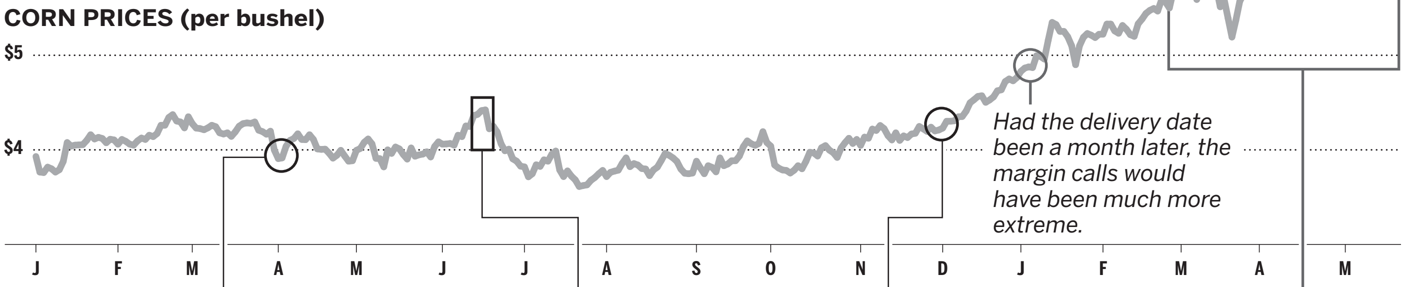
How surging grain prices can squeeze the middleman

High commodities prices are not a boon for everyone in the complex world of grain trading. Those in the middle are feeling a pinch as they try to gauge which way the increasingly volatile market will swing. A simplified hypothetical example of the grain trade's inner workings:

CORN PRICES (per bushel)



INITIAL DEAL

In April 2007, a **farmer makes a deal to sell his corn** for $4 a bushel in December to the grain elevator operator. The operator is bound to pay this price, whatever the market price of corn at the delivery date.

INSURANCE POLICY

As insurance against losing money if the market price of corn falls below the $4 he must pay the farmer, **the operator sells corn futures contracts** on the Chicago Board of Trade for $4 a bushel, which he will repurchase in December for the market price of corn. If the price rises, he makes money on his deal with the farmer, but loses on the futures contracts. If the price sinks, the reverse occurs. But either way, he's covered.

MARGIN CALLS

If prices spike, the operator's contracts at the Board of Trade lose value. Although his deal with the farmer will offset those losses, **the operator must post additional money**—a "margin call"—as a good-faith deposit on his trading position to the brokerage account that records his contract deals.

DELIVERY

In December, the **farmer delivers the corn** to the operator and collects his $4 per bushel. Because the market price is $4.10, the operator has made a profit. However, the **operator must now repurchase the futures contract** for $4.10, costing him the 10 cents per bushel he made from the farmer.

BUY OR SELL

The operator is now the owner of millions of bushels of corn, which he can immediately sell, or wait to sell, hoping the price goes up so he can make a profit.

CURRENT CRISIS

For contracts that are still active, the recent explosion in corn prices has caused margin calls to balloon, potentially forcing operators who cannot borrow the money to pay them out of business.

SOURCES: Bloomberg, Tribune reporting, "Fundamentals of the Futures Market" by Donna Klein

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