Author's Note

The report of the Administrator of the Commodity Exchange Authority of the USDA occasioned the next venture into the governmental policy area. The comment was published in the *New York Commercial and Financial Chronicle* on April 19, 1951. It had a fairly long life because the issue of control of margin requirements kept coming to the surface for the next twenty or more years. Each time that I was asked for an opinion by members of Congress, exchanges, and farm organizations, I responded with a copy of the paper. It says two things: that speculation is a positive force in directing economic activity and that governmental intervention in price formation is undesirable.

A Comment on Margin Requirements in Futures Trading

CHAPTER 3

For some time the Commodity Exchange Authority of the U.S. Department of Agriculture has been promoting legislation to give it authority to regulate margin requirements on speculative transactions in commodity futures markets. The most recent attempt was with the Defense Production Act of 1950, which provided for the regulation of margins, among other things. The margin control provisions of the act were defeated. The 1950 "Report of the Administrator of the CEA" continues the campaign.

The Commodity Exchange Authority takes the position that the low speculative margins required by the exchanges encourage excessive speculation and speculation with insufficient capital. They note that upsurges of speculative activity are accompanied by rising prices, and cite the January 1948 price increases and rapid increase of soybean prices following the outbreak of the Korean War.[1] They suggest that higher margin requirements would curb such speculative booms.

Because of the importance of commodity markets and the significance attached to the margin question by both the CEA and the exchanges, a review of margin requirements seems desirable.

Nature of the Margin Requirement

Commodity exchange clearinghouses require that clearing members post margins to guarantee contract fulfillment. Trading members in turn must require their clients to post certain minimum margins. Commission houses may require larger than minimum margins. The historical purpose of the margin has been the prevention of contract default.

Functions of Futures Markets

Futures markets have two basic functions: (1) the registering of grain prices and (2) the shifting of risks. Grain prices should reflect both current and anticipated values. Buyers and sellers must make estimates of total supplies and the demand for them, and form expectations of the average prices that will prevail at future times. If current prices are above the average expected, the quantities offered for sale are

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1 See "Reports of the Administrator of the CEA," 1948, 1949, and 1950.

increased; if they are below, quantities are decreased. This is a process of discounting the total supply-demand conditions into current prices. It is essential in regulating the flow of grains onto the market at a rate that will make supplies last the full year but at the same time have them all consumed. Current prices are functions of expectations of futures prices. If the supply-demand conditions change so that expectations are changed, these changes should be immediately registered in current prices. The extent to which they are so registered depends upon the effectiveness of the discounting system, which in turn depends upon the level of speculative activity. The discounting process requires speculation. Futures markets with an extensive speculative interest are singularly good discounting markets and especially useful in rationing supplies over time.

Price risks in grain marketing are extensive. Crops are harvested during a few weeks of each year and are consumed at a fairly even rate. Part of the stocks must be owned for as long as twelve months. Speculators in futures markets assume much of the risk in marketing grain. Risk premiums must be paid to get risks assumed; anyone purchasing for deferred delivery must be able to buy more cheaply than he expects to be able to sell later.

A good risk-shifting (hedging) market must (1) provide a liquid market so that hedges can be placed and removed instantaneously without price penalty and (2) get risks into the hands of those persons who require the smallest risk premiums.

Necessary Volume of Trading

The volume of trading necessary for a good hedging market is not known. We only know that the volume in some markets is at least large enough and in other markets not large enough. From a hedging point of view, too large a volume of trading is impossible. There seems to be no objective evidence that a given amount of trading is the minimum necessary. Whether the minimum is just equal to the size of the crop or five, ten, or fifteen times the size of the crop is not known. Neither is it known that ten, fifteen, or twenty times the size of the crop is more than necessary. *Volume in relation to the size of the crop may or may not be the appropriate measure.*

A large volume of trading is essential to uncontrolled and sensitive price adjustment. A small volume of trading by a few people results in prices that are *infrequently* adjusted by relatively large amounts, while a broad market with many traders results in prices that change more often and by smaller amounts. A broad market is less susceptible to influence by one or a few traders than a narrow market. How large a volume of trading is necessary to assure uncontrolled prices is not known. Volume cannot be too large for this purpose. Much speculation helps assure free prices.

Volume of Trading and Prices

Increases in the volume of trading and erratic price changes seem to occur at the same time. This does not mean that erratic price changes are caused by a large amount of speculative activity. A more logical line of reason is that erratic price changes cause a large volume of trading. There is no logic in speculating in prices that do not change.

Speculators buy when they think that prices are too low and sell when they think prices are too high. They differ in their opinions about what is too high and what is too low. The actions of individual speculators in buying and selling tend to force prices to the average expected by the market participants. Speculation tends to eliminate the reason for speculation. If the judgment of speculators were perfect, prices would change only when the underlying economic conditions changed.

Speculation cannot affect prices very much in a liquid market. Cash and futures prices are tied together by the delivery feature. Grains must move on the market for what the market can afford to pay. They cannot be held above or below that level.

A large volume of trading does not mean futures prices are above real commercial values. In December 1950 the volume of trading in soybean futures was about 10 to 12 million bushels per day, an annual rate of eight to ten times the size of the crop. Oil and meal values reflected an unusually wide processing margin. East-central Illinois cash prices were not as much below Chicago prices as the freight cost to Chicago. If anything, Chicago prices were deflated in terms of cash soybean, oil, and meal prices.

In the summer and fall of 1950, profits from long positions in soybeans were much greater than the margins required. The Commodity Exchange Authority states that the summer market was 67 to 75 percent speculative. For every purchase there is a sale, for every long a short. Losses from short positions must equal profits from long positions and vice versa. Was trading itself inflationary, or did price increases stem from underlying economic conditions?

Margins and the Cost of Speculation

The principle of buying at the lowest price is to shop in the broadest market possible. The principle of shifting risks is to get them into the hands of those people who will carry them for the smallest premiums. Low margin requirements broaden the market for risk and reduce its costs; efficiency of marketing is increased. Such savings result in higher farm prices and lower consumer prices.

Speculators perform an essential marketing function. Successful speculators must operate on the basis of a rather modest return. If a speculator were willing to take

market risks for a 10 percent return on his risked capital and margins were doubled, he would be getting only 5 percent. Fewer people would be willing to speculate, and the market for risk would be narrowed. Further, if a 10 percent return on risked capital is the reservation price for risk bearing, an increase in margin requirements would result in a corresponding increase in the cost of getting risks assumed.

Control of Prices

The argument for federal control of margin requirements is that excessive price changes are caused by excessive speculation and that the volume of speculation can be controlled by adjusting margin requirements. Principal criticisms have been leveled against price increases and the low margins required by the exchanges. The implication is that if margins and the volume of trading can be controlled, excessive price changes can be prevented. As it would be judged that prices were too high, margins would be increased; and as prices were too low, margins would be decreased; that is, to control margins is to control prices. Some of the statements above cast considerable doubt on the practicability of such control. Whether or not it would work is beside the issue. The use of margins for any purpose other than the guarantee of contracts is a violation of the principle of competitive pricing of commodities and would tend to take pricing out of the hands of economic forces and submit it to administrative decision.