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The futures markets look promising for farmers

IAMO Policy Brief 39 highlights the benefits of futures markets for farmers and suggests a departure from the widely-used minimum variance hedge (MVH) ratio.

Halle (Saale), 08 March 2021. Futures transactions serve a number of important functions in agriculture. These include, in particular, protecting farmers against price fluctuations, stabilising income and increasing market transparency. In the scientific literature, the minimum variance hedge (MVH) ratio has become the standard recommendation for minimising spot price and basis risks. Sören Prehn, Thomas Glauben and Jens-Peter Loy take a critical look at this recommendation in the latest IAMO Policy Brief No. 39, and suggest farmers and grain traders adopt other strategies if they want to avoid economic disadvantages and use advantages.

For decades, agricultural futures markets were used almost exclusively by grain traders, while farmers tended to overlook their advantages. However, in recent years a considerable change has begun to take place. For example, more than a quarter of large US farms and as much as five percent of smaller farms now operate directly on futures markets. This enables them to not only hedge spot price risks but helps them ensure the profitability of the storage business.

Despite the growing importance of futures markets for agriculture, the literature currently lacks concrete recommendations on how to use them. According to Prehn, Glauben and Loy, the MVH ratio, which is widely used in the literature, is not a suitable means of hedging risks. What's more, in practice, it can have significant negative consequences. Put simply, MVH leads to over-hedging on inverse markets (demand-driven markets) and under-hedging on carry markets (supply-driven markets). In both cases, farmers and grain traders lose profits because they are unable to cover their storage costs. The authors therefore recommend a different strategy. On a carry market, the best option is to trade the basis. The opposite is true for inverse markets, where hedging on futures markets does not make sense. Here, it is better to follow a rather speculative strategy that takes account of price trends. In a nutshell: buy on a weak basis and sell on a strong basis (carry market), or speculate (inverse market).

The authors furthermore call for closer collaboration between research and practice in agriculture. According to IAMO Director Prof. Thomas Glauben, "Universities, (technical) colleges and vocational

training institutes should increasingly include courses related to futures transactions in their training programs so that students can learn about these opportunities early on and make targeted use of the increasingly important futures markets in their professional lives.”

IAMO Policy Brief 39 [Looking into the futures markets: What are they really for?](#) is available in German and English. The Policy Briefs can be downloaded for free at: www.iamo.de/en/publications/iamo-policy-briefs.

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IAMO Policy Briefs

IAMO conducts research on important agricultural policies. In our IAMO Policy Briefs we share our take on the researched issues. In this series of publications, we elaborate briefly and in comprehensive language on various topics, which are relevant for today's society. We hope to involve the interested public in these topics as well as decision makers in politics, the economy and the media. Since 2011, we publish IAMO Policy Briefs at irregular intervals.

About IAMO

The Leibniz Institute of Agricultural Development in Transition Economies (IAMO) analyses economic, social and political processes of change in the agricultural and food sector, and in rural areas. The geographic focus covers the enlarging EU, transition regions of Central, Eastern and South Eastern Europe, as well as Central and Eastern Asia. IAMO works to enhance the understanding of institutional, structural and technological changes. Moreover, IAMO studies the resulting impacts on the agricultural and food sector as well as the living conditions of rural populations. The outcomes of our work are used to derive and analyse strategies and options for enterprises, agricultural markets and politics. Since its founding in 1994, IAMO has been part of the Leibniz Association, a German community of independent research institutes.

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