Study: Price gap threatens Chicago Board of Trade's wheat futures market

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A commodity market that has long helped wheat growers and processors manage price risks could lose its relevance unless the Chicago Board of Trade bridges a wide gap between futures and cash prices, a new University of Illinois study warns.

U. of I. economists say outdated grain delivery locations in CBOT futures contracts are likely behind wheat futures prices that have topped the simultaneous cash price by as much as $2 a bushel since the disconnect emerged in late 2005, clouding the market's value as a hedging tool.

Left unchecked, the disparity could seriously undermine the CBOT's wheat futures market because farmers and processors will pull out if they can no longer rely on futures trading as a barometer of expected prices, said Scott Irwin, one of four U. of I. agricultural economists who spent three years studying the problem.

"This is attacking a vital organ of U.S. agriculture, and there's a real danger of the patient going terminal," he said. "If the market died, I think we'd find out just how expensive the alternatives are for farmers, processors and ultimately consumers."

Irwin says the malfunction has diminished the market's value in providing "price insurance" to guide long-term decisions ranging from planting to food costs.

Typically, the market provides a benchmark because cash prices generally land within a few cents of futures prices by the time futures contracts are due for delivery, he said. But the current price gap has left farmers and processors unsure about which price is accurate.

"They lose their ability to forecast what the final price will be," Irwin said. "That's the bottom line and the fundamental justification for the market's existence."

Changing the delivery location for wheat under futures contracts could restore balance, according to the study by Irwin and fellow agriculture economists Philip Garcia, Darrel Good and Eugene Kunda.

As a result of shifts in production and transportation, the CBOT's historic delivery locations - Chicago and Toledo, Ohio - are no longer in the main commercial flow of wheat, netting inefficiencies that are distorting prices, the study says. Nearby locations were recently added along the Ohio and Mississippi rivers, but are effectively safety valves rather than solutions.

The study recommends switching to a single delivery location in New Orleans, a heavily used port where significant U.S. wheat exports move out through the Gulf of Mexico. Over the last five years, an average 206 million bushels of wheat a year moved through New Orleans, compared to an average 30 million bushels for Chicago and Toledo combined.

"It's where large volumes of wheat are moving, so you have ample supplies to become involved in the delivery process," Irwin said. "Chicago and Toledo are too remote, so delivery is costly, inefficient and throws off prices."

The CBOT and Commodity Futures Trading Commission are considering the proposal, but Irwin says it's too early to tell whether the change will be adopted.

"We hope so because if this persists another market could spring up that works better," he said. "That's not necessarily a bad thing, but it's better to fix the one that's here, one that's large and well established."

The study says similar price gaps that yielded nearly $1 disparities for soybeans and 60 to 70 cents for corn have closed since the CBOT boosted commercial storage rates under futures contracts.

But Irwin warns that lingering problems in the wheat market should not be overlooked just because corn and soybean markets have calmed.

"Often, economists are the first to defend markets and are the voice of caution when it comes to changes," he said. "This is an unusual case where we are very concerned about the long-term viability of a market that is very important to U.S. agriculture."

Source: University of Illinois at Urbana-Champaign (news : web)

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