UN Commission on Reforms of the International Financial and Monetary System

Civil Society Consultation, February 2009

"Comments on regulating commodities exchanges as financial markets"

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On October 18, 2008, the President of the United Nations General Assembly, Miguel D'Escoto Brockmann, announced the formation of a Commission of Experts to analyze the causes and make recommendations to governments and international financial institutions on how to remedy the global financial crisis. IATP President Jim Harkness went to a preparatory session of the Commission and blogged about it on November 2, noting in particular, connections made there between the global food and financial crises.[1] The Commission prepared background documents and then opened a civil society consultation in January, requesting comments about four sub-themes to be analyzed by Commission working groups, chaired by Nobel Prize winner Dr. Joseph Stiglitz. The Commission of Experts will incorporate civil society contributions in papers to be discussed at a UN High-Level Meeting, June 1-4 in New York City. Civil society representatives will be able to speak with government delegates at multi-stakeholder round tables on June 1-2.[2]

Comments were limited to 5,000 characters on each of the sub-themes, plus supporting bibliography. IATP submitted the following (slightly expanded and edited) responses to two of the sub-themes.

Financial regulation

IATP has had Special Consultative Status with the UN's Economic and Social Council (ECOSOC) since 2000. IATP is grateful to have the opportunity to respond to the NGO Consultation for the Commission of Expert's report to the General Assembly.

Perhaps the least regulated of all financial markets are commodity exchanges, which, despite their name, are primarily a market for trading price risk management instruments, rather than a venue for trading physical commodities. In the globally influential U.S. commodity exchanges, perhaps as few as 7 percent of all futures and options contracts result in a commodity delivery. Government and private sector agricultural, mineral and energy investments and planning are determined with reference to global commodity prices that are strongly influenced by financial speculation. When speculation becomes excessive relative to the liquidity needs of bona fide hedgers in physical commodities, the resulting price volatility can become so extreme as to frustrate *ex* ante rate of return analysis and paralyze investment.

The market power of private Over the Counter (OTC) trades in commodities derivatives, such as commodities index funds, has created a kind of "shadow" commodities system whose trading data is not reported to regulatory authorities. Weak regulation of these markets and extreme price volatility resulting partly from regulatory failure has had devastating affects on food and energy security around the world.[3] Nevertheless, for firms that can induce and profit from price volatility, commodities speculation instruments are enormously profitable, and hence the incentive for traders to circumvent regulation is very high. For example, an estimated third of all net income for Goldman Sachs in 2008, some $1.5 billion, came from commodities trades.[4] For the aforementioned reasons and more, the Commission of Experts should deliberate on how to best regulate commodity exchanges.

IATP has published a short report on commodities speculative instruments and U.S. legislation that would reduce the amount of and opportunity for excessive speculation in commodity exchanges.[5] The report considers the possibility of multilateral rules on commodities derivatives. We submitted invited testimony[6] to a U.S. congressional hearing on a later version of that legislation.[7] A Commission of Experts analysis of the effects of excessive speculation on the U.S. agricultural system and of commodity exchange legislation may yield some recommendations for broader jurisdictions of financial regulation.

Extreme price volatility induced by excessive speculation is only one factor in the commodities price spike that induced food riots and energy shortages in 2007 and the first half of 2008. The consequences of a return to falling agricultural commodity prices for most years of the past three decades are perhaps less obvious, but equally severe: agricultural export dumping that undermines national productive capacity in net food importing developing countries. Better regulation of commodities exchanges alone will not ensure more stable and remunerative commodity prices. Public management of commodities stocks and tough enforceable trade disciplines on the dumping of commodities at below cost of production are other policy tools needed to stabilize prices for investment and planning. However, improvements in supply chain management and trade policy will be readily undermined by the induced price volatility of weakly regulated commodity exchanges. Here then, are issues that the Commission of Experts' report should bring to the attention of the General Assembly.

1. OTC trades of both commodities and financial derivatives form part of the trillions of dollars of "dark pools" of private and unregulated investments. Since OTC trades strongly influence prices in public exchanges, all OTC trading data should be reported completely and promptly in all jurisdictions of globally traded derivatives, so that exchange regulators can act promptly when traders exceed speculative position limits. Position limits should apply equally to all market participants, lest there is a continuation of the regulatory exemptions, exclusions and waivers of the last decade for favored financial institutions. These deregulatory measures have resulted in crony capitalism "legally" enriching the few financial institutions "too big to fail," and now enormous public liabilities with few performance requirements.

2. "Self -regulation has failed," Alan Greenspan, former U.S. Federal Reserve Bank Chairman noted at least a decade too late. Nevertheless, even today financial services industry "reformers" still advocate large measures of self-regulation, e.g. authorizing commodity exchanges to enforce violations of trading rules. The General Assembly should unambiguously affirm the authority of

governments to enforce compliance with all financial market rules, including those of commodity exchanges. A public ombudsman should be created in each regulatory authority to take evidence and provide "whistleblower" protection in the event of government abuse of regulatory authority or non or inequitable enforcement of trading rules.

3. During the Financing for Development discussions, the "Tobin Tax" on financial market transactions was proposed as a means for creating a development fund that would be less subject to the loan related "policy advice" for which the World Bank Group and International Monetary Fund are notorious. The Commission of Experts should consider a Tobin Tax as a viable option for capitalizing development projects at a time when the Wall Street contagion is draining hundreds of billions of dollars from developing countries. We suggest that a variant of the Tobin Tax be applied to commodities speculation, both as a regulatory means for reducing the volume of sometimes minute to minute trading that drives excessive speculation and as a means for partly financing commodity exchange regulatory authorities.

4. The prevalence of commodity index funds that bundle up to 24 agricultural, energy, base and precious metal commodities into a speculative instrument has lead to extreme price volatility in bundled commodities, particularly when regulators waive capital reserve requirements for favored traders. Agricultural commodities, as the minor part of these funds, are subject to price swings driven by energy and mineral prices that have little, if anything, to do with agricultural fundamentals. Because these price swings endanger both food security, particularly in net food dependent developing countries, and agricultural investment, the Committee should consider whether, in the absence of effective regulations, these funds should be banned. Fund trading at least should be subject to exchange "circuit breakers" whenever it leads to extreme price volatility, as defined by regulators for specific commodities.

Multilateral institutions

The following comments concern how several multilateral organizations may contribute to, impede or be affected by the regulation of commodity exchanges as financial markets.

International Monetary Fund

At the Annual Meetings of the IMF and World Bank in October 2008, more than one banker commented publicly on the spectacular failure of the IMF as a macro-economic and financial regulator. The IMF's Charter authorizes it to review the macro-economic performance and financial regulatory policies of its members, including policies that pertain to commodity exchanges. Many rich country members of the IMF have refused to allow such a review of their own financial houses, thus impeding analysis and corrective action for the global financial contagion. Such a review would be relevant to prudent regulation of the commodity exchanges. In 2004, U.S. authorities waived the capital reserve requirements for the biggest commodity index players (Goldman Sachs, Morgan Stanley, Lehman Brothers, etc.), freeing up billions of dollars for speculation and then allowed them to build up unsustainable debt to equity (e.g. 30:1) ratios.[8] Since national authorities are sometimes unable or unwilling to regulate excessive speculation and other symptoms of an unsustainable macro-economic

order, the General Assembly should urge the IMF to review the financial regulatory policies and enforcement of all its members. If the IMF is unable to get a mandate to report on rich country regulatory policies and failures, it should at least report on specific regulatory causes of balance of payment problems resulting from those failures, particularly for commodity export dependent developing countries.

World Trade Organization

As national authorities try to regulate the financial services industry, of which commodity exchanges are one, those financial institutions may ask authorities to review government commitments to the 1997 Financial Services Agreement of the General Agreement on Trade in Services (GATS). The proposals of the GATS Working Party on Domestic Regulations, if agreed by WTO members, likely will add to the burden of proof for governments to justify the "necessity" of regulations under the GATS and other WTO agreements.[9] Although the GATS allows an exemption from its rules for "essential security interests," (Art. 14bis, b), a financial emergency does not exempt WTO members from the pressure to make financial services "least trade restrictive," even if the global financial contagion leads to widespread economic deterioration and social conflict in their countries. (On February 12, the U.S. National Intelligence Estimate characterized the global economic crisis as the top U.S. security threat, hence it is not implausible that the U.S. could invoke the GATS exemption.) The Commission of Experts should review whether proposed financial institutional reforms violate the GATS and if so, propose how the GATS may be changed to enable WTO members to ensure prudent regulation of financial services.

UN Conference on Trade and Development (UNCTAD)

Although UNCTAD staff economists and consultants forewarned member governments over the lack of lessons learned from the financial services industry debacle in 1997 in East Asia, the reduction of UNCTAD's mandate and budget left the staff largely on the public policy sidelines as the global financial crisis unfolded. As extreme price volatility seized commodity markets and sent food and energy import bills to record heights, with concomitant balance of payment problems, UNCTAD's mandate and budget limitations hampered use of its historic commodities expertise to undertake a full study of commodity exchange operations and regulation worldwide. We urge the Commission to provide guidelines for a General Assembly resolution to call for such a major study. Among the possible uses of such a study would be to prepare a Model Regime for Commodities Exchange Regulation and/or a multilateral Code of Practice for commodities exchange regulation.

UN Task Force on the Global Food Crisis

The Task Force "Comprehensive Framework: report[10] contains only a slight and tentative reference concerning the relation of commodities speculation to the food crisis. The Commission should consider recommending that the General Assembly advise the Task Force to initiate a civil society consultation to try to determine the extent to which commodities speculation affected agricultural commodity and retail food prices, taking into account the energy price factor of food production and distribution.

UN Framework Convention on Climate Change (UN Environmental Program)

The capping and trading of Green House Gas emission credits on commodity exchanges has been touted as a "market-oriented" way of meeting GHG reduction commitments to the Kyoto Protocol. Yet in the weakly regulated commodities exchanges, the potential for emissions credit trading to increase GHG emissions, while enriching some traders, is high. Governments are preparing for the Conference of Parties to the Framework Convention in December in Copenhagen to consider whether negotiations should revise the cap and trade schemes or adopt an alternative mechanism for reducing GHG. Part of this discussion should concern how a market in "climate derivatives,"[11] derived from cap and trade emissions credits, may affect GHG emissions under current and reformed regulatory practice scenarios.

The Commission further may wish to review critiques of traditional cost and benefit analysis,[12] particularly those regarding climate change,[13] in light of the financial regulatory failures that are partly due to the cost-benefit framework of regulatory economics. Cost benefit analysis, despite these critiques, has often been used as a justification for not regulating or for deregulating. The cost of taking "no action" on climate change while letting the "market-oriented" instruments work their putative magic may be too high and too late to pay.

IATP thanks the Commission for its work and stands ready to answer any questions it may have about our submission to the consultation.

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[1] http://iatp.typepad.com/thinkforward/2008/11/index.html

[2] For the Commission's terms of reference, background documents and related information, see http://www.un.org/ga/president/63/commission/financial_commission.shtml

[3] http://agriculture.house.gov/testimony/111/h020409/Masters.pdf

[4] http://online.wsj.com/article/SB122705339535539245.html

[5] http://www.iatp.org/iatp/publications.cfm?accountID=451&refID=104414

[6] http://www.agobservatory.org/library.cfm?refid=105090

[7] http://agriculture.house.gov/inside/Legislation/111/HR977.pdf

[8] Stephen LaBaton. "Agency's '04 Rule Let Banks Pile Up New Debt, and Risk." *The New York Times*. October 3, 2008.

[9] http://www.tradeobservatory.org/library.cfm?refID=103596

[10] http://un.org/issues/food/taskforce/cfa.shtml

[11] http://www.rybinski.eu/index.php?tag=climate-derivatives&language=en+pl

[12] http://www.progressivereform.org/articles/SunsteinOIRA901.pdf

[13] http://www.nrdc.org/globalwarming/cost/contents.asp