

Introduction

Suppose that you and I lived in rural Iowa. I raise beef cattle. You raise corn 15 miles down the road. Each fall, when your corn comes in, you truck the entire crop to me, and I buy it to feed to my steers. To make things fair, we agree that I will pay you the cash price for corn on the Chicago Board of Trade on the day I take delivery.

Corn is important to both of us. It is your principal crop; it is my main cost in feeding cattle. I hope for low prices. All summer long you are praying that something benign—an unexpected Russian purchase, for example—will send corn prices up.

One spring day you come to me with a suggestion. “Let’s set our corn price now for next fall,” you say. “Let’s pick a price that allows each of us a reasonable profit and agree on it. Then neither of us will have to worry about where prices will be in September. We’ll be able to plan better. We can go on about our business, secure in the knowledge of what we will pay and receive for the corn.”

I agree, and we settle on a price of \$3.00 a bushel. That agreement is called a forward contract—a “contract” because it’s an agreement between a buyer (me) and a seller (you); “forward” because we’re going to make the actual transaction later, or forward in time.

It’s a good idea, but it’s not without flaws. Suppose the Russians did announce a huge surprise purchase, and corn prices went to \$3.50. You would be looking for ways to get out of the contract. By the same token, I would not be too eager to abide by our agreement if a bumper crop caused corn prices to fall to \$2.50 a bushel.

There are other reasons why our forward contract could fail to be met. A hailstorm could wipe out your entire corn crop. I could sell my cattle-feeding operation, and the new owner not feel bound by our agreement. Either one of us could go bankrupt.

Futures contracts were devised to solve these problems with forward contracts, while retaining most of their benefits. A futures contract is simply a forward contract with a few wrinkles added.