# Comment Regarding Regulatory Treatment of Agricultural Swaps

***In response to U.S. Commodities Futures Trading Commission 9/28/10 Advance Notice of Proposed Rulemaking seeking public comment regarding appropriate treatment of agricultural swaps***

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One of the most important single features of the Dodd-Frank financial reform law is its provision to prohibit swaps in agricultural commodities. It is crucial that this prohibition be maintained in its full force, to prevent destabilizing speculative trading to dominate the setting of prices in agricultural markets. Dodd-Frank does include provisions for exemptions to this prohibition. But providing such exemptions will compromise the integrity of the new financial regulatory regime under Dodd-Frank.

Derivative markets in agricultural commodities have long been relied upon to assist farmers and others to maintain stability in their business operations and plan for the future. But deregulation of these markets through the 2000 Commodities Futures Modernization Act created extreme volatility in agricultural derivative markets, which led to severe price swings in food prices, along with oil prices, that destabilized businesses and household budgets in the U.S. and throughout the world. This experience led Gary Gensler, the Chair of the Commodities Future Trading Commission (CFTC)—the federal agency charged with regulating commodities futures markets—to report in a 2009 Senate hearing that "I believe that increased speculation in energy and agricultural products has hurt farmers and consumers." The huge run up in food prices in mid-2008 also created a worldwide food emergency, with about 130 million additional people in the developing world having faced malnourishment as a result, according to a United Nations study.

## Agricultural Price Volatility and its Consequences

A 2009 study by the United Nations Conference on Trade and Development reported that the commodity "price boom between 2002 and mid-2008 was the most pronounced in several decades—in magnitude, duration, and breadth." Just starting from the full year of 2006, the average price of crude oil on global commodity markets rose by 71 percent by mid-2008, before collapsing by 60 percent over the next six months. Similarly, the average price of a broad basket

of food products rose by 43 percent on global commodity markets, before dropping by 23 percent over the next six months.

Focusing on the global wheat market, the price of wheat rose by 125 percent between May 2007-March 2008, then fell by 50 percent between March – December 2008, then rose by 17 percent between December – May 2009, then fell again by 38 percent from May 2009 – June 2010, before, most recently, rising again by a massive 72 percent between June and September 2010 (data from the IMF Commodities Prices database).

Such food price volatility wreaks havoc on the business operations of U.S. farmers. Of course, farmers like high food prices just as much as consumers like low prices. But wild swings in global market food prices make it extremely difficult for farmers to manage their businesses. Consider, for example, a small U.S. farmer family with an annual income of $60,000. The family is considering purchasing a new tractor for $20,000, which they could afford as long as the business continued generating an average of $60,000 in income. But if global food prices fall by 40 percent, and family income declines with it, to, say, $40,000, the funds to cover the tractor along with normal living expenses are gone.

The most severely impacted victims of commodity price volatility are people in developing countries, where it is common for families to spend 50 percent or more of their total income on food. It is therefore no surprise that, as the United Nations cited above found, the 40 percent rise in average food prices in mid-2008 led to malnourishment for 130 million additional people This food price spike also generated food riots and political instability in 33 developing countries at that time (as based on testimony by Josette Sheeran, Executive Director of the UN World Food Programme, in testimony submitted to the U.S. Senate Committee on Foreign Relations, 5/14/08). Low-income people in developing countries have been further hammered by the fact that, even though global food prices falling sharply from their mid-2008 peak, they are still today, on average, about 20 percent higher than they were in 2006. The 72 percent rise in the price of wheat between June – September of this year makes clear that the extreme food price spike in 2008 was not a one-time aberration.

**Are Unregulated Derivative Markets Responsible for Agricultural Price Volatility?**

It is now widely acknowledged that financial speculation was the major factor behind the sharp price rise of many primary commodities, including agricultural items over recent years (see, for example, UNCTAD 2009; IATP 2008 and 2009; Wahl 2009; Robles, Torrero and von Braun 2009; UN Special Rapporteur 2010). One of the most important recent studies on this question was by the World Bank (Bafis and Haniotis 2010). This World Bank analysis recognises the role played by the “financialisation of commodities” in the price surges and

declines, and notes that price variability has overwhelmed long-term price trends for important commodities.

Other factors have contributed to the extreme volatility in food prices. One additional influence has been the rising demand for agricultural commodities to be used for biofuels. This has pushed up prices for corn, sugar cane, and vegetable oil, the food products used most heavily as biofuel raw materials. But this increase in demand is occurring at a fairly steady pace. Such steadily growing increased demand pressures could not explain wild price swings such as we have seen with wheat over the past two years.

One factor that is frequently cited as an influence is the rising demand for commodities in China and India tied to their rapid economic growth. But this factor has been greatly overstated. In fact, food consumption in China and India has actually declined in recent years, both in the aggregate and on a per capita basis.

Some research has been recently produced that dismisses the role of speculation on unregulated derivative markets as contributing to food price volatility, most notably a draft report issued in September by the OECD. Without plunging into the technicalities of the literature more generally, it is reasonable at this point to conclude that the overwhelming weight of research does find that speculation on agricultural derivative markets has been highly destabilizing for food prices.

**The Problem of Distinguishing Hedgers from Speculators with Agricultural Swaps**

Even if, in principle, the CFTC saw merit in granting a limited number of exemptions to agricultural swap dealers on grounds that they are legitmate hedge operations as opposed to market speculators, in practice it is very difficult to separate out such market hedgers from speculators. This problem was explained forcefully in a paper “On the Nature of Trading: Do Speculators Leave Footprints” by Prof. William Silber of New York University. Prof. Silber describes how two types of traders, “market-makers” and “speculators” establish their positions and manage their risk exposure. Market-makers are customer-based traders, who earn money on the bid/ask spread without speculating on future prices. Speculators are traders who earn money trying to anticipate the direction of future price movements. The key relevant point here is that Silber’s discussion makes clear that balance sheets are insufficient to determine whether a trader is a market-maker or a speculator. This means that speculators can readily engage in activities that, a least through examining their balance sheet, would make them appear to be market-makers. Hence, if the CFTC chose to relax the prohibition on agricultural swap trading endorsed by Dodd-Frank, there is a strong prospect that speculators will find ways to allow themselves to appear eligible for exemptions.

## Conclusion

There is a straightforward reason why Dodd-Frank established a prohibition on agricultural swaps: the severe volatility of food prices in recent years caused by the deregulation of commodities futures markets has created great harm for consumers and farmers in the United States, and has produced malnutrition and food emergencies throughout the developing world. It is crucial for the CFTC to maintain the integrity of Dodd-Frank, by not granting exemptions to the outright prohibition of agricultural swap trading.

Even with the prohibition against agricultural swap trading, there are readily available venues within the Dodd-Frank regulatory system for farmers and others to hedge as needed to support their business purposes. That is, they can hedge in futures markets that are operating in exchanges and subject to the regulations within these exchanges, as stipulated by Dodd-Frank. These regulations include capital requirements for the operators of exchanges, margin requirements for traders, and position limits on traders. There is no basis for allowing any trader to obtain an exemption from this regulatory regime, and thus, specifically, no basis for offering exemptions from the prohibition of agricultural swaps.

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