon Johnson, former IMF chief economist in *The Atlantic*, May 2009

Overview: Spikes in food and energy prices in 2007-2008 contributed to a conservatively estimated increase of 100 million food insecure people between 2006 and 2008, according to the U.N. Food and Agriculture Organization. This paper reviews one factor in food and energy price volatility—financial speculation in commodities futures markets. Futures prices are used as benchmarks for cash prices of commodities and hence affect the price of consumer and industrial goods. Policy options for international cooperation toward regulating these markets are outlined. The options include a Financial Transactions Tax (FTT) designed to reduce the volume of intraday trading that is a driver of the commodity price volatility. As proposed by the Austrian economist Stephan Schulmeister, an FTT levied at .01 percent of all transactions in 2007 would have yielded $287 billion.[1] We estimate that if the FTT were applied to private (over-the-counter) and publicly traded commodity derivatives, the tax would have yielded about $10 billion. Such revenue would not only finance international cooperation on commodity exchange regulation, but, if put into an endowment, could finance commodity-related projects, as well as economic diversification away from commodity export dependence.

Some intergovernmental views on commodity price volatility

1. There is strong disagreement among intergovernmental organizations about the extent to which financial speculation in commodity exchanges played an important role in commodity price volatility in 2007-2008. The "fundamentalist" position contends that the sharp rise and fall of prices resulted from fundamental factors (e.g., China and India's demand, biofuels feedstock use, crop failures, etc.), in which speculation played at most a minor role. If you view extreme price volatility as largely a result of deregulation and de-supervision of the commodity exchanges and the financial institutions that invest in them, then regulation is urgently needed. This paper takes the latter position.

2. An International Organization of Securities Commission (IOSCO) report, prepared for the G-20 summit in London on April 2, summarizes the "fundamentalist" case. Neither the U.S. Commodities Futures Trading Commission (CFTC), nor the United Kingdom's Financial Services Authority (FSA), nor the International Monetary Fund (IMF) have determined that financial speculation in commodities exchanges "systematically caused" price increases and volatility.[2] Nevertheless, IOSCO acknowledges that "the complexities of markets and the economic implications associated with large commodity price changes will continue to foster public concern." (9-10) To allay that concern, IOSCO proposes

measures to make market information more transparent and to institutionalize cooperation among regulatory authorities.

3. In contrast to the IOSCO report, a key message in UNCTAD's "The Global Economic Crisis: Systemic Failures and Multilateral Remedies" is that "the growing role and weight of large-scale financial investors on commodities futures markets have affected commodity prices and their volatility. Speculative bubbles have emerged for some commodities during the boom and have burst after the sub-prime [mortgage] shock." (iii) The nominal value of commodities derivatives reported to the Bank for International Settlements was $13 trillion as of June 2008. (25) UNCTAD calls for agreements among national authorities to ensure reporting of all commodities derivatives trades to regulatory authorities for all exchanges that trade "look alike" (e.g., same commodity, same contract period, same volume) contracts. The exemption from regulation of privately negotiated ("over-the-counter") derivatives contracts should cease, so all contracts will be publicly traded and reported to authorities in all jurisdictions. In sum, UNCTAD advocates for a broad agreement among national authorities of commodity exchanges and other financial institutions to prevent regulatory arbitrage; i.e., to seek competitive advantage in weaker regulatory jurisdictions and/or in unregulated financial instruments. (59-60)

4. It should be noted that the International Food Policy Research Institute and the World Bank have proposed to dampen price volatility (and repair "the collapse of confidence in the international grain market") by means other than regulation of speculation. In March, they published a concept note that includes a proposal for a virtual grain reserve, backed by a $12-20 billion fund that a group of experts could use to prevent price spikes in the futures markets by betting on prices to fall (short-selling).[3] Whether or not this proposal is politically viable and operationally feasible, it is unlikely to have its intended effect without further regulation of commodity exchanges to reduce the "weight of money" effect of financial speculators.

5. IATP, based on market analysis and testimonies to U.S. congressional hearings, believes that speculation by financial institutions has played a crucial role in price volatility.[4] To conclude that speculation played no major role, the IMF, CFTC and FSA had to omit evaluation of the effect of commodity index fund trades on price increases and volatility. The funds bundle up to 24 agricultural and non-agricultural commodities in an instrument traded according to various fund formula. These funds bundled an average of 33 percent of all U.S. 2006-2008 agricultural futures contracts.[5] The omission of fund trading data hampers comprehensive analysis of commodity market dynamics. Index funds control far more futures contracts than are held by traders subject to exchange regulations. For example, in May 2008 one analyst noted that CFTC rules limited regulated traders to hold maize futures contracts amounting to 11 million bushels, "Yet the two biggest index funds [Goldman Sachs and Morgan Stanley] control a combined 1.5 billion bushels!"[6] Regulation of index funds and related commodities derivative contracts, e.g., by limiting the number of futures contracts that an investor can control, should not be limited to one commodity exchange jurisdiction. The global reach of investors requires an agreement to regulate wherever commodity exchanges operate.

Options for international oversight of commodity exchanges: some normative proposals

1. Delegates to the United Nations High-Level Meeting (HLM) on the global financial and economic crisis and its impact on development, set for June 1-3 in New York City, may wish to consider policy options for regulating commodities speculation. There are at least three not mutually exclusive means to do so. First would be the negotiation of a new international agreement in which all U.N. members would be invited to participate. Parties to the

agreement would adapt and enforce agreement provisions in their national commodity exchange legislation and regulation. One such provision could be the President of the General Assembly's Commission of Experts recommendation to all but eliminate over-the-counter (OTC) derivatives (para 63), which are private trades exempt from regulation.[7] OTC trades of commodity index funds drove commodity prices far above and below what could be explained by fundamental factors in 2007-2008, according to testimonies submitted to the U.S. Congress in 2008 and 2009.[8]

2. Second would be for the approximately 200 financial institution members of IOSCO to revise and adopt the non-binding recommendations of its Task Force on Commodity Futures Markets in a code of practice. Developing country members could seek to influence the terms of final recommendations, which are not binding on the members. Such a code could be an interim form of enhancing regulatory cooperation, until a more comprehensive U.N. agreement can be achieved. Since implementation of the code would be voluntary, there is a danger that some member exchanges could continue to seek competitive advantage through deregulation and de-supervision.

3. Third, U.N. members and civil society could support national measures that prevent the regulatory arbitrage in unregulated jurisdictions and financial services products described in the UNCTAD secretariat report. For example, on February 12, "The Derivatives Trading Transparency and Accountability Act of 2009" was passed by the U.S. House of Representatives Committee on Agriculture, which has authority over the Commodities Futures Trading Commission (CFTC).[9] The bill would require the CFTC to ban U.S. exchange access to all foreign exchanges and investors unless foreign regulators adopted and enforced contract and value limits on "non-commercial" (i.e., purely financial) speculation relative to the total value and number of contracts specific to a commodity. This measure would prevent traders engaged in excessive speculation in other markets from being able to do so in U.S. markets, as well as encourage foreign regulators to adopt speculative position limits. The CFTC would appoint advisory committees for agricultural, energy, base metal and precious metal derivatives to propose periodically speculative position limits for each commodity. These committees should also include civil society representatives who were selected neither from physical hedgers (firms that either traded or processed the commodity) nor from financial investors. These representatives would represent food and energy security interests according to criteria stipulated in the bill.[10] Such provisions of the bill could be adopted in other national jurisdictions or multilateralized and incorporated either into a new agreement or an IOSCO code of trading practice.

Taxing financial transactions to reduce price volatility

1. Stephan Schulmeister's proposal for a Financial Transaction Tax (FTT) follows his demonstration of how 1092 technical analysis models, trading according to mathematical formula, inflated and deflated oil, wheat, maize and rough rice prices far beyond what is fundamentally explicable. The widespread use of technical analysis and investment according to price trend formula results in price volatility as prices "overshoot" what can be fundamentally justified. The investors' belief in the profit potential of automated formulaic investments is such that in 2007, "derivatives trading volume is roughly sixty-eight times higher than world GDP, whereas spot trading [of real assets] amounts to `only' six times world GDP," (71) with the derivatives volume ratio dominance being significantly higher in the United States and the European Union. Given the huge excess financial liquidity, relative to the liquidity needs of markets for commodities and other real assets, Schulmeister believes that it is "at least probable that an FTT will dampen `excessive' liquidity to a larger extent than the basic liquidity needed for market efficiency" (72). Speculative traders invest for the short to very short term, sometimes trading the same contract several times in a day.

Hence, a per transaction tax will affect less longer term traders who provide the liquidity needed for commodity exchanges to close contracts at a settled price. Schulmeister assumes that as the transaction volume drops because of the added opportunity cost of the FTT, the draining of excessive liquidity from the market will result in greater price stability. The FTT would achieve through fiscal means some of the objectives of the aforementioned normative proposals.

2. Schulmeister estimates the revenue potential of the FTT at levies of 0.1, 0.05 and 0.01 percent applied to different classes of financial and commodity exchange transactions, using 2007 transaction data and three scenarios. At a 0.01 levy on all transactions, with a projected medium fall in transaction volume, the FTT would raise $287 billion. Applied at this rate and scenario only to publicly traded commodities derivatives, the tax would raise "only" $1.2 billion. If OTC (private) index fund transactions were regulated and taxed, even allowing for reduced index fund investment, an FTT applied to commodities would yield several multiples of $1.2 billion. Applied to all OTC (private) transactions, at 0.01 percent in medium scenario, the FTT would raise $111.3 billion. In 2004, before the rise of index funds, UNCTAD estimated that commodities derivatives accounted for 8 percent of all derivatives value.[11] If commodities OTC value were 8 percent of all OTC transactions in 2007, we could add about $9 billion in FTT revenues to Schulmeister's $1.2 billion estimate.

3. The administrative simplicity and efficiency of the FTT is that it is calculated and collected at the time of transaction by the national exchange authorities. Our hypothetical $10 billion a year, following deduction of an agreed administrative fee by national authorities, could be used first to pay a secretariat to help implement a U.N. commodities exchange agreement. Yet administrative and implementation costs would take no more than a small fraction of the FTT revenue. How should the remainder of these funds be used?

4. We believe that the majority, if not all, of the FTT revenues not allocated for agreement implementation should form an endowment whose interest on principle could be allocated for development projects under the aegis of U.N. agencies that would administer the project grants. Remaining FTT revenues, if conservatively invested, would yield perhaps $500 million a year for project grants. The building of a development endowment would reduce U.N. agency and member dependence on U.N. voluntary funds and aid tied to purchase of good and services from aid donors.

5. Part of the endowment grants could be dedicated to economic diversification projects to reduce commodity export dependence, particularly among commodity export-dependent developing countries. (Even if regulation of speculation succeeds in making it possible for developing countries to use price risk management tools to export and import commodities successfully, the long-recognized need for diversification away from commodities will persist.) Another part could be used to make commodities production and processing more environmentally and economically sustainable, e.g., to pay farmers to conserve plant and animal diversity for agricultural commodities. Particularly in view of the evermore dire economic consequences of climate change,[12] an FTT on greenhouse gas (GHG) emissions permit trading could be used for projects and technology transfer to actually reduce GHG emissions. In sum, there is no end of projects that an FTT-derived endowment program could fund.

6. Just as there is strong opposition to tougher regulation of the financial markets,[13] so too will some U.N. members oppose a U.N. agreement on commodity exchanges. Yet as the depredations and threat of deregulated markets to human security become more evident, perhaps the political will to regulate will increase to the point where an agreement and an FTT to finance the agreement and development projects are achievable.

[1]http://www.wifo.ac.at/wwa/servlet/wwa.upload.DownloadServlet/bdoc/S_2009_TRANSACTION_TAX_34919$.PDF (All sources accessed April 30, 2009. Document page numbers are given in parentheses in the text.)

[2]https://www.iosco.org/library/pubdocs/pdf/IOSCOPD285.pdf

[3]http://www.ifpri.org/PUBS/reservenote20090302.asp

[4]http://www.iatp.org/iatp/publications.cfm?accountID=451&refID=104414

[5]Christopher L. Gilbert, "Commodity Speculation and Commodity Investment," September 27, 2008, Unpublished paper, Table 4, At 11.

[6]"A Big Move Lies Ahead," *The Brock Report*, May 23, 2008.

[7]http://www.un.org/ga/president/63/letters/recommendationExperts200309.pdf

[8]E.g., http://agriculture.house.gov/testimony/111/h020409/Masters.pdf

[9]http://agriculture.house.gov/inside/Legislation/111/HR977.pdf

[10]http://www.agobservatory.org/library.cfm?refid=105090

[11]"Overview of the World's Commodity Exchanges," UNCTAD/DITC/COM/2005/8, January 31, 2006 at 7.

[12]Fiona Harvey, "Climate scientists warn of looming disaster," *Financial Times*, April 29, 2009.

[13]Jeremy Grant and Brooke Masters, "Brokers set out to fight backlash against OTC trade," *Financial Times,* April 28, 2009.