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Russia Can Lead Commodities Trading Reform

By Adrian Pabst

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President Dmitry Medvedev condemned “speculators” last week for jacking up food prices and making unjustified profits. Knowing that higher prices will fuel food costs for the next year, the Kremlin is clearly worried about popular discontent ahead of 2011 parliamentary elections and the 2012 presidential vote.

But instead of indulging in opportunist populism, the Russian leadership has a unique opportunity to initiate a wholesale transformation of commodities trading at home and abroad. As one of the world’s leading commodity producers and exporters, Russia has a particular responsibility and the necessary power to instigate real reform. This could be a centerpiece for Medvedev’s strategy to modernize both the Russian economy and the international financial sector.

Like the financial crash with which it is closely linked, the ongoing food crisis is both local and global. When Prime Minister Vladimir Putin announced last week a possible extension of

Russia’s ban on wheat exports into late 2011, Mozambique witnessed violent food riots in response to a 30 percent price increase for bread, in which 13 people were killed and several hundred injured.

Coincidence? Hardly. Russia is the world’s third-largest wheat exporter. With the worst heat wave in 130 years and catastrophic wildfires in the country’s main production areas, it is scarcely surprising that global wheat prices have risen rapidly, with food prices up by 5 percent in the month of August alone.

These events recall summer 2008 when international commodity prices peaked and dozens of food-importing countries experienced social unrest over soaring food costs.

By July 2008, the price of corn and rice had almost tripled compared with 2005 levels. All this was compounded by sky-high oil prices, raising fuel costs.

Commodity prices have since fallen back to pre-crisis levels, but the savings have not been passed on to consumers, and certainly not the world’s poor. On the contrary, the 2008 price hike plunged more than 100 million people into hunger. From 2006 to 2009, the number of malnourished people grew from 854 million to a record level of 1.02 billion.

This scourge affects not just sub-Saharan Africa but also developed economies like the United States (where more than 50 million people live below the official poverty line) and emerging markets such as Brazil and Russia. Across the world, the recession has trapped many hundreds of millions in poverty, unable to cope even with small increases in food costs.

Of course, the effects of strong population growth and adverse climate change have, in many instances, simultaneously increased demand and reduced supply. But 2010 is on track for the third-highest wheat crop ever recorded by the UN’s Food and Agriculture Organization. Compared with 2008, fuel is inexpensive and grain stocks are abundant. So why are we seeing another food crisis?

Clearly ordinary demand and supply forces cannot account for what’s going on. Like other commodities, the price of foodstuffs is not exclusively determined by the interaction of natural and demographic factors or the imperfections of distribution networks. Rather, growing financial speculation is exacerbating price fluctuations and injecting further volatility into the international system.

What’s the evidence? Well, the parabolic shape of price movements suggests that speculation is an important driver. The underlying fundamentals of demand and supply matter, but frenetic speculative activity at the margin exacerbates price hikes and subsequent drops. This is evinced by the sharp movement in commodity prices like oil, skyrocketing to $148 in July 2008 before tumbling to below $35 in January 2009.

What we are seeing is a rapid succession of booms and busts — not a regular business cycle, but instead an extreme bubble cycle. As the dramatic contraction of Russian national output by about 10 percent in 2009 showed, the country’s overreliance on commodity exports is hurting the entire economy.

Bets on commodity prices are a substantial source of trading revenue for global banking conglomerates like Goldman Sachs or Morgan Stanley and major Russian banks such as Alfa. This involves financial instruments like derivatives — so-called proprietary bets on price movements using futures and swaps. In addition, many banks also trade in real, physical assets, buying and selling actual shipments and deliveries of primary commodities. Groups store diesel aboard tankers and make a killing when fuel prices rebound.

Paradoxically, the financial crash has reinforced commodity speculation.

Now that interest rates are low and stock markets volatile, unprecedented volumes of money are poured into commodities. And with growth so sluggish and the specter of a double-dip recession looming large, global finance has an ever-greater preference for short-term speculative profits instead of long-term investment in the real economy.

Moreover, every crisis is followed by a concentration of ownership and market control. For instance, JPMorgan acquired in 2009 commodity businesses from UBS and Bears Stern, and now is in talks to take over Sempra Commodities.

Likewise, large food retailers, backed by corporate banks, are squeezing small and medium-sized farmers and exploiting their dominant market position to raise higher consumer prices — as is currently happening in Russia.

So what is to be done? First of all, Russia could press the Group of 20 to include commodities trading in proposed reforms of the global financial system. So far, U.S. and EU proposals to regulate banks and finance corporations do not affect global commodity trading houses like Trafigura, Glencore or Vitol.

Second, Medvedev could team up with French President Nicolas Sarkozy, who will be the next G20 chairman. One of Sarkozy's priorities is to ban certain speculative practices like naked short-selling and to correct the imbalance between finance, on one hand, and agriculture, manufacturing and industry, on the other.

Third, Moscow needs to eliminate the conditions for speculation in commodities. One concrete policy idea is to break up large retail conglomerates that form cartels and exert monopsony — excessive buying power through market dominance that crowds out small and medium-sized enterprises and drives down prices paid to farmers.

As an emerging market aspiring to be a developed economy with a global financial center, Russia has much to gain from advocating real reform of financial and commodity trade.

Adrian Pabst is a lecturer in politics at the University of Kent, Britain, and a visiting professor at the Institut d'Etudes Politiques de Lille (Sciences Po), France.