

vestment capital flows to the commodity futures markets on the selling side in exactly the same way as on the buying side, so there is no reason to fear inflationary consequences of such a flow. An increased flow of capital into the stock market, on the other hand, necessarily raises stock prices, as the new investment capital comes on the buying side. It is possible, in a rather cumbersome procedure, to sell stock short by borrowing stock certificates; but this device is by no means the equivalent of selling futures contracts.

The second reason why the inflationary concern does not apply to commodity futures transactions is that their prices must come to the actual commodity price from four to twelve times a year, depending upon the number of delivery months. The price-earning ratio of the stocks in the Dow-Jones Industrial average has ranged from 6.4 to 51.5 since 1933, indicative of how far stock prices can range from the true current earning capacity of the physical assets they represent. Commodity futures prices can depart from the true expected earning capacity of the physical assets which they represent also; but this departure is necessarily temporary and limited because of the delivery provisions. Occasionally a commodity futures price is forced above the true economic value of the commodity in a delivery month squeeze; but such actions are severely punished on other than inflationary grounds, and indeed their general economic impact is trivial.

The consequence of prohibitive margin requirements for the commodity trade

Consider a merchant who carries large stocks of grain, hedged in futures contracts, margined with the clearing house at approximately 5 per cent of the value of the grain represented in the futures contract. He borrows 90 per cent of the value of the grain from his banker, on the condition that it be so hedged. His banker's practice is to require 25 per cent credit margin on unhedged grain inventory. Now if the futures margin is raised to even 16 per cent, the balance has been tipped against hedging. The merchant can finance his inventory unhedged for 25 per cent, or hedged for 26 per cent (16 per cent futures margin plus 10 per cent credit margin.) Moreover, his minimum capital requirement has been raised from 15 per cent to 25 per cent.

He prefers to hedge, of course, for other reasons than the lower margin requirements on bank credit which it assures him. So he might approach his banker and request some compensatory reduction in credit margins to enable him to continue hedging with higher futures margins. But his costs have been increased in any event, and if the futures margin were set still higher, at say 25 per cent or more, he would almost certainly stop hedging. Then he might approach his banker to request lower credit margins on unhedged grain. The banker could conceivably respond to the merchant's plight by granting lower credit margins conditioned upon (1) hedging in forward commitments, instead of futures contracts, (2) relating credit margins to price changes in the inventory, thus in effect taking on one of the functions of the grain trade, which is to watch grain prices.

These are, of course, backward steps in economic development; for these were the practices that had to be followed before the futures markets evolved. Forward sales are more costly and less reliable than futures contracts (in fact, it is not uncommon to use the futures market for hedging against contract cancellations.) A hedged position in futures is a much cheaper way for the banker to guard against inventory price fluctuations than actual day-to-day study of the prices of all the various categories of inventory that serves as loan collateral. Moreover, with the departure of the commercial firms from the futures markets, these markets would soon wither and die, so that the banker would have no reliable source of price information to watch, even if he chose to study prices.

The consequences of higher margins for some growers

Commodity futures contracts are used by some farmers to protect the price for a growing crop, or for a crop which has been harvested and placed in storage. This is particularly advantageous to growers of a crop like potatoes, for which there are no government price supports and which are subject to wide price fluctuations. Oftentimes the grower may have to borrow margin money from his local bank, whereas in other cases a dealer may handle the commodity futures transaction in conjunction with a contract to buy the farmer's potatoes at harvest time. The economy of futures trading is of particular importance to the potato grower. If margins were substantially increased he would revert to a system of forward contracting which places him at a bargaining disadvantage vis-a-vis dealers.