



International Policy Aspects of Food Price Inflation: Some Remarks **By Aldo Caliari, Center of Concern**

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There are, undeniably, a number of fundamentals at play behind the ongoing food price inflation.

- Weather shocks, starting in 2005: droughts in key grain-producing regions. There is not much we can do about these. In fact, they will only intensify if the forecasts about the effects of climate change are right.
- Increased demand: higher demand for animal protein—which demands more grain feedstocks—by dynamic emerging economies such as China. This is not a “natural” factor but it is one we actually would not want to do anything about. After all, it is a good thing that more people are in a position to purchase food.

But there are a number of “man-made” factors that have exacerbated the crisis, and today I want to talk about these, because these are the ones we actually can do something about, and should.

Commodity investment

Large amounts of capital that have flown into commodity-based investments, for many investors these have been an option to diversify portfolios. As global demand for commodities intensified, investments became not just a way to diversify, but a source of returns, or made with purely speculative purposes. In some estimates, funds diverted to commodity investments amount to USD 100 billion to 300 billion.

Besides these funds, a number of instruments and institutions –such as hedge funds – can leverage their investments, betting on rising prices (“Bubble” dynamics created).

In this regard, there is evidence of marked increase of activity in commodity-linked instruments. There are now 60 commodities-linked US funds and notes tracked by Financial Research Corporation (only nine have records stretching back more than two years). In Europe, over 100 exchange traded commodities are on offer, mostly from London-based ETF Securities.

It is important to distinguish the funds, representing a stake in the commodities, from exchange-traded notes, essentially debt instruments, often unsecured debt, which poses credit risk.

Because of the growing interest in commodity markets, there is also a proliferation of commodity indices. Many leading investment banks have launched their indices in an effort to capture a share of the funds flowing into commodity markets.

In London, last March, series of 33 leveraged exchange traded commodity products based on indices tracking, among other things, coffee, corn, wheat. In this case, besides the risk of the underlying indices, investors are also advised to consider the potential risk of the bank underwriting the note. Thus, there are underlying liquidity risks, exactly like the ones in the mortgage-based securities that triggered the unsustainable growth in asset prices leading up to the unraveling of the US crisis last year.

Goldman Sachs estimates that pension funds and mutual funds have invested a total of approximately \$85 billion in commodity index funds, and that investments in its own index, the Goldman Sachs Commodity Index (GSCI), has tripled over the past few years. Since the end of 2005, index-linked commodity investment has doubled to \$260 billion, according to Citigroup. During the first quarter, about \$40 billion was added to the market.

Adding to this trend is the proliferation of hedge funds that have the flexibility to invest in commodities in all their forms - physical, indices, public and private equity and derivatives.

Now, the impact of speculation on food prices is felt by three channels:

1) Speculation on agricultural commodities, directly

In Chicago Stock Exchange (CHX), since January of this year alone, investment activity in the agricultural sector has risen by a quarter. Involvement by hedge funds in the raw material sector has trebled in the past two years to reach a total of \$55 billion.

A hedge fund manager is on record recommending, in the summer of 2006, the "extraordinary profitability" of agricultural crops to his shareholders. According to German investor, Andreas Grünewald, (that controls a volume of €50 million, of which €15 million is from investment in raw materials) says "Raw materials are the mega-trend of the decade," and his company intends to intensify its involvement in both water and agricultural stocks. MIC (his company's) investment in wheat alone has already yielded profit levels of 93 percent for the 2,500 members of the club.

2) Speculation on oil markets

The high cost of oil impacts food prices through its impact on transportation, processing and distribution costs. But, how much of the increase in the cost of oil is due to fundamentals? Also open to question.

Noting that in all previous economic downturns commodity prices went down, the IMF puts the oil price impact purely due to activity in the financial markets at around USD 20 -30. Other estimates say around 60 % of the price is manufactured by speculation.

A large problem is that the price-discovery function of the market has been compromised. The price of oil is set in very non-transparent mechanism. Large influence of over-the-counter futures, and unregulated trading in the process of price determination throw doubt on the extent to which oil prices respond to actual market dynamics.

In fact, the OPEC countries have also raised this issue several times, pointing out that there are no shortages in supply that could justify the extent of the increase, neither are increases in supply the answer to rising prices.

The determination of oil prices today is done by a process so opaque that only a handful of major players --oil trading banks such as Goldman Sachs or Morgan Stanley -- have any idea who is buying and who selling oil futures or derivative contracts that set the physical oil prices. The role of the international oil exchanges in London and New York is crucial (Nymex in New York and the ICE Futures in London today control global benchmark oil prices which in turn set most of the freely traded oil cargo.)

With the development of unregulated international derivatives trading in oil futures over the past decade or more, the way has opened for the present speculative bubble in oil prices.

A critical issue here is that the CFTC's ability to detect and deter energy price manipulation is suffering from large information gaps as traders on OTC electronic exchanges and the London ICE Futures are currently exempt from CFTC reporting requirements. The reporting on large traders' activity is essential to analyze the effect of speculation on energy prices. NYMEX in New York isn't exempted, but persons within the United States seeking to trade key US energy commodities (US crude oil, gasoline, and heating oil futures) are able to avoid all US market oversight or reporting requirements by routing their trades through the ICE Futures exchange in London instead of the NYMEX in New York.

Because of the lack of regulation and reporting there is no precise or reliable figures as to the total dollar value of recent spending on investments in energy commodities, but the estimates are consistently in the range of tens of billions of dollars.

3) Speculation on biofuel industry

Given the feedbacks between the biofuel and the oil markets, there are, of course, impacts on the possibility of a bubble mounting on the biofuel market. As oil becomes more expensive, the perceived profitability of biofuel production as an alternative, also rises. Then the perception drives increases in investment, leading to higher demand for the raw materials –corn being the most problematic in this regard, but not the only one.

The FAO reports growing feedback and significant interlinkages between crude oil- biofuels- biofuel commodities. Moreover, the linkages will become tighter if trend to policies that facilitate substitution continue. Then, the biofuel sector risks mirroring the price inflation of oil.

Feeding this rising commodity market activity are two important factors that it is important to mention:

- 1> Subprime mortgage crisis, and the pricking of the real estate bubble. As Minsky reminds us, as soon as a bubble gets pricked, another starts forming, this is the nature of financial markets. So the investment flying out of real estate is finding a new heaven in commodities.
- 2> The US Fed's consistent easing of monetary policy.

The unintended consequence is growing worldwide inflation.

The US Fed responded to the credit crisis by cutting interest rates and by other extreme measures to pump liquidity in the system. Because of the unique position of the U.S. at the center of the world dollar standard, this has the result of increasing monetary supply worldwide, and inflation is the consequence. This is no different, in that sense, from the exporting of inflation that happened in the 1970s, with a similar easing of US monetary policy.

The inflation threat is aggravated because many foreign central banks intervene to prevent their currencies from appreciating too fast, thereby expanding their money supplies. A number of countries have tried to achieve stability by fixing their currencies to the dollar. These countries now must follow Fed's cuts in rates—of investors would move money to these countries undermining the pegs—so they also create inflation by increasing the supply of money.

So the rush to commodities (fuel commodities AND agriculture) is also fed by investors trying to preserve the value of their assets in the face of a depreciating dollar.

Non-competitive structure of markets

There are other dimensions to the food crisis that have to do with the non-competitive structure of the markets that contribute to the formation of food prices.

In a period of high inflation in raw materials, one would expect to see the profits of major food companies being squeezed. After all, the high prices of raw materials would mean they have lower profit margins as they have difficulties in passing the prices to consumers.

But the oligopolistic and monopolistic characteristics of the market have meant that the major food companies are actually reaping highest profits than ever.

Monsanto's net income for the three months up to the end of February this year had more than doubled over the same period in 2007 [from \$543m (£275m) to \$1.12bn, Its profits increased from \$1.44bn to \$2.22bn.]

Cargill's net earnings in that same period went up by 86 per cent [from \$553m to \$1.030bn]. Also in this period Archer Daniels Midland increased its net earnings by 42 per cent [\$363m to \$517m, the operating profit of its grains merchandising and handling operations jumped 16-fold from \$21m to \$341m.]

It is also important to scrutinize the fertilizers market, which offers an example of unwarranted price increases in a highly non-competitive structure. Fertilizer prices are rising faster than those of almost any other raw material used by farmers. In April, farmers paid 65% more for fertilizer than they did a year earlier (in the same period, price increases of 43% for fuel, 30% for seeds and 3.8% for chemicals).

In this market, a small group of companies in the U.S., Canada and Russia dominate the global production of potash and phosphate. These are the ingredients of fertilizer, alongside nitrogen. In several countries, like in the US, makers of potash and phosphate are shielded from certain antitrust rules (In the U.S., for example, phosphate makers are among a handful of industries empowered by the 1918 Webb-Pomerene Act to talk with competitors about pricing and other issues.)

By way of example, Potash Corp. of Saskatchewan Inc., posted first-quarter net income of nearly triple the year-earlier figure. Mosaic Company, in which Cargill Inc. of Minneapolis holds a controlling stake, saw its income for the three months ending 29 February rise more than 12-fold, from \$42.2m to \$520.8m.

Price volatility and aggravating factors

It is noteworthy that, more than anything, price volatility characterizes agricultural markets, and it always has. But there are a number of factors that aggravate this feature this time round. They have to do with the general conception of the agricultural sector that shaped policies advised—in many cases imposed-- by the World Bank/ IMF in the last two and a half decades-- though in a number of cases they were adopted for ideological reasons- and the role of the World Trade Organization. The net result of these factors has been a higher exposure to volatility of farming sectors, especially in developing countries, but also in developed ones—as

we refer to small producers. The environment for long term agricultural production was, thus, undermined. Factors that can be attributed to these policies are:

Low stocks: The shock in supply would not be so pronounced without the added factor that stocks are unusually low. Sustained reduction in world stocks were noted since the mid-1990s.

The IMF/ World Bank have advised countries to get rid of their state-owned trading companies or marketing boards, that used to play a role in keeping prices stable. The infamous case of Malawi's grain reserve, sold by IMF instructions, is a case in point. By selling grain in times of scarcity and buying in times of oversupply, state-trading companies would keep a certain stock as a cushion, and mitigate price volatility. In turn, price volatility makes sustained investment in agriculture –another factor contributing to low production and low stocks—less profitable and, therefore, more difficult.

Reduction of supply capacity: lowering of trade barriers, subsidies to inputs, services, research and extension, in the assumption that the global market should provide for food in a more efficient way, are also consequence of IMF/Bank policies, and the disciplines of the World Trade Organization agreements. The same ideological beliefs had an impact on lower investment in agriculture.

Food aid: there seems to be a growing consensus on the way that the provision of food aid in kind, rather than in cash—a delivery modality particularly preferred by the US-- has contributed to the destruction of agricultural output in many developing countries. This is because normally cash could be used to buy locally or regionally, thereby strengthening demand and market stability for local producers, with in-kind delivery having the opposite effect as it crowds out the output from local farmers.

Thank you for your attention.

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