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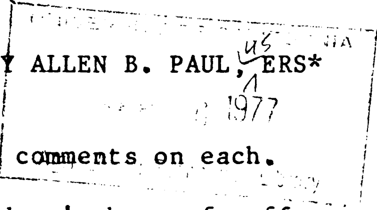
DISCUSSION OF POWERS-TOSINI AND GARDNER PAPERS BY ALLEN B. PAUL, ERS*



These are two thoughtful papers. I have three comments on each.

1. Powers-Tosini show that Latin American traders' share of coffee futures recently had reached 25 percent of the total on the long side. Shades of 1953? An FTC study, (4) found that in December 1953 a few Brazilian long accounts in N.Y. futures increased from 856 to 1,846 contracts, or one-half the open interest--largely accumulated in one week beginning December 2 when Brazil had announced an increase in the loan rate from 1,200 to 1,500 cruzeiros per bag, after the hard July freeze. Such trading smacked of unfair advantage.

FTC suggested imposing position limits. This advice was never followed and it is just as well. It would not prevent anyone from making large forward cash commitments which in turn could be laid-off against futures. As Powers-Tosini argue, U.S. markets cannot readily be insulated from manipulative actions from abroad, whether by individuals, groups or governments. But we probably can improve other people's available information in order to reduce the power of some to manipulate or otherwise distort prices. More disclosure of changes in large cash and futures positions is needed, if the game is to be competitive.

2. The relation of financial institutions to development is one of the grand themes of economics. Does financial development lead or follow growth of output? Goldsmith (1) concluded that there is evidence on both sides. Powers-Tosini show the route to capital accumulation via futures trading that would promote local savings and investment, attract foreign

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capital, and to develop banking services. And they list conditions in LDCs essential to successful functioning of futures. To test these ideas, one might study India's experience with many small inland commodity exchanges.

Hicks (2) teaches a larger perspective. Over the centuries, man has bettered his lot through the rise of markets, which implies the rise of a class of people who specialize upon trade. The conditions for the rise of markets are best at certain geographic nodes (historically the city-state at the water's edge) and when this happens, it sets in motion the mercantilization of more and more of economic life. Institutions first arise to create widely acceptable money and credit, then to create more tradable rights in commodities, and finally more tradable rights in land and labor. This evolution of the ideas and instruments of property that can be readily bought and sold by anyone who has the means, then works its way back into the hinterland and ultimately brings about great changes. Mercantile institutions spread slowly--much more slowly than most technology--but spread they do. The paper suggests that there are large educational opportunities to guide policy into fruitful channels, not only in respect to futures trading but in respect to all institutions of trade, if we were only equal to the task.

3. On buffer stocks, Powers-Tosini suggest that governmental programs, however handled, are largely incompatible with futures trading. I agree. Thus, it is an illusion to think that, in practice, Government can enter into futures trading to influence the carrying of stocks, without also sapping its usefulness in allocating resources.

Futures trading is but one entity in the conflict between state and private decision-making. We are a long way from settling such issues

on a scientific basis. We need solid empirical studies of program alternatives, including the benefits of preserving the institutions of trade, e.g., what would be the effect on the world economy if there were no Chicago Board of Trade, or its equivalent, with which to price grain dealings within and between countries, state-planned or otherwise?

4. This is a fitting place to turn to Gardner's paper on commodity options. Such trading now is banned for major farm products. He makes a plausible case for their use to stabilize net income from a given crop whenever its prices and yields are uncertain and negatively correlated.

This gets to the heart of a farmer's problem in using futures. Gardner shows how options could be used to supplement forward sales of a safe part of his expected crop; he also shows how options might replace futures altogether. But, conceptually, the same problem now could be met by strategic use of futures--e.g., sell the normal output forward and then buy-in one-third of this quantity, if the futures price were to rise by the cost of an option; later, sell this quantity forward if the futures price were to drop to the original level; and so on. Option trading may cost less if the intermediaries were to deal in volume; and they may offer less lumpy units. Also market orders are uncertain of execution at a selected price. But currently the costs of 8-month options in London trading in coffee and sugar futures are about 20 percent of the price of futures, and options are thinly traded.

5. Options pose some social problems. While historically they have arisen in response to a genuine business need--like that shown by active trading in call options in the 17th century on the Amsterdam bourse for

herring and other commodities that were to arrive by ship in uncertain quantities--option trading also has been outlawed from time to time. Undoubtedly reasons were not always well-grounded in theorems of economic welfare. Genuine problems arise because in modern times option trading has been conducted in conjunction with highly organized futures machinery and it has been used to hide increases or decreases in large futures positions. Mehl (3) seems to suggest that the big option-writers had manipulated futures prices in their favor when the exercise date had arrived. An important question at issue is whether regulation of option trading could be effective in preventing such manipulation and at what cost.

6. Gardner's analysis of Government price supports as a put option freely given to farmers is apt. His suggestion, that a Government commodity reserve could be operated by granting such a put option, conditional on the farmer's granting the Government a call option at twice the loan (put) price, is intriguing. But there might be nonperformance by some farmers because of low yields. A problem would arise only where there are not "safe" levels to create a call option against but there may be ways to handle this problem.

## References


(1) Goldsmith, Raymond W., Financial Structure and Development, New Haven: Yale University Press, 1961.

(2) Hicks, John, A Theory of Economic History, London, Oxford Press, 1969.

(3) Mehl, Paul, Trading in Privileges on the Chicago Board of Trade, USDA Grain Futures Adm. Circular 323, 1934.

(4) U.S. Federal Trade Commission, Economic Report of the Investigation of Coffee Prices, Washington, D.C., 1954.