CHAPTER 8

FUTURES TRADING FOR IMPERFECT CASH MARKETS: A SURVEY

Ronald W. Anderson

1. INTRODUCTION
The purpose of this essay is to survey the literature concerning the role of trading futures contracts when those contracts call for the delivery of a good which is produced under imperfectly competitive conditions. This literature makes up only a small part of the overall literature on futures markets where the normal form of the market is typically assumed to be perfect competition. Indeed, for some, the vigorous rivalry of open outcry trading in a futures market pit seems to epitomize a perfectly competitive market. Nevertheless, there has been an increasing awareness that a number of interesting issues concerning futures markets require a departure from the competitive assumption at least for certain aspects of the analysis. In the present essay the studies covered share the assumption that in some respect the underlying market which will determine the price of the futures contract at its maturity is imperfectly competitive. By and large these markets take the futures market to be one in which there is free entry and exit so that there is no natural market power endowed in any futures trader. Thus any element of imperfect competition in the futures market would be inherited from

---

1 We are grateful to Christopher Gilbert, Larry Karp, Louis Phlips, and Margaret Slade for their helpful comments. All views expressed and all errors are the responsibility of the author.

2 The market underlying the futures contract is conventionally called the "cash" market. The link between the two markets is either because the futures contract calls for the delivery of the good exchanged in the cash market or because the terms of the futures contract calls for a cash settlement in an amount which depends upon the price prevailing in the cash market at a particular time.
the underlying cash market.

What are the basic questions that motivate these studies? The first set of issues concerns the viability of futures trading when the underlying market is imperfectly competitive. Practitioners sometimes state that an adequate degree of competition is a necessary condition for the successful launching of a new futures contract. The intuition for this view is the idea that small traders would be reluctant to trade a contract when they were aware that some other trader has the power to affect the price of the contract. While this intuition has some appeal, it is clear that some departure from atomistic competition is consistent with future trading. For there is or has been active futures trading for crude oil, tin, aluminum, copper, coffee, and cocoa. In each of these markets there is either a large producer or a producers' cartel which possesses sufficient power to influence the price of the underlying good. Thus we see that the presence of some powerful producers does not necessarily undermine futures trading.

There is a need then for further analysis to determine if there is some partial incompatibility between futures trading and market power in the sense that marginal increases in the degree of market power will tend to depress futures trading. Alternatively, are there some circumstances in which market power and futures trading will be compatible and other circumstances in which they will not?

One possible impediment to futures trading for goods produced under imperfect competition is that participation of small traders may be discouraged. An alternative possibility is that the powerful agents would like to discourage futures trading and may furthermore have the power to suppress it. There is at least some casual evidence to suggest this might be the case. For example, the copper futures markets were long boycotted by the large suppliers of copper. Furthermore, the fact that a diamond futures contract has never been successfully introduced is sometimes attributed to the resistance by DeBeers. While these cases suggest there are circumstances when powerful producers may seek to suppress futures trading, there are other cases, such as tin and coffee, when the opposite has been true — powerful producers have been active in the futures market. Again this suggests the need to take a closer look at the issues through the device of an economic model.

Beyond the question of the feasibility of trading futures for goods produced by powerful agents is the question of its desirability. In particular, is there reason to think that futures trading can be used by powerful producers in a way that