Futures, the Coveted Scapegoat

(Editor's note: In lieu of a President's Report this month, the FIA is reprinting a recent speech by Leo Melamed, Chairman of Dellsher Investment Company, chairman of the executive committee of the Chicago Mercantile Exchange, and a director of the FIA. Mr. Melamed delivered his thought-provoking speech during a seminar sponsored by the American Enterprise Institute on October 1st, in Washington, D.C.)

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"It's ludicrous to think that foreign exchange can be entrusted to a bunch of pork belly crapshooters," proclaimed a prominent New York banker back in 1972 on the eve of the Merc's launch of the International Monetary Market.

"The New Currency Market: Strictly for Crapshooters," echoed *Business Week* and wrote that "if you fancy yourself an international money speculator but lack the resources . . . your day has come!"

Derogatory comments, defamatory innuendos, inflammatory jokes, false accusations, misleading opinions, half-truths, out-and-out lies—such has been the burden and fate of futures markets; thus it has been . . . thus it will no doubt remain.

And why not? From time immemorial, predicting the future has been a hazardous occupation. Good news was universally welcome, but its failure to materialize or its counterpart was shabbily treated. "Behead the messenger of bad tidings" was not an uncommon reward.

Has anything changed?

During the 1977-78 farm crisis, U.S. farmers drove their tractors to LaSalle Street to protest low prices on their products. A few years earlier (1973-74), a group of Chicago housewives marched on the Merc to protest high prices for food products. Obviously, our markets were the cause of both results?

Has anything changed?

Back in the early 1800s, after the War of 1812 had played havoc with the U.S. farm economy, anti-speculative sentiment was rampant. Buying forward was acceptable. But any market which also allowed the opposite—forward sales—was sinful. The New York legislature, in its ultimate wisdom and exhibiting its economic astuteness, complied by enacting legislation banning all forward selling.

Has anything changed?

In January of 1985, 70 years later, leaders of the American Agriculture Movement wanted exactly that. Ban short sales in futures, they demanded, because selling depresses prices.

Later, this year, mounting frustrations over our nation's failed agriculture policy, its low farm prices, its record crop surpluses and its sagging land values, caused farm spokesmen, in search for someone to blame, to call the Chicago exchanges the "Bermuda Triangle of Agriculture," and a U.S. Senator piously agreed, by pointing a finger in our direction to echo farmers' sentiments that "never have so few done so little to make so much from so many."

Futures and options, that little understood corner of business activity, that complex arena of esoteric economics, that distant cousin of the financial community—is always a lightning rod for those who seek a convenient scapegoat . . . a place to place blame . . . a place shrouded in mystery and misunderstanding, one with many detractors and few supporters . . . the ideal scapegoat.

And why not?

HEADLINES

Read the headlines, the stories. Someone is always making a killing in those markets; clearly, there is something nasty going on out there.

Go to the trading floor . . . tumultuous, colorful, rowdy . . . no place for legitimate business activity!

Look at the members, the brokers . . . rough, boisterous, undignified . . . not to be trusted with serious financial matters!

And what do their traders do? They speculate; clearly no place for real investments!

By the way, have you ever checked the definitions?

Speculation: To engage in a risky business venture on the chance of making large profits.

Investment: To put money into business in order to make a profit.

Who am I to quarrel with *Webster's*, but it sounds like a distinction without much difference.

Has anything changed?

In 1976 when the T-bill and T-bond futures markets were introduced, published articles were abound, tirelessly warning of the negative impacts of these new inventions, their unfavorable effect on the underlying cash markets, their tendency to cause price distortions to the actuals, their disruptive market influence due to fraudulent acts by their members and their negative impact to the Treasury's debt management activities. Were it known then of our eventual 200-plus billion dollar deficit, these futures surely would have been a candidate for its probable cause.

Listen to what the respected *Economist* had to say about the new interest rate markets in its 1/17/76 issue:

A FLUTTER ON INTEREST RATES

"Like Linda Lovelace, the girl with the deep throat, the International Monetary Market (IMM) of Chicago Mercantile Exchange tries to make money by being more outrageous than its rivals. Now that its currencies futures market is well established—it was opened in 1972 by women in fancy dress—the IMM has this month opened a trading pit in United States treasury bill futures. Bidding for the government paper takes place on the same floor as for pork bellies, live cattle and three month eggs."

Or, listen to *Barron's*, a few years later, about the new stock index futures market:

PIN-STRIPED PORK BELLIES: WHY STOCK INDEX FUTURES ARE RED HOT

"Like their lightning-paced video game counterparts, stock index futures offer instant gratification or instant annihilation depending on the accuracy of your impulses and the quickness of your reflexes."

What fun! A new futures market is always fair game for ridicule, derision or mockery. For on this point, there is near unanimous consensus: they are a coveted and universal scapegoat.

Well, we are here to submit that futures and options markets—while surely not immune from criticism, while surely not utopian, while surely not without sin—neither are they the work of the devil!

The next time you hear a story, see a headline, hear a rumor maligning futures and options, ask yourself: would the world's financial system have survived the economic stresses and strains of the 70's and early 80's as well as it did without these markets?

Ask yourself, would the shrinking base of private sector capital have been equal to the increased public sector demands without throwing the free world into financial chaos, were it not that futures markets provided a new and more efficient means of capital utilization?

Would the speculative fevers unleashed by volatile price movements due to unprecedented inflation and record interest rates followed by unprecedented disinflation and falling interest rates, not have materially disrupted the world's financial fabric were it not that futures and options acted as a buffer and a pressure valve?

Would the shrinking world we live in, where a bank in South East Asia is as near as your downtown counterpart where an event in Abu Dhabi is as close as your nearest telephone, not demand a means, such as our markets provide, to instantly partake and protect yourself from the financial effect of a significant world event? Indeed had there not been futures and options markets in place would they not have been invented by now?

Ask yourself, were there no economic justification for financial futures, how could these markets have achieved such phenomenal growth in a matter of just thirteen years? How could they have attracted so many financial institutions, so many pension and money fund managers, the world over? Have all of them been hoodwinked?

Ask yourself, how could Exchange membership scrolls have swelled so quickly with blue-blooded names representing the very high priests of the temples of finance—Goldman Sachs, Phibro-Salomon, Morgan Stanley, Morgan, Bank of America, Citicorp, Chase, Manny Hanny and on and on. Have all of them lost their sense of respectability?

VOLUME INCREASES

Ask yourself, how could the transaction volume of these markets have experienced such unparalleled increases unless there was a fundamental reason for their need as a modern tool of business and finance.

—1960 volume, 7.8 million transactions;

—1970 volume on the eve of the financial futures revolution, 13.6 million transactions;

—1980 volume, 92.1 million transactions, a 579% growth in 10 years;

—and, four years later, 1984 volume was 159.3 million transactions.

Ask yourself how these markets could be as evil as their detractors claim, and yet be as coveted and copied as they are by every financial center of the world, be it Singapore or Sydney, be it Montreal or Manhattan, be it Toronto or Tokyo, Great Britain or Geneva, Brussels or Brazil. Is everyone blind to their wickedness?

And then ask yourself, how could these markets have completely fooled four U.S. federal agencies of impeccable credentials and unquestionable qualifications?

How could they have escaped the truth from the intense light of recent scrutiny by the Board of Governors of the Federal Reserve System, the Commodity Futures Trading Commission, the Securities and Exchange Commission with assistance from the U.S. Treasury in conjunction with the study mandated by the U.S. Congress for the express purpose of determining the effects on the U.S. economy as a result of trading in futures and options.

A study so comprehensive it took over two years to complete, included interviews by the CFTC and SEC of

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more than 100 financial institutions and commercial firms who participate in these markets, included a broad survey of "public" participants conducted by Market Facts, included a poll of outside experts on various issues raised by Congress, included an extensive survey of about 50 years' worth of academic articles written on the subject of futures and options and included the preparation of several original special papers on selected facets of the questions raised by Congress.

A study, under the helmsmanship of the Fed which was so all inclusive that it covered virtually every issue ever raised about these markets and examined each from every aspect. A study whose result was a massive document which, together with the Fed's separate report on securities and futures margin, represented the most comprehensive report on the subject ever produced.

STUDY FINDINGS

Ask yourself how these markets could be as evil as the myths about them claim and yet be the recipient of the following findings by the Fed, to wit:

I. That financial futures and options do serve a useful economic purpose by providing a more efficient way to manage risk;

II. That, if anything, the liquidity of related cash markets such as those for U.S. Treasury securities and common stocks have been improved by the presence of futures and options;

III. That there appear to be no significant regulatory problems concerning either manipulation or customer protection.

Ask yourself, how could these markets have so fooled the experts that they would offer the following specific endorsements, to wit:

A. That "it would appear that futures and options make possible greater output per unit of productive resources, just as in the case of any cost saving technological innovation."

The practical importance of this statement must be underscored. It means the Fed found that anyone who is charged with managing other people's money—and this includes pension fund managers, stock and bond mutual funds, and banks—can produce higher rates of return with our markets for any given level of risk. Or, if greater stress is laid on avoiding risk, the same rate of return can be earned but at a lower level of risk. Either way, pensioners, investors, and bank depositors can be better served.

B. That the age-old assertion that positions taken in futures and options divert investable funds from the rest of the economy, is blatantly false.

C. That "... it appears that financial futures and options markets, have, if anything, generally increased cash market liquidity, perhaps most particularly, liquidity in markets for Treasury securities."

That, from the Fed's standpoint, this means their "... ability to conduct open market operations in an orderly manner across a range of maturities in government securities appears to have been enhanced by the new futures and options contracts." It also means that "... the Treasury's ability to conduct debt management operations is similarly enhanced."

Indeed, E. Gerald Corrigan, President of the Federal Re-

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serve Bank of New York, recently concurred, stating: "The quantitative importance of these new markets is far greater than what most observers would have imagined a few shorts years ago."

Ask yourself, if accusations made against these markets were true, then how could the Fed study conclude that the public benefits as a result of their application and utilization. That the improved liquidity in the Treasury securities market means interest rates paid by the taxpayer on debt incurred by the Federal government is lower than they would be without financial futures markets. And, that from interviews with investment banking firms, it is clear the ability to hedge corporate bond underwritings results in a lower all-in cost of funds for the private sector as well.

D. That "most formal empirical studies of the impact of futures and options markets on cash market prices and direct studies on the behavior of cash market prices suggest that it is stabilizing, or at least do not establish that it is destabilizing."

Yes, we are here to submit that if you asked yourself these questions, if you reflected on the answers, you would in all candor become somewhat skeptical about derogatory comments, defamatory innuendos, inflammatory jokes, false assertions, misleading opinions, half-truths or the out-and-out lies one reads and hears about futures and options.

No, we are not without sin, but neither are we the work of the devil.

NOTHING'S CHANGED

Can we therefore now breathe easier? Can we expect things to change? Can we expect a fairer review now that the mandate of Congress has been satisfied, now that we have some credible answers to age-old concerns ... concerns which have historically plagued and inhibited these markets? Can we now expect futures and options to become a universally accepted and integral tool of risk management? Can we do away with symposiums such as this one whose motivation is simply to explain our merit and necessity?

Forget it. Some things never change. Listen. Cover story, *Business Week*, 9/16/85:

PLAYING WITH FIRE: AS SPECULATION REPLACES INVESTMENT OUR ECONOMIC FUTURE IS AT STAKE

"Ah, progress. Spurred by deregulation, the financial inventors have been working overtime. They've churned out a vast array of new instruments and created whole new markets. It's now possible for even the average citizen or company to take a financial position almost instantaneously in just about anything, anywhere. What only 15 years ago was an oppressively restrictive financial system has been recast in a pluralistic, almost anything goes mold.

"... by stoking a pervasive desire to beat the game, innovation and deregulation have tilted the axis of the financial system away from investment toward speculation. The U.S. has evolved into what Lord Keynes might have called a 'casino society'—a nation obsessively devoted to high-stakes financial maneuvering as a short-cut to wealth."

Imagine that, *Business Week* paying homage to Lord Keynes. Will wonders never cease!

That's right. Some things never change. It is therefore incumbent upon us to inform and instruct, divulge and debunk, proclaim and protest, again and again.

Thank you.