Geoforum 83 (2017) 71–79

Contents lists available at ScienceDirect

Geoforum

journal homepage: www.elsevier.com/locate/geoforum

Examining the influence of intellectuals on commodity speculation

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ARTICLE INFO

Keywords:
Hegemony
Index funds
Hedge funds
Food price spikes
Cultural economy
Financialization

ABSTRACT

Global food price volatility began shortly after Gorton and Rouwenhorst (2004, 2006) recognized that commodity index speculation was financially underexploited by institutional investors. Pro-commodity speculation and pro-index speculation arguments were not new, but gained new significance when the US Mortgage and Global Financial crises began to unfold and investors were looking for new places to funnel money. The literature has linked financial speculation by index funds and hedge funds to global food price volatility and the food riots in 2008 and 2011. The literature, however, leaves readers with the perception that index funds and hedge funds *alone* created the recent wave of commodity futures speculation. This paper argues that a small but important group of intellectuals were vital to the promotion and regulation of commodity speculation by index funds and hedge funds, which has affected the world as a whole.

1. Introduction

Western intellectuals influenced the creation and regulation of financial speculation that contributed to the 2008–2011 food prices spikes. Global food price volatility began shortly after Gorton and Rouwenhorst (2004, 2006) recognized that commodity index speculation was financially underexploited by institutional investors. Institutional investors are organizations such as pension funds with large investable assets. Gorton and Rouwenhorst (2004, 2006) show that a commodity index can insulate institutional investors from inflation and provide reliable profits (Gorton and Rouwenhorst, 2004). This speculation strategy invests money across a range of commodity futures contracts and Treasury Bills (T-Bills) the way that a mutual fund invests money across a portfolio of investments. Around the same time that Gorton and Rouwenhorst (2004, 2006) put forth their argument, Till and Gunzberg (2005) similarly argued that index speculation by hedge funds can generate anything from reliable insurance-premia to large “equity-like profits” (Till and Gunzberg, 2005: 8). For investors, equity investments are traditionally considered more risky but can yield higher profits than fixed income investments (derived from debt such as bonds, mortgages, etc.), especially when interest rates are low (Cheong et al., 2009; Yankow et al., 2011). Gorton and Rouwenhorst’s (2004, 2006) arguments were not new; several authors had previously argued that commodity index speculation could provide wealthy private investors and institutional investors with inflation protection and, at times, equity-like profits (Strongin and Petsch, 1995; Greer, 2000; Till, 2000, 2004; Shemilt and Unsal, 2004). Pro-commodity speculation and pro-index speculation arguments gained new significance, however, when the US Mortgage and Global Financial crises began to unfold and investors were looking for new places to funnel money amid falling US interest rates and global financial uncertainty (Aalbers, 2008; Lagi et al., 2012). This was around the time that Gorton and Rouwenhorst (2004, 2006) released their paper (first as a National Bureau of Economic Research working paper and two years later as a journal article). By participating in the cheering and marketing of commodity index products, Gorton and Rouwenhorst (2004, 2006) played an authoritative role in legitimatizing, normalizing, and perpetuating financialized forms of food speculation – helping them go “mainstream”.

The mainstreaming of commodity index speculation is important because it has been shown elsewhere in the literature that financial speculation by index funds and hedge funds is linked to global food price volatility, which has exacerbated global hunger (Tadesse et al., 2014; Lagi et al., 2011a,b, 2012; Gilbert, 2010; Mayer, 2012; Field, 2016). These accounts, however, only tell part of the story and may leave readers with the perception that markets, commodities, and financial speculation are autonomous and unconnected rather than socially constructed relations between people. These accounts also leave readers with the perception that index fund dealers and hedge funds *alone* crafted the recent wave of commodity futures speculation. I show, however, that a small but important group of intellectuals were vital to the creation and perpetuation of commodity futures speculation by index funds and hedge funds.

The role that intellectuals played in mainstreaming commodity speculation to institutional investors (like pension funds) is crucial to understanding global food price volatility since the mid-2000s. While

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http://dx.doi.org/10.1016/j.geoforum.2017.05.005
Received 7 June 2016; Received in revised form 12 May 2017; Accepted 15 May 2017
Available online 22 May 2017
0016-7185/

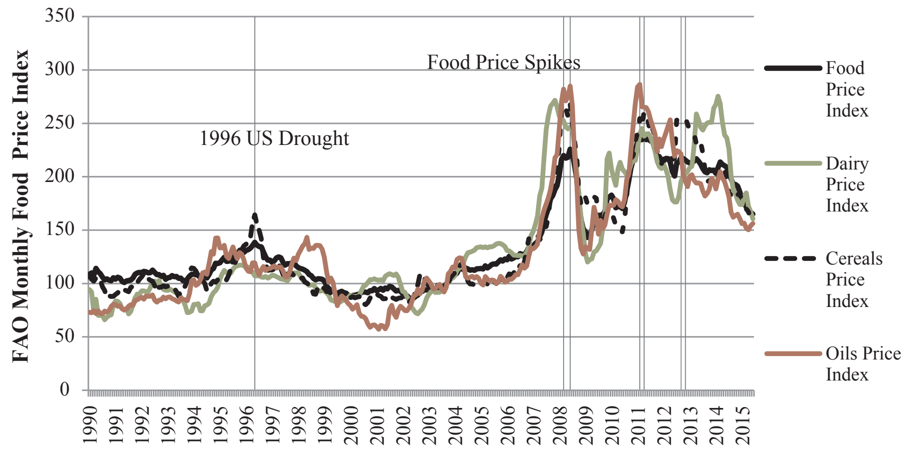

Fig. 1. FAO global food price indexes 1990–2015. Note: the vertical lines denote when global food prices, measured by the FAO's (2015) food price index, "spiked". The first price spike occurs in 1996 in response to the 1995–1996 U.S. Midwestern drought, which caused a 26% decline in U.S. grain production and a 75% reduction in U.S. grain stocks (Light and Shevlin, 1996). The subsequent spikes occur in 2008, 2011 and again in 2013.
Source: FAO (2015).

the regulatory and product infrastructure needed to facilitate a surge in commodity index speculation was in place by the early-2000s (PWGFM, 1999; CFMA, 2000; FCIC, 2011), demand for commodity index speculation had to be cultivated amongst institutional investors. This paper contends that Gorton and Rouwenhorst (2004, 2006) and, later, Irwin et al. (2009, 2011) were vital to this cultivation: first, by encouraging intuitional investors and, second, by assuring institutional investors and regulators that the surge in speculation was unrelated to increased global food price volatility. The findings presented in this paper underline the under-scrutinized cultural political economy of commodity index speculation where intellectuals (i.e. professional academics) play a key role in the (re)production of socio-cultural norms. It contributes to the academic literature by being one of the few studies to use a cultural economic theoretical framework (Gramscian) and qualitative data to examine commodity index speculation.

2. Global food price volatility & commodity speculation

Global food prices started rising precipitously in 2006 before peaking in 2008. Prices then plummeted before rising and peaking and again in 2011, see Fig. 1 (FAO, 2015; World Bank, 2015; Trostle et al., 2011). Evidence indicates that fluctuations in global energy prices had little effect on staple agricultural prices, and that biofuel production cannot account for the acute spike in global food prices that occurred in 2008 and 2011 (Gilbert, 2010; Mayer, 2012). The role that financial actors have played in influencing global food prices has consequently received increased attention in the academic literature (Martin and Clapp, 2015; Clapp, 2014a, 2014b; Isakson, 2014; Burch and Lawrence, 2009).

New empirical evidence shows that financial speculation has significantly contributed to global food price volatility since the mid-2000s (Tadesse et al., 2014; Lagi et al., 2011a,b, 2012; Gilbert, 2010; Mayer, 2012; Field, 2016). Global food price volatility is important because it can drive up the street price of food in low-income and food import dependent countries like Mexico, Afghanistan, and Egypt (D'Souza and Jolliffe, 2012; Valero-Gila and Valerob, 2008; Lagi et al., 2011a,b; Barrett, 2013). In low-income countries, a larger percentage of household income (on average) is spent on food than in high income country households, making people's livelihoods more vulnerable to acute unexpected increases in prices (D'Souza and Jolliffe, 2012; Valero-Gila and Valerob, 2008; Barrett, 2013). Local food prices in food import dependent countries (many of which are also low-income) are more closely tied to international prices because food is being imported. When international prices unexpectedly rise or become volatile, local prices in food import dependent countries can experience acute increases and increased volatility unless buffered by government price controls and/or price stabilization subsidies; Lagi et al., 2011a,b; Clapp, 2009; Pieters and Swinnen, 2016). In places such as Egypt and Libya, rising food prices caused by global food price volatility sparked food riots in both 2008 and 2011 (Lagi et al., 2011a,b). When global food prices plummet, it can undercut domestic farmers by lowering domestic food prices below the cost of production (Clapp, 2009). In the long term, undermining local farmers can lead to greater regional food import dependence (as local farmers are put out of business) and greater susceptibility to global price volatility (Clapp, 2009; Pieters and Swinnen, 2016).

The surge of speculative money into food commodities through US commodity futures markets has predominantly come from two types of speculators: index funds and hedge funds (Mayer, 2012; Gilbert, 2010; Tadesse et al., 2014; Field, 2016). Hedge funds pool the money of investor-owners under the management of one firm that's whole purpose is to generate profit through financial speculation using a wide variety of financial tools, including commodity speculation, and typically a lot of borrowing – called "leverage" (PWGFM, 1999; Fichtner, 2013). Their main investors are wealthy individuals and institutional investors, although managers also typically have a financial stake in the hedge fund as well (Fichtner, 2013). Hedge funds are known to speculate using physical commodities and commodity futures and have grown in number and size since the early-1980s (Till and Eagleye, 2005; Till and Gunzberg, 2005; Till, 2006).

Once an alternative asset class, index funds went mainstream in the mid-2000s around the time Gorton and Rouwenhorst (2004, 2006) argued that index funds were investment vehicles underexploited by institutional investors. Index funds offer to take investors' (also wealthy individuals and institutional investors) money and, for a fee, invest it across a diversified portfolio of commodity futures contracts and treasury bills in weighted proportions, like a mutual fund (Greer, 2000; Gorton and Rouwenhorst, 2006). Index funds can be bought and sold as exchange traded funds that are bought and sold like regular stocks, or take the form of a commodity index swap between an institutional investor and an investment bank for example. Index fund managers do not typically invest clients' money in physical commodities although some do (Dunsby and Nelson, 2010; Greer, 2000; Gorton and Rouwenhorst, 2006; Shemilt and Unsal, 2004).

Commodity index funds specialize in commodity index speculation and fund managers typically invest money in futures contracts rather than physical commodities. The first advantage of futures contracts is that they do not need to be physically stored or transported (Greer, 2000; Shemilt and Unsal, 2004; Birkner and Collins, 2008). By speculating on commodity futures contracts, rather than physical