

KEY

Econ 337 Agricultural Marketing, Spring 2020

In Class Activity 2, January 28, 2020

Basis and the ability to hedge wheat					
Action		Date	Cash Price	Futures Price	Basis
Scenario 1 Price levels rise basis increases	Plant crop Sell futures	April 15	\$7.50	\$8.00	-\$0.50
	Sell crop and offset futures	October 15	\$8.00	\$8.25	-0.25
	Profit		\$8.00	-\$0.25	
		Effective Price Received	\$7.75		
Scenario 2 Price levels fall basis increases	Plant crop Sell futures	April 15	\$7.50	\$8.00	-\$0.50
	Sell crop and offset futures	October 15	\$7.00	\$7.25	-\$0.25
	Profit		\$7.00	\$0.75	
		Effective Price Received	\$7.75		
Scenario 3 Price levels rise basis decreases	Plant crop Sell futures	April 15	\$7.50	\$8.00	-\$0.50
	Sell crop and offset futures	October 15	\$8.00	\$8.75	-\$0.75
	Profit		\$8.00	-\$0.75	
		Effective Price Received	\$7.25		
Scenario 4 Price levels fall basis decreases	Plant crop Sell futures	April 15	\$7.50	\$8.00	-\$0.50
	Sell crop and offset futures	October 15	\$7.00	\$7.75	-\$0.75
	Profit		\$7.00	\$0.25	
		Effective Price Received	\$7.25		

KEY

In order to hedge using futures a farmer takes a short position in the futures market at the time he wants to lock in his price. Unfortunately, variation in the basis reduces the effectiveness of his hedge.

1. Fill in the shaded cells to indicate the profit (per bushel) he receives in the cash market, the profit he receives on his futures position, and his effective price received.

2. Farmers who have hedged are said to be long in the basis. Explain why this is true.

Farmers hedge because they would like to pass price level risk to someone else and keep only the smaller basis risk, which means that they are long in the basis. As you can see from question 1, farmers receive better than the spot price in spring when the basis increases and they receive worse than the spot price in spring when the basis decreases.