

Derivatives strike again, this time in the corn belt

by Anthony K. Wikrent and Marcia Merry Baker

Remember financial derivatives, those complex financial contracts, the value of which are based on other financial contracts, and which forced Orange County into bankruptcy at the end of 1994, caused Procter and Gamble to sue Bankers Trust after losing over \$100 million, and wiped out Barings PLC in February 1995? Now some similar contracts, based on agricultural commodities, are in the process of forcing farmers and grain elevators out of business in the U.S. corn belt, stretching from Ohio to Kansas and north to Minnesota.

About 1 of every 20 farmers in this region—who got involved in derivatives contracts, called “hedge to arrive” (HTA) or “hybrid cash” contracts, to lock in what they believed, in autumn 1995, was a good price for their grain for the next few years—are now threatened with being completely wiped out by the recent, unprecedented run-up in corn prices. While the number of farmers affected appears to be small, and the use of HTA contracts is limited to handfuls of counties across the farm states, there is great concern that farmers’ attempts to save themselves may bring down their local grain elevators, upon which entire local farm communities depend. Direct losses are projected to be in the range of \$600-800 million.

What smart-talking “experts” sought out the gullible farmers, and induced them to go into exotic deals? The agents of the U.S. Department of Agriculture extension service, in conjunction with major brokerage houses.

This process was kicked off in the late 1980s by the blanket approval for off-exchange deals sanctioned by the *laissez-faire* policies of the Commodities Futures Trading Commission (CFTC), headed then by Wendy Gramm, wife of Sen. Phil Gramm (R-Tex.). Today, Wendy Gramm is on the board of Iowa Beef Processors (IBP), the world’s largest butcher company, which belongs, along with other food commodities

“super” companies—Cargill, ADM, ConAgra, Tate & Lyle, Continental, Louis Dreyfus—to cartels dominating 70-80% of the processing and distribution of staples of the U.S. and world food supply. These cartels, interconnected at the center with London financial and political interests, are making a killing by hoarding, speculating, and controlling scarce food supplies. They are directly involved in perpetrating “price hoaxes” of all kinds. For example, right now, IBP, Cargill, et al. are systematically underpaying farmers for their beef.

Hedge-to-arrive contracts

The hedge-to-arrive contracts were invented five or six years ago by large grain producers, to allow them to fix a floor under the price of grain they would sell to an elevator. HTA contracts “work” when grain prices are stagnant or falling. But when prices are rising rapidly, it turns out, *multi-year* HTA contracts are big money-losers.

In October 1995, some farmers decided to lock in what they believed, at that time, to be a good price, of about \$3 a bushel for corn, for the next two to three years. Almost all elevators “hedge” their grain contracts with the farmers. That is, as soon as an elevator contracts to buy grain from a farmer, it will immediately sell a commitment to deliver that grain to someone else. This is usually done by selling a futures contract on an exchange, such as the Chicago Board of Trade. But, the longest-term futures contract that is available is about 14 months. That is, in October 1995, the longest-range futures contract available was for December 1996. So, for a multi-year HTA contract, the farmers’ commitment to the elevator would have to be hedged through a series of futures contracts. As the first futures contract neared its settlement date, an offsetting futures contract would have to be bought in order to terminate the position, and a new futures contract pur-

chased to replace it.

What happened this spring, is that the relationship between cash prices and futures prices became inverted. Normally, the cash price would come to nearly equal the futures price, by the time the futures contract terminated. This year, however, grain prices soared, with cash prices moving higher than even the futures prices, a very unusual situation that reflects the very low stocks of corn. When time came to roll over the May futures contracts used to hedge many of these multi-year HTA contracts, the elevators found that it would cost about \$1.50 a bushel more to buy offsetting futures contracts, than the original futures contracts sold for. Thus, a price gain in the cash market was transformed into huge losses for the elevators.

The elevators, of course, because they are simply trying to roll over their hedging of the risk of the multi-year contracts the farmers insisted on, are passing the loss on to the farmer. The farmer finds that where he had expected to sell his 1996 crop for \$3 a bushel, the elevator is now deducting from his account the losses incurred in rolling over the May futures contracts. That means that the farmer's 1996 or even 1997 crop, is being valued at around \$1.50 or less a bushel, far less than even the projected \$2.40 cost of production.

Not surprisingly, hundreds of farmers in this situation have hired lawyers to try to find some way to wriggle out of these HTA contracts. As the St. Paul *Pioneer Press* reported on May 7, "Throughout the Midwest, bankers, lawyers, grain buyers, state officials and federal regulators are scrambling to assess potential losses. . . . Rural banks and main street merchants will run into trouble as farm income is diverted to settle these contracts."

Heavy losses

What action has been taken? So far, lots of talk. On May 15, the Senate Agriculture Committee held hearings on the situation, and Chairman Sen. Richard Lugar (R-Ind.) has scheduled more for June 5. Also on May 15, the CFTC issued a "guidance" on hedge-to-arrive deals.

C. Richard Starke, Jr., of Fort Dodge, Iowa, warned the Agriculture Committee May 15, that "these obligations have grown to the point where some industry people think there may be 400 million bushels of corn that have been sold into the marketplace which, in reality, do not exist. In a year with extremely tight supplies, such as this year, practices such as this, which may have gone unnoticed in normal years, have a tendency to become a destabilizing force in the marketplace, and wreak financial havoc on elevators, farmers, and potentially some banks."

According to the USDA, the U.S. corn supply, as of March 1, was 3.8 billion bushels, down 32% from a year earlier.

Mark Hanson, a St. Paul, Minnesota attorney representing several grain elevator companies in Minnesota and Iowa, told the St. Paul *Pioneer Press* on May 7, "We know that some farmers have already sold some of the 1995 crop, some of

their 1996 crop, and some of their 1997 crop."

The National Grain and Feed Association, based on a survey of its members, found that about 6% of 1995 corn production had been sold using multi-year HTA contracts, mostly in Illinois, Iowa, and Minnesota. The association estimated that losses may be as high as \$500-700 million. Some problem contracts are also being reported in Ohio and Indiana.

Roger G. Ginder, a professor of economics at Iowa State University, told the Senate Agriculture Committee, "From the start, most elevator managers have been at best uneasy with the typical hedge-to-arrive contracts. With very few exceptions, the contracts were offered in response to competitive pressures rather than being actively promoted by the elevators themselves." Ginder explained that elevators reluctantly agreed to such contracts, because, in "the razor-sharp competitive climate," some large producers threatened to take their business elsewhere, if the elevator did not agree.

Tom Sims, president of the Association of American Warehouse Control Officials, noted in an interview on May 21, that no farmer or elevator manager ever expected grain prices to skyrocket the way they have the past year. "We have never seen, any time before, that crops have doubled in price in just one season," he said.

In fact, during the summer of 1995, *EIR* warned of just such a steep upward trend in commodities prices, because of the flow of "smart" money into havens of control positions in the supply chain of food, metals, fuels, and other strategic necessities, as the world financial system further disintegrated.

Watch out for higher 'volatility'

There is a great irony in this situation. We are seeing a derivatives blowout in the U.S. farm belt, only weeks following the enactment of the Conservative Revolution's "Free Market Transition" farm law.

And unless national-interest remedial measures are taken (anti-trust against the cartels, penalizing of speculation, and resuming parity-based commodities pricing for farmers and other producers), then more blowouts are on the way, and the food supply is threatened by the public and lawmakers refusing to act in time.

Prognosticators are already forecasting more blowouts, although they use restrained jargon, such as, "volatility in the markets."

Professor Ginder explained in an interview on May 23, "In the absence of known [grain] reserves, we're going to see much more volatility in the markets. . . . Now, we're moving into a new environment of very cyclical production. We have acted, with our programs in the U.S., as a food reservoir for the world. Without that, it will take a while to fully learn and understand the implications." Ginder believes that new "marketing tools" will be developed for this new environment, and accepts that "marginal producers" will be forced out of business.