Price surges in food markets
How should organized futures markets be regulated?

The drastic increase of food prices in the period 2006-2008 spurred fears of global food insecurity. Apart from actual changes in supply and demand of some commodities, the upward swing might also have been amplified by speculation in organized futures markets. However, limiting or banning speculative trading might do more harm than good.

Food prices on the rise

Food prices soared on world markets between 2006 and 2008 (see figure). Prices of maize, rice and wheat, for example, reached their highest levels in 30 years. The crisis caused political and economic instability and led to food riots in a number of countries. Although prices have declined notably, the market is still perceived as more volatile than before the crisis.

While macroeconomic factors in conjunction with changes in supply and demand certainly caused an upward pressure on food markets, they alone cannot satisfactorily explain the hike. Some therefore believe that the “commodities super cycle” was amplified by speculative behavior in organized futures markets.

What are commodity futures?

Futures contracts involve the formal obligation to sell or buy a given amount of a commodity at a specified time. They thus provide an important instrument to “hedge” against the price risks in commodity markets and are basically used by all traders of physical commodities as part of their normal trading behavior. By entering in a futures contract, both the seller and the purchaser gain certainty of the price of their transaction, independent of the actual development of the market.

However, only 2 percent of futures contracts end in the delivery of the physical commodity. Instead, commodity futures are generally traded before their expiration date. As a result, futures also attract investors who are not interested in the commodity as such, but in making a speculative gain. In fact, commodity futures have become increasingly appealing to non-commercial investors as their returns seem to be negatively correlated with returns to equities and bonds. They thus constitute an attractive vehicle for portfolio diversification. This process has provided important liquidity to the market since speculators are assuming risks related to the price of the commodity.

Speculation and food prices

Does speculation in commodity futures increase price volatility on food markets? Some economists say no, suggesting instead that futures markets have a stabilizing effect as traders merely react to price signals that eventually depend on market fundamentals. In this way speculation would even accelerate the process of finding an equilibrium price.

High oil prices, strong demand for crops from the bio-fuel sector, falling stockpiles of food and lower cereal production all contributed to the price surge. The development was further boosted by strong economic growth and expansive monetary policies that resulted in low interest rates. Policies such as export restrictions that many countries implemented as a response to rising food prices also played a role.
What type of regulation?

Available analyses and data suggest that trading in futures markets may have amplified price volatility in the short term only. Longer-term equilibrium prices, however, are ultimately determined in cash markets where buying and selling physical commodities reflects the fundamental supply and demand forces.

Efforts to reduce speculation in futures markets might even have unintended consequences. Mechanisms to intervene in futures markets, if the futures price diverges from an equilibrium level determined by market fundamentals (a level which in itself will be difficult to determine), might divert speculators from trading and thus lower the liquidity in the market available for hedging purposes. Proposals to create an international fund to react to price hikes in futures markets might therefore not be an optimal solution. What is more, such a fund would require exorbitant resources to counteract speculation effectively.

Instead, regulatory measures should aim primarily at enhancing confidence in the good functioning of the market. This can be achieved by increasing transparency and the amount of available information on futures trading. Furthermore, suspicious behavior (e.g. traders requesting permission to invest above their speculative position limits) should be investigated closely, as already practiced by the US futures trading supervisory body. In August 2009, the agency lifted exemptions for two firms trading in maize, wheat and soybean futures.

Commodity futures have become an integral part of food markets, and they perform an important role for many market participants. Adequate regulation should improve, not ban, speculative trading in order to foster market performance.

Further information

- FAO Food Outlook, June 2010.

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