

## FINANCIAL SPECULATION INCREASES HUNGER

No. 20 / April 2011

### Overview

*World market prices for food are currently at the highest level they have been for a century. The Food Price Index of the Food and Agricultural Organization FAO is currently at 236 points – this is higher than during the hunger crisis in 2008 and the highest value since the introduction of the index in 1990. The FAO rightly fears that current price increases will once again drive millions of people into hunger.*

*The fundamental factors pushing up prices on the global food market – the growing demand for (animal-based) food and energy crops as well as increasing mineral oil prices – have been joined in recent years by further price-drivers: capital investments on the commodity markets.*

*A study conducted by the Bremen University of Applied Sciences (Bass, H. 2011) on behalf of Welthungerhilfe estimates that the involvement of investors on the forward markets for grain in 2008 was responsible for around 15 percent of the observed price level on the spot markets. Also at the present time, via various mechanisms, activities on international financial markets are having a negative impact on the import prices of developing countries and are being transferred from there to local markets.*

*The German government, the European Union and major agricultural trading countries, first and foremost the USA, must therefore, immediately and with an international display of solidarity, use their political power to curtail price-driving speculative investments in food markets. In order to do this, the involvement of financial market players from outside the industry and speculative investors on the food markets must be monitored according to internationally binding rules. Important instruments in this connection are the implementation of strict duties to report, as well as the introduction of position and price limits. A stock market turnover tax on food-based betting transactions is, according to our present estimates, a suitable instrument to make the business more expensive for “non-commercial” financial market players. This would make it possible to decelerate the financial market activities and thereby impede speculation.*

### High food prices hit the poor

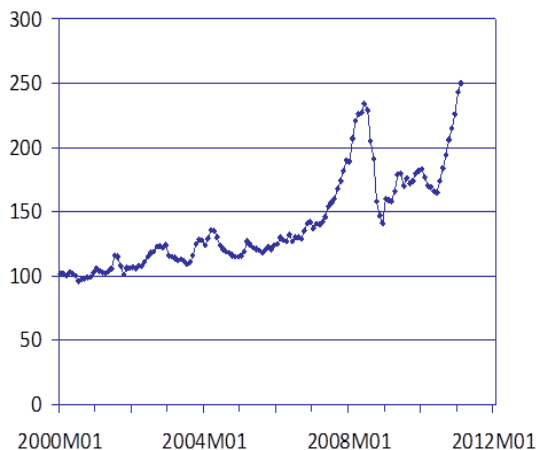
Within the last ten years the number of people suffering from hunger worldwide has increased in absolute terms and has now almost reached the one billion mark. A major reason for this is that – accompanied by sharp price fluctuations (“high volatility”) – in the same time period there has been a continuous increase in the price level of grain. The latest data shows an increase in the wheat price on the world market from about US \$ 200/ton in July 2010 to about US \$ 360/ton in February 2011.

For developing countries, which are dependent on food imports, the development of grain prices in the last ten years represents a considerable burden. Although the price increase expressed in US dollars is attributable in part to the depreciation in the value of the American currency, even taking these changes in exchange rates into account, importers from Mali or Kenya are having to pay 50 percent

more for each ton of imported grain than they did ten years ago. For Haiti, import prices for grain have increased no less than fivefold! In the last eight months alone the number of people living in extreme poverty has increased by around 44 million according to World Bank estimates.

Some developing countries are trying to stop world market price trends being transferred to local markets by granting high subsidies when very small quantities are sold to the particularly needy, or by offering food-for-work programmes. A sustainable uncoupling of local prices from increasing import prices, however, is practically never achieved, at best some time is gained.

The inflation rate for food in the majority of developing countries is therefore well above the general inflation rate.



**Fig. 1:** Food prices at a record high. The chart shows the index of world market prices for food at constant 2000 US Dollars (Basis year 2000 = 100). Source: Bass, H. 2011 with data from the World Data Bank.

Nationwide hunger protests in numerous developing countries in 2007/2008 (e.g. Burkina Faso, Haiti, Ethiopia, Philippines) and the most recent reports from Welthungerhilfe project countries (e.g. Afghanistan, Pakistan, Burundi, India, Cambodia) clearly show that high food prices intensify the hunger and poverty risk of people with a low income in developing and threshold countries: poor families spend a disproportionately high share of their household income - up to 70 percent - on staple foods. Hence, a sufficient and balanced diet becomes impossible in the event of further price increases. Families are also forced to sell such important assets as land or animals and cut down on essential expenditures on health, education and birth control. Small children, in particular, suffer in hunger situations and are affected by this for the rest of their lives (see also *Global Hunger Index 2010*).

As a rule, only farmers who are able to produce significant surpluses and make them available on the markets profit from the higher prices for staple foods. High volatility of the price of staple foods creates uncertainty among producers worldwide and inhibits the urgently required investments in agriculture in developing countries.

#### **New financial players – the inflaters "on top"**

The reasons for the price increase in staple foods since the beginning of the 1990s are diverse: although from a global point of view agricultural production has so far kept pace with the increasing demand for food, the produced food is being used to an increasing extent for other purposes. Against the background of a reduction in the area of land utilizable for

agriculture worldwide, we are experiencing competition in terms of use and area between grain for the production of food, on the one hand, and animal feed and biofuels, on the other. Other problems are extreme weather events which can have a negative influence on crops, in some countries even destroying large parts of the harvest, and rising oil prices which increase the cost of fertilizers and transport.

For several years now, however, there has been another factor that has been pushing up world market prices for grain, and which also partly explains the price bubbles of 2008 and the present price bubble: the activities of financial market investors. In order to understand this connection, we have to be aware that the actual grain trade, also known as the spot market, has for centuries (in Germany since 1842) had a counterpart on the financial market: the futures market. To protect themselves against future price increases in the coming months, wholesalers buy grain on the forward market at a guaranteed price. Conversely, producers sell grain at a guaranteed price on the forward market if they want to protect themselves against falling prices. This method of guarding against price movements is referred to in English as "hedging", players with this motive are known as "commercials" in the USA. In addition, there have always been speculators from outside the trade ("non-commercials") on the forward trading markets who try to correctly forecast future prices and, as a result, make a profit. And finally there have always been arbitrageurs who try to take advantage of small price discrepancies between different marketplaces or futures contracts with different terms, for example, by buying a little cheaper at one place and selling a little more expensively at another.

About five years ago, however, finance investors began to behave quite differently. These new players, who are also referred to as index speculators, speculate that an investment portfolio which reflects the volumes traded on the markets as in an index (for example, 5% wheat, 5% soya, etc.) will produce the safest profits while prices in an investment class generally increase. In the meantime, hedgers, traditional speculators from outside the trade and new index speculators in the USA each account for around one-third of the players on the forward markets for grain.

By continuing to purchase new contracts when the old futures contracts reach their due date for payment without paying much attention to current prices (because they expect prices to increase in the long term), the index specula-

tors create permanent demand. This results in a generally rising price trend. However, if prices rise particularly sharply, a great deal of additional capital flows into these funds and price bubbles can occur.

Although the futures market concerns purely financial transactions and not the grain trade as such (because all players, regardless of their speculation behaviour, are only making financial wagers), via the arbitrageurs the forward market does have an effect on the spot market: if the prices for the next contracts due differ from those on the spot markets, the arbitrageurs will buy on the one market and sell on the other. As a result, the spot market prices become similar to prices on the forward market, which are determined by financial market speculation.

According to the calculations of this study, the entitlements to grain supplies held on the US American grain futures exchanges by around 70 index speculators corresponded respectively to about five to ten percent of the annual global production of maize, wheat and soya – or 40 billion US Dollars.

No corresponding data is available for Germany. The study commissioned by Welthungerhilfe has therefore produced an estimate. According to this estimate, the capital invested in index-based funds for wheat, maize and soya amounts to 1.5 billion US Dollars. Since only a fraction of this capital, however, must be deposited as security for futures transactions, entitlements to grain supplies which might actually be acquired is a multiple of this figure. This is generally referred to as the leverage of

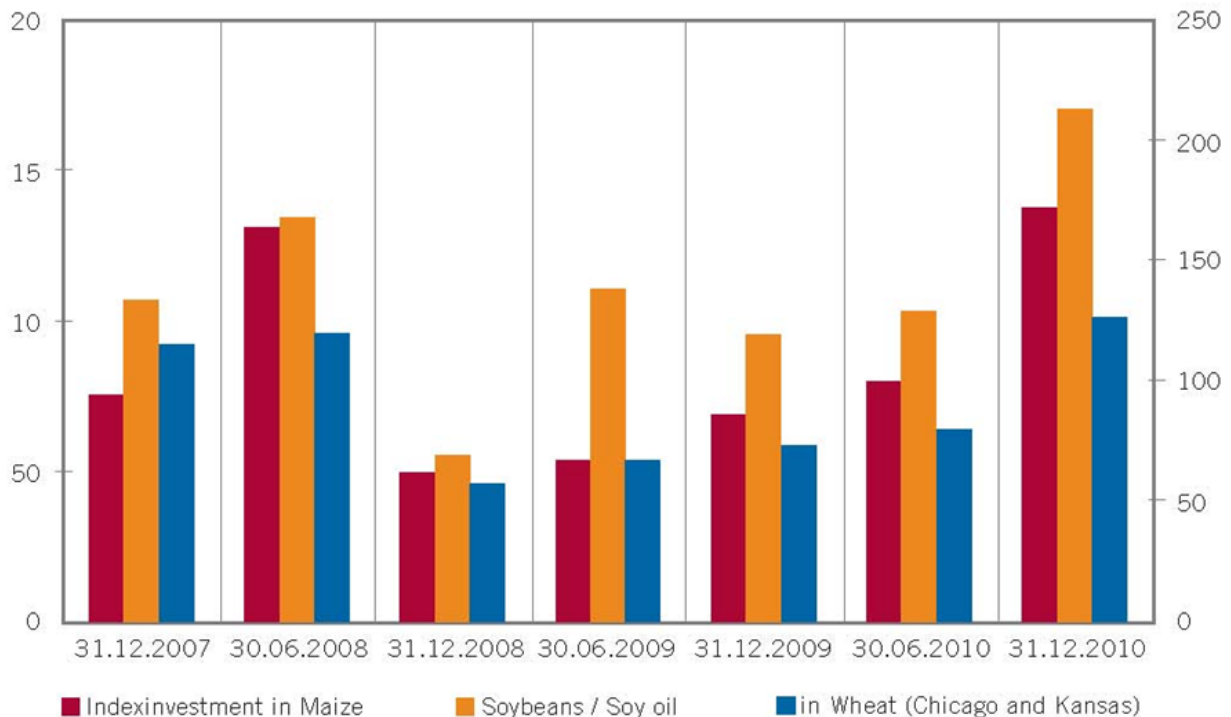


Fig. 2: Index investments of US finance companies in USD bill., 2007-2010 . Source: Bass, H. 2011 with data from the CFTC.

The study commissioned by Welthungerhilfe and conducted by the **Bremen University of Applied Sciences** (Bass H. 2011) estimates that the involvement of speculators on the grain market in the years 2007 to 2009 led to a price which was up to 15 percent higher than the calculated price based on the fundamental factors.

these investments. A threefold leverage would mean that with the capital accumulated in Germany, grain supplies worth a total of 4.5 billion US Dollars could be secured - if the investors wanted this, which is rarely the case. These transactions focus on the wager about correctly forecasting prices.

It is to be expected that the capital accumulated for these purposes in Germany will reach American levels within the next few years. The instruments necessary to do this have recently been developed and legalized; in view of the

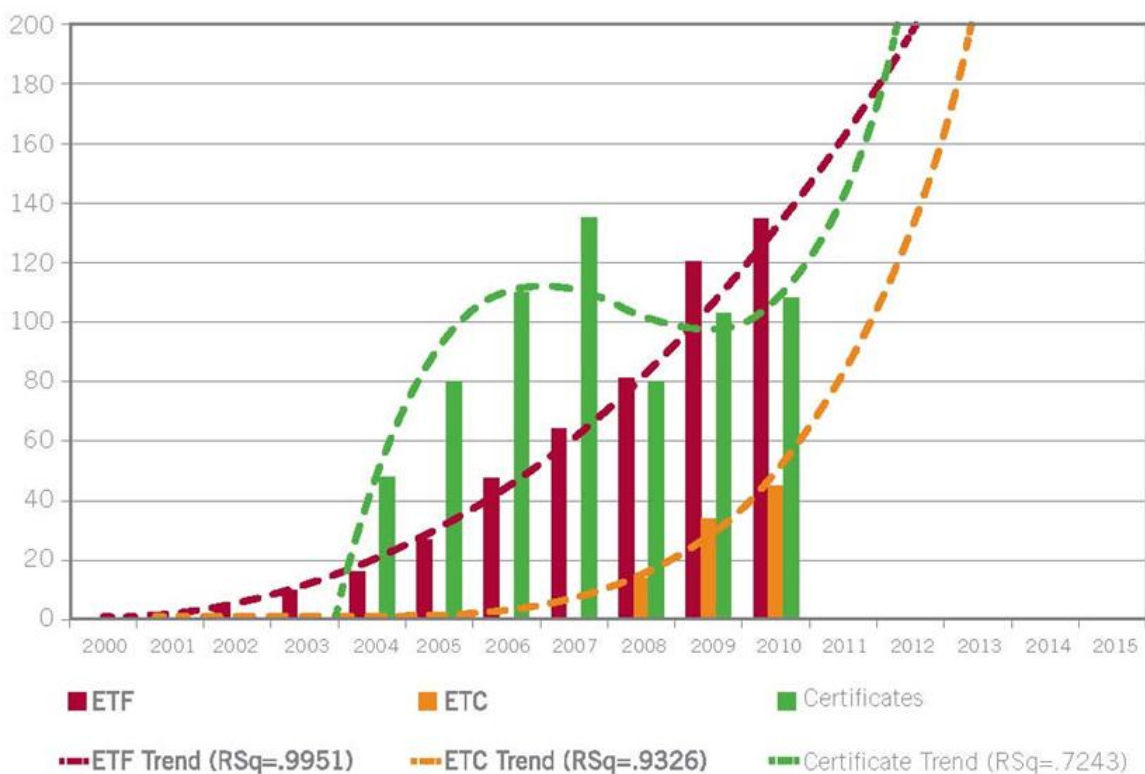
low interest rates offered by the conventional types of investment, private investors are again prepared to take risks, while the banks (first and foremost, Commerzbank, DZ Bank, BlackRock and ETF Securities) are aggressively advertising their products.

With Exchange Traded Commodities (ETCs, available since 2006), Exchange Traded Funds (ETFs: available in the USA since 1993, in Germany since 2000) and Investment Certificates also on the basis of raw materials (since the 1990s, in Germany especially since 2004), capital can be collected and purposefully invested in commodity markets.

**Market transparency**

To prevent a repetition of the food price crisis of 2007/2008, governments and others must urgently ensure that global markets for basic staple foods, like grain and soya, once again operate according to fundamental market data – supply, demand, stock levels – in order to stabilize markets and cut price peaks.

A more transparent market is of central importance in this context. If export restrictions (such as those in Russia in 2010) lead to an artificial scarcity of supply and thus to a direct, alarming increase in the price of wheat on the



**Fig. 3:** Managed assets in ETFs, ETCs and investment certificates, Germany, 2000-2010 and trend forecast. Source: Bass, H. 2011.

**Market transparency and adequate regulation of the agricultural raw material derivative markets are important regulating instruments to prevent a renewed food price crisis**

In view of the grave consequences of exploding food prices on the poor populations of developing countries, **Welthungerhilfe demands:**

world markets, as they did in 2010 despite the best wheat harvests in three years, this not only indicates severe market distortion. It also strengthens the scenario for financial market investors, who bet on rising prices. Even in times of global and regional grain shortages, the international community must keep the trade open (exception: countries with food crises) in order to preserve the functionality of agricultural markets.

**Regulating markets for agricultural commodity derivatives**

It is impossible to fully ascertain the precise effects of the involvement of financial market

players on trade in grain and soya, primarily as a result of the inadequate data situation.

In the discussions about the imminent European reform of the financial market directive, Welthungerhilfe is appealing to the German government and European Union, in an international act of solidarity - primarily together with the USA - to develop regulations for trade with agricultural commodity derivatives which will curb excessive speculation with agricultural commodities. In particular, it calls for:

#### The introduction of strict reporting obligations

The objective of the measures must be to create stable, settled markets for agricultural commodities so that profit potentials for speculators are reduced. Improved documentation and, as a result of this, a reduction in the speed of transactions resulting from the obligation to report, would contribute to a clear deceleration and simultaneously increase the transparency of the market. Obligations to report would obstruct over-aggressive trade instruments, such as the "Exchange Traded Commodities". They apply to the issuers of derivative products, to trade activities conducted by so-called index traders, also to "over the counter" (OTC) transactions, in order to limit evasive movements from the easily-monitored exchanges to the quasi-private and thus non-monitorable trade.

#### The introduction of a stock exchange tax on food-based speculative transactions

The speculative activities of market players who have no connections to the agricultural trade push up food prices higher and exacerbate global hunger. It is therefore justifiable to impose the negative external effects of such transactions upon these players and make their speculative business more expensive. In our opinion, a stock exchange tax on food-based speculative business is conceivable for this purpose. This would make it possible to decelerate financial market activities and thereby impede speculation.

#### Imposing position and price limits

Dealers should only hold a certain volume of derivatives in order to prevent a concentration among individual dealers. Volumes should be based on the actual volumes of available agricultural goods. If the price limits for agricultural commodity derivatives are exceeded, trading should be suspended in order to prevent panic reactions and price distortions.

#### Conclusion

Speculation-related price hikes for staple foods lead to the violation of the human right to food if they make it difficult or impossible for poor people to access adequate food. Within the context of G8 and G20 and in an international act of solidarity, the German government, the European Union, and major agricultural trading countries must use their political power to contain price-distorting agricultural speculation. Governments should make full use of their means to ensure that banks refrain from any action that violates the human right to food.

#### Sources, among others

Bass, H. (2011): Finanzmärkte als Hungerverursacher? Study by the Bremen University of Applied Sciences.

(Commissioned by Welthungerhilfe).

Available as download:

<http://www.welthungerhilfe.de/nahrungsmittelstudie2011.html>

Welthungerhilfe, IFPRI, Concern Worldwide (2010): Global Hunger Index. The Challenge of Hunger: Focus on the Crisis of Child Undernutrition. Available as download: [http://www.welthungerhilfe.de/fileadmin/meda/pdf/WHI/WHI2010\\_final\\_en.pdf](http://www.welthungerhilfe.de/fileadmin/meda/pdf/WHI/WHI2010_final_en.pdf)

#### Author

Antje Paulsen  
Adviser for Development Policy

*Deutsche Welthungerhilfe e.V.*  
*Friedrich-Ebert-Straße 1*  
*D-53173 Bonn*

[antje.paulsen@welthungerhilfe.de](mailto:antje.paulsen@welthungerhilfe.de)

Tel: +49-228-2288-205  
Fax: +49-228-2288-188

We would like to thank Prof. Dr. Hans H. Bass from the Bremen University of Applied Sciences for his valuable guidance.