How Wall Street's Bets Are Increasing the Price of Food

Financial speculation played a significant role in driving up food prices during the Great Recession of 2007-2009 and is doing the same today.[1] Many agricultural commodities reached record highs in 2022 accompanied by significant increases in speculative financial activity.[2] This is no coincidence. Speculation on commodities exacerbates price volatility and distorts prices.[3] Due to regulatory loopholes and the powerful financial lobby, it is now easier than ever for banks and other financial institutions to overwhelm farmers and commercial commodity purchasers with trillions of dollars' worth of unaccountable speculation, all in search of short-term profit. This harms farmers and consumers, especially those in developing countries.[4]

Commodity Markets Basics

Commodity markets are where raw products (like grain, livestock, and oil) are traded, often through derivatives (i.e., contracts).[5] These derivatives include commodity *futures*, which allow farmers to sell crops — and buyers to buy them — for an agreed-upon price in the future, regardless of the market price at the actual time in the future when the contract is resolved. Commodity *options* (another type of derivative) also give farmers/buyers the option to sell/buy crops for an agreed-upon price in the future but do not require the exchange to be completed.[6] In theory, these financial instruments help farmers and food manufacturers reduce risk from volatile prices and uncertain crop yields. In practice, due to insufficient regulation, commodity markets are subject to price distortion due to excessive speculation (the trading of commodity contracts for profit) as well as outright fraud and manipulation.[7]

Speculation often comes from participants that have no intention of ever purchasing the physical commodity in question (corn, wheat, oil, etc.). Speculators include hedge funds and investment banks whose main concern is return on investment.[8] These speculators often trade commodity swaps, which are the financial instruments seen as the cause of the 2008 financial crisis.[9] Swaps are essentially a bet on the value of an underlying commodity and are most used by speculators because swaps deal with exchanging cash flows rather than the physical commodity underlying the trade.[10]

An example is a trader who owns a claim worth one bushel of wheat priced at $10 in three months' time who is trading this claim to someone else for $12. In this case, the new owner of the claim is betting that the value of the underlying wheat will increase by at least $2 per bushel in three months. Clearly, the purpose of this swap has nothing to do with producing wheat but is instead to speculate on the future value of wheat in search of profit. In swaps, the physical commodity (in this case wheat) is not actually exchanged — yet swaps can still drive up prices.[11]

The main exchange body overseeing the trading of commodities is the Chicago Mercantile Exchange (CME), which facilitates over 92 percent of U.S. exchange-traded derivatives.[12] Traders also band together in organizations such as the International Swaps and Derivatives Association (ISDA).[13] The larger banks in the ISDA are some of the loudest voices in the association: the four largest U.S. banks — Citibank, JPMorgan Chase, Goldman Sachs, and Bank of America — control 90 percent of the U.S. swaps market.[14]

Despite the significant role that unregulated swap trading played in the 2008 financial crisis, Wall Street lobbied against position limits (which limit the number of derivative contracts one trader can own) that were proposed by the U.S. Commodity Futures Trading Commission (CFTC) as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The ISDA lobbied against similar rules proposed by the European Securities and Markets Authority.

In October 2020, the CFTC lost a decade-long battle with speculators and exchanges to impose position limits on 26 commodities, instead leaving the exchanges and traders themselves in charge of determining what trades they count toward these limits.[15] Speculators also take advantage of regulatory loopholes, including one that allows banks to trade unlimited amounts of swaps unregulated by any U.S. entity as long as the trade comes from an offshore subsidiary.[16]

Speculation Drives Up Food Prices and Global Hunger

The current imbalance in the market means that "genuine buyers and sellers are virtually irrelevant now when it comes to setting prices."[17] Moreover, with help from recent regulatory rollbacks won by the financial lobby, commodity markets have seen an increase in non-commercial trading (speculation) since the onset of the COVID-19 pandemic and the Russian invasion of Ukraine. In early 2022, speculators' bets on price increases for grains and oilseeds hit highs not seen since August 2012.[18]

While many blame supply chain shocks for rising food prices, the increase in speculative trading has left many farmers and food buyers unable to use futures contracts due to inflated and volatile crop prices — similar to events leading up to the 2008 financial crisis.[19] Some experts estimate that deregulated speculative activity dictates at least 10-25 percent of the current prices that consumers face.[20]

Oil is another example of a commodity that involves price spikes that ripple throughout the economy. Similar to agricultural commodities, swaps determine the price of oil, outnumbering trades of physical oil 13:1.[21] Increased speculation drives price volatility that can profit oil traders and producers. In the years following the onset of the pandemic, oil traders saw record profits and revenues, with the largest independent oil trader, Vitol, earning net profits of more than $4 billion in 2021.[22] The current combination of increased speculative activity in the oil market, record profits for oil companies, and the highest levels of inflation in over 40 years, all in the first half of 2022, is no coincidence.[23]

Food prices have similarly experienced record increases.[24] Because lower-income households spend a larger share of their income on food, they feel the pressure of rising food prices the hardest.[25] This exacerbates food insecurity for many marginalized families in the United States and across the globe, with the situation in less-affluent countries reaching a dangerous tipping point.[26]

Across the United States in 2022, food insecurity rose to levels similar to those seen in 2020, after falling in 2021; meanwhile, food insecurity for employed adults in 2022 surpassed 2020 levels.[27] Worldwide, since 2007, the soaring cost of staple crops has pushed more than 40 million people into hunger, and in 2020 nearly 12 percent of the world was classified as severely food insecure, a figure that is expected to keep increasing.[28] Without intervention, the United Nations estimates that "300,000 people could starve to death every single day over a three-month period;" overall, global food shortages and high prices exacerbated by speculative activity could lead to more deaths than the COVID-19 pandemic.[29]

On top of this, increasing and volatile food prices do not translate to increased income for farmers. Rising energy costs raise farmers' input prices, meaning that farmers may not see increased revenue even when crop prices are high.[30] For wheat, increased speculation in the market following Russia's invasion of Ukraine drove the price to levels not seen in over a decade, causing purchasers to withdraw bids and leaving farmers without buyers for their wheat crop.[31] This phenomenon, which also occurred leading up to the 2008 recession, sums up the disconnect between speculators' goals in the commodity market and the physical exchange of goods that the markets were originally set up to facilitate. This is a direct consequence of the lack of regulation in commodity markets.[32]

Looking Ahead

In sum, the oversized role of speculation in commodity markets raises food prices and hurts both farmers and consumers.[33] Not only have markets become less regulated, but the main exchange — CME Group — is introducing a price volatility index that will allow traders to bet on the volatility of prices.[34] This development will allow traders to profit off of the volatility they cause. It could even incentivize more price volatility as those traders see an opportunity to profit off of bets on the index.

Climate change will only increase these price changes because it will impact the supply of food across the world. The Intergovernmental Panel on Climate Change estimates that agricultural productivity has fallen 21 percent since 1960 due to climate change, with the worst of these effects occurring in Africa and Latin America.[35] These effects can be extreme: for example, Canada's wheat yield dropped nearly 40 percent between 2020 and 2021 due to abnormally dry weather.[36] Since the 1980s, many low-income countries have become dependent on grain imports, with import bills tripling over the past few decades. Supply shocks, coupled with price increases amplified by unregulated speculative activity, will greatly impact food supply for millions of people who are already food insecure.[37]

To recalibrate commodity markets so they operate in the interests of farmers and consumers, as they were originally claimed to do, the CFTC and other regulatory bodies must regain the authority recently taken over by the exchanges and ban speculative trading in these markets on vital commodities. This can be done by closing existing loopholes and establishing meaningful and binding position limits for traders. Without sufficient regulation in these markets, we will repeat mistakes of the past and the world's most vulnerable populations will suffer.

Endnotes

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