The Greens / European Free Alliance

Raw Materials – A Green Strategy

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Commodity Markets and Speculation

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I would like to broaden the topic, if I may, to cover the role of finance in commodity markets. Speculation is an important part of this but a lot else has also been going on in recent years, and I think it should be seen in this wider context.

The first thing to remember is that commodity markets exist for the purposes of trade, not finance. When I first encountered them in the late 1970s, that was how they stood; banks' and financiers' position in relation to them was at most supportive and subordinate.

Now that has changed. Consider these two quotations from the *Financial Times*, the first of them five years ago in April 2006:

'"There is so much investment money coming into commodity markets right now that it almost does not matter what the fundamentals are doing," said one hedge fund manager … last week. "The common theme for why all these commodity prices are higher is the substantial increase in [investment] fund flow into these markets, which are not big enough to withstand the increase in funds without pushing up prices," he said.'

Then yesterday, May 3rd, the *FT*'s 'Commodities Daily' blog reported on a 'deep uncertainty in oil markets, where banks such as Barclays Capital, Goldman Sachs, Morgan Stanley and JPMorgan Chase – the top four commodities dealers – have invested heavily.'

They have also invested in agricultural commodities as an 'asset class'. Just as important is the fact that these four leading investment banks – among the biggest villains in the 2008 crash – are now the 'top … commodities dealers'. Thirty years ago that was not so: banks did not deal in commodities at all, that was a job for companies which specialised in that business.

What we are faced with is the 'financialisation' of the commodities trade, a consequence of financial deregulation in the 1980s and 1990s. Futures trading started in commodities, and until the 1990s there was very little of it in basic agricultural products in Europe: most futures markets were in the US, serving US domestic markets, and in the UK, mostly serving that country's global trade interests in products such as coffee, cocoa and metals – but hardly at all in basic foods. So Europe largely managed without futures markets. But agricultural prices tended to be less volatile anyway under such policies as the CAP before it was reformed.

From the 1970s on, there was an expansion of futures trading into financial instruments, starting with currencies and interest rates, and then a geographical spread and diversification of commodity futures with the opening of oil futures markets as well as milling wheat and maize futures in Paris. Other financial 'derivatives' followed on, including such things as the credit default swaps and

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[*] Written up by the presenter from his notes the following day.

mortgage investment vehicles which played a large part in the 2008 banking crash. Much of this new activity, including that in commodities, was done 'over the counter' (OTC) - away from the exchanges and at the banks.

US regulations distinguish between the futures activities of 'commercial' and 'non-commercial' (i.e. financially motivated) participants, and the growing weight of the latter is seen on numerous markets. When I first encountered it in the late 1970s, the London Metal Exchange (LME) was basically a trade market, serving the needs of physical metal production and fabrication and the trade that links them. Technically, it was not a fully-fledged futures market but only a 'forward' market since its contracts did not go further than three months forward and they were settled directly between traders rather than through a clearing house. The LME played an important role as a 'market of last resort' in times of physical shortage and glut because of the stores of metal in its accredited warehouses. However, in a report published in 2007 the UK's regulatory body, the Financial Services Authority, estimated that by then 85 per cent or more of activity on the LME was conducted by financial 'index' funds and hedge funds. Meanwhile, in New York coffee futures the non-commercials' share of activity ('open interest') rose from 25 per cent in the late 1980s to more than 60 per cent in 2006.

Since the middle of the last decade this process has gone a long way further and both of those figures will assuredly have risen again since the 2008 crash. After the collapse of the 'dot.com' boom on the stock markets in 2000 investors were recommended to diversify away from a narrow dependence on company stocks and to hold up to 5 per cent in commodities and related instruments. This was reinforced by predictions from influential bank analysts of a 'commodities supercycle' which would push prices higher for many years, and the creation of 'index funds' which channel investors' money into specific classes of assets, including commodities, regardless of the 'fundamental' situation of supply and demand on the markets concerned.

Index funds built up strongly in the first half of 2008, when other asset markets had already weakened under the pressure of the early stages of the credit crisis. However, the latest push in commodity prices, since the middle of 2010, has attracted more conventional speculation from hedge funds and others, including banks' trading departments. This aims to make money out of short-term price movements rather than longer-term 'passive' investment as the index funds do.

Since futures trading has long played a bigger part in US domestic business than in Europe, that country's regulations in this area have also been more highly developed ever since President Roosevelt's New Deal in the 1930s. Since 1975 they have been in the hands of a single, specific regulatory body, the Commodity Futures Trading Commission. The CFTC requires all futures exchanges to report the trading positions on them, and these are published every week as aggregate figures divided between the two classes of commercial and non-commercial traders. Stricter rules are imposed on the latter, including limits on position sizes in several markets.

It is noteworthy that when the US strengthened its regulation of derivatives markets under the Dodd-Frank Act of 2010, much of the business even in financial derivatives was placed under the oversight of the CFTC, because a commodities regulator was deemed to understand derivatives better than regulators of financial markets did. This separation of commodities from general financial regulation, and the regular public reporting of each market's status, has not been followed in other commodity-trading centres, including London, the other main one besides Chicago and New York.

As for the future, the European Commission is to be congratulated for pursuing the strengthening of commodities regulation under a series of directives that are under preparation or being revised. However, they are being done piecemeal in a series of separate pieces of legislation, and they continue to place commodities regulation under the aegis of financial regulation rather than as a separate field in itself.

The main areas of reform now required are as follows:

1. The first requirement is to re-regulate the banks, permitting them to undertake only strictly *banking* functions and not trade on commodity markets, whether on the exchanges or with OTC instruments, or to purchase metal warehouses, launch commodity index funds or plan to set up shipping lines, as the four big ones named above have recently done. It was the banks' diversion into derivatives business which led to the crash, and then to the near-collapse of international trade in the last quarter of 2008 when the banks refused to accept each other's letters of credit, an essential day-to-day tool of foreign trade. Thus their activities in this field indirectly led them to fall down on this dull but essential function, the sort of thing that they are granted banking licences to do.

2. Introduce specific regulation of the commodity markets, separately from financial markets, as discussed above.

3. Consider the application of special rules to prevent any financial investment or hoarding in food commodities and food-related futures contracts. This legislation will not be easy to draft because there are difficulties in the precise definition of hoarding and speculation, as distinct from regular physical trade, but the principle should be accepted and followed up.