



Opinion

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Trading Developments in Futures Markets and their Impact on Commodity Prices



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Agricultural commodities are actively traded all around the world and their prices are determined by the interaction of buyers and sellers (i.e. demand and supply). A large portion of those transactions are for future delivery, i.e. buyers and sellers agree on a price today but delivery will only happen on a specific day in the future. These transactions for future delivery are essential in commodity markets because they allow buyers and sellers to plan their business more effectively. Buyers can know ahead of time when they will have the product and how much they will pay for it, while sellers also know in advance when they will need to deliver their product and how much they will receive for it. For many commodities, such as corn, soybeans and cattle, futures exchanges play a major role in the pricing of transactions for future delivery.

Futures exchanges are a marketplace where buyers and sellers trade commodities for future delivery. Prices negotiated within a futures exchange are called “futures prices”, which are the commodity prices that we often see in the news (especially prices “traded in Chicago”, which is home to the largest futures exchange for agricultural commodities). Futures prices are important because they are used as a benchmark in all negotiations between buyers and sellers around the world. When corn producers in Nebraska or Brazil are negotiating their grain with food companies, they are all looking at the futures price in Chicago as a reference to what price they should be selling their corn.

In the last 10-15 years, commodity trading in futures markets has evolved dramatically, moving from the traditional “open outcry”, where buyers and sellers would stand in the same room crying buy and sell orders to each other, to the current “electronic trading”, where orders to buy and sell commodities are placed and executed through computer systems. Nowadays, trading decisions can still be made and executed by a person, but the orders are transmitted to and executed in the futures

exchange through a computer. Focusing on agricultural commodities, 15 years ago there was barely any trading in electronic platforms. For example, less than 5% of all futures contracts in corn, soybeans and wheat was traded electronically in the early 2000’s. In 2006-2007, electronic trading started to pick up. By 2010-2011, electronic trading was already dominant in agricultural futures markets with more than 90% of all futures contracts in corn, soybeans and wheat traded electronically [1]. With the growth of electronic trading, new trading practices and new market participants emerged [2,3]. Studied some of these new practices and showed how much the futures market landscape has changed in the recent past.

In theory, electronic trading would be beneficial for commodity markets. Proponents of electronic trading often claim that the new trading systems provide more liquidity to markets, i.e. more buyers and sellers, and hence more transactions. With more market participants, it would become easier to execute trades, prices should be more accurate and transaction costs would be lower. By its very nature, electronic trading should allow buyers and sellers to execute their transactions faster and more efficiently. However, some concerns have emerged after the behavior of commodity prices and some specific events in the last few years.

One of the main concerns is that electronic trading allowed a larger participation of speculators in commodity markets, along with trading practices that could potentially be distorting commodity prices and moving them away from their “equilibrium” level determined by supply and demand. The new trading environment could be “creating” commodity prices that have no economic meaning. Many researchers have lately investigated how those new trading practices may have affected commodity prices [4-6]. Overall, there is no clear evidence that electronic trading and the larger number of speculators in commodity markets has been distorting prices.

Still, there have been reports of some events in which market prices swung dramatically within a few minutes, affecting the accuracy of market prices and creating more risk for market participants, as discussed by [2]. Those events were likely caused by improper execution of trading orders, such as traders accidentally hitting the “wrong button” on their computers or automated systems malfunctioning. Problems with order execution are certainly not new, but in the current environment with larger and faster orders, they can potentially lead to larger and faster disruptions. Critics argue that current trading systems lack human judgment. Machines just follow a pre-determined set of orders and do not have the capacity to judge when they should or should not be executed. When things go wrong, and they now can go wrong very fast, the consequences may be dramatic until somebody has time to understand what is happening and figure out how to stop it.

Overall, electronic trading has brought benefits to the market. However, it is not completely clear whether those benefits are always present or whether they outweigh potential disruptions caused by new trading systems and strategies. Either way, the futures market is not going back to the open outcry system in the pits. Electronic trading is here to stay. The question we need to debate is not whether we should have electronic trading, but how we want to shape it. In other words, we need to debate whether potential disruptions generated by recent developments in

trading systems may outweigh the benefits of the larger liquidity provided by those systems. Currently, it appears we do not have a clear answer to these questions. More and better data, along with more research, are needed in order to properly address these points [7].

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