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Playing the global money game — Chicago style

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By Edgar Shook

ONE autumn day in 1967, Dr. Milton Friedman, the internationally famous University of Chicago economist, telephoned a major Loop bank with a moneymaking scheme in mind. Convinced the British government was about to devalue the island-nation's currency, Friedman wanted to sell short $300,000 worth of British pounds sterling. He correctly figured that if the pound were cut in value he could buy back the same amount at a cheaper price and pocket a tidy profit.

To Friedman's surprise and dismay, the bank would not accept his order, even though he was prepared to pledge $30,000 in cash as a security deposit for the transaction. The reason: a long-standing tradition among U.S. banks prohibiting private citizens from speculating in foreign currencies.

Undaunted, Friedman contacted two other major Chicago banks with the same proposition — and got the same polite but firm refusal.

Three weeks later Britain devalued the pound by a hefty 14.3 per cent, from $2.80 to $2.40.

"It was disgraceful," Friedman recalls with a snort. "I was prepared to put up $30,000, which was more than adequate margin. The banks arbitrarily kept me from more than doubling my money."

Largely as a result of that incident, today anyone with a little risk capital and a lot of nerve can wheel and deal in seven major foreign currencies — from Japanese yen to Dutch guilders — by buying or selling contracts for future delivery of the currency on the International Monetary Market of the Chicago Mercantile Exchange, Inc. And speculating in currency futures on the IMM takes considerably less money (from $1,500 to $4,000, depending on the currency traded) than the $30,000 Friedman was willing to ante up with the banks.

Actually, the idea of a futures market in foreign currencies wasn't Friedman's. It was the brainchild of the boys at the Merc (as the Chicago Mercantile Exchange is popularly known), but they give Friedman a large share of the credit for transforming their concept into reality.

"The IMM would not have been conceived were it not for the help and inspiration provided by Dr. Friedman," says IMM chairman Leo Melamed. "It was Dr. Friedman who gave us the courage to believe we were onto something big and worthwhile. It was his unquestionable prestige and authority that not only opened doors for us in Washington but enabled us to pronounce with credibility that a futures exchange in currency was a necessity and that its time had come. I seriously doubt if we would have proceeded without his full embracement of this project."

SO, ARMED with the expertise, moral support and clout of one of the nation's foremost economic thinkers, the pork belly and egg traders at the Merc did proceed —and managed to cause quite a furor in the world's established money markets in Zurich, London, Frankfurt, Paris, Tokyo and New York—the lairs of that close-knit, jealous little band of financial wizards known as foreign-exchange dealers.

As the IMM's Melamed rather grandly explains: "What we did was enter uncharted waters upon which many felt we did not belong." That is putting it mildly.

"I'm amazed that a bunch of crapshooters in pork bellies have the temerity to think that they can beat some of the world's most sophisticated traders at their own game," announced one outraged New York foreign-exchange dealer on the eve of the IMM's opening. "A peanut game," sniffed another.

Thick-skinned aggressiveness has never been in short supply at the Merc. The exchange did not rise meteorically to become the nation's second-largest futures market (after the Chicago Board of Trade) by being timid or overly sensitive to criticism. Indeed, as officials of the Merc are fond of pointing out, trading volume on the exchange has soared 1,090 per cent in the past decade, mainly as a result of the introduction of trading in meat related commodities—frozen pork bellies, live hogs and live cattle.

Thus, incongruous as it might seem, it was not at all surprising that "a bunch of crapshooters in pork bellies" were the ones to desegregate one of the financial world's most exclusive private clubs. Why? Because the thing that really turns on the boys at the Merc, who are among the most astute commodity traders in the business, is money—and money, after all, is the ultimate commodity. Money and the Merc: an eminently logical, almost preordained, match.

As it happened, the IMM's creators had some unexpected help in the form of a series of international monetary crises that rolled like shock waves through central banks of the major industrial nations in 1971. Those crises and the ensuing international monetary upheaval, which is still unsettled, drastically and forever altered the rules of the foreign-exchange game and made the Merc's idea of bringing currency trading to the speculator-masses more attractive and timely than ever.

TO UNDERSTAND those events and the effect they had on the birth of the IMM, one must delve a bit into the history and intricacies of the esoteric world of international finance.

Back in July, 1944, in a little, out-of-the-way New Hampshire resort town called Bretton Woods, politico-economic experts from 47 countries met to start planning for the world's postwar economic recovery. The international monetary system they devised, known as the Bretton Woods system, has been in effect ever since, although it is now undergoing considerable scrutiny and change.

Out of Bretton Woods came four key actions:

—The International Monetary Fund (IMF) was created as a supranational agency to act as a sort of watchdog over the non-Communist world's finances.

—A fixed price, in terms of U.S. dollars, was established for the currency of each IMF member-nation.

—It was agreed that the U.S. dollar was literally as good as gold, and that any IMF member-nation could cash in dollars for gold at a rate of $35 an ounce.

—The U.S. dollar was positioned as the Free World's main reserve currency, which meant the dollar became the medium of exchange between nations and, since the United States had pledged to redeem dollars for gold, could be held in foreign treasuries in lieu of gold.

With amazingly little difficulty the Bretton Woods system functioned superbly for nearly a quarter-century. As a result, industrial output in the Free World soared, employment was high and goods flowed freely across international boundaries as tariff barriers dropped. By the end of the 1950s, currency convertibility (which meant a Britisher, for example, could go to a bank and freely exchange his pounds at the fixed rate for, say, French francs) was restored among the major non-Communist nations, and this led to an unprecedented expansion in the flow of money between nations — for investment, for tourism and for the purchase of goods and services.

Monetarily, at least, for the first time since the worldwide Depression of the 1930s, God was in His heaven and all was pretty much right with the world. But this happy and unusual state of affairs didn't last long. Storm clouds were forming on the international financial horizon, and their linings were of a greenish hue, not unlike that of the U.S. dollar.

The problem was this: Since Bretton Woods the U.S. had been financing first the postwar recovery and then the growth of most of the non-Communist world by running its international business affairs at a loss. In other words, the United States spent more money abroad, for everything from Japanese television sets to tourism to the maintenance of overseas troop garrisons, than foreign nations spent to purchase U.S. goods and services. The result was a steady drain on the hoard of dully gleaming gold ingots stashed away in the U.S. Bullion Depository at Fort Knox, Ky. Under the Bretton Woods system, remember, this gold was the financial underpinning of the Free World's international monetary system.

To stanch this golden hemorrhage, Washington had pressed, argued and cajoled foreign governments into stockpiling huge amounts of greenbacks in their bank accounts rather than cashing them in for the yellow metal. Most obliged and, by the early 1970s, some 30 billion U.S. dollars had piled up in central banks from London to Tokyo. Meanwhile, the U.S. gold stock, which stood at $24.6 billion in 1949, had dwindled to $10 billion and change. With roughly three times more dollars in official foreign hands than it had gold to redeem with, the United States of America theoretically was financially busted.

This dreary fact was not lost on that shadowy group of individuals whom finance ministers, barely refraining from adding the adjectives "wicked" and "evil," refer to as "international currency speculators."

(Although the phrase conjures up visions of Daddy Warbucks-like characters, diamond stickpins and all, sitting on their converted-destroyer yachts in the middle of some obscure ocean, talking to Beirut money merchants via radiotelephone, the culprit is far more apt to be a harried, Tums-taking corporate treasurer who is simply trying to show a profit, or at least less of a loss, on his company's international transactions.)

WHOEVER the international currency speculators are, advertently or inadvertently, they mounted massive attacks against the already-battered dollar by shifting huge sums out of dollars into stronger currencies, notably the West German mark and the Japanese yen. To keep the values of their own currencies from soaring beyond the fixed-price "ceiling" set by the Bretton Woods system, West Germany and Japan were forced to sell unlimited amounts of marks and yen for dollars. The result was that these two nations alone unwillingly bought billions more of unwanted dollars to add to the billions they already had.

(As the United States was painfully learning, being banker to the world is a mixed blessing. There is a curious economic anomaly involved: The more of your currency you spend, lend or give away, the more you lubricate and stimulate the global economy; at the same time, the more of your currency there is floating around the world, the less confidence other nations have in it and the sooner an international financial crisis is likely to occur. This vicious monetary circle was a fatal, built-in flaw of the Bretton Woods system.)

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Loath to take this monetary mauling any longer, West Germany and Japan, which between them by now held approximately 24 billion U.S. dollars in their reserve assets, cut their currencies' moorings to the dollar and allowed the mark and the yen to "float" — that is, to fluctuate in value in response to economic influences. No matter that floating a currency was in direct violation of IMF rules; it was now a matter of every country for itself—including, finally, the United States.

On Sunday, Aug. 15, 1971, Richard Nixon slammed shut the U.S. gold window by announcing we would no longer honor our longtime pledge to exchange gold for foreign-held dollars. The international financial world gasped with shock and closed down for a few days.

What prompted Nixon's drastic maneuver was drastic news: In the first six months of 1971, the U.S. had achieved an all-time record deficit in its balance of payments (its business dealings with the rest of the world) of $11.6 billion, or more than the value of all the gold left in Fort Knox.

Four chaotic months later, finance ministers of the leading industrial nations met in Washington's Smithsonian Institution and hammered out an agreement. For starters, the U.S. agreed (gulp) to devalue the dollar by raising the official price of gold from $35 to $38 an ounce. This meant, in effect, an American would pay more for a Volkswagen, a German would pay less for a roll of Kodak film. More U.S. goods would be sold overseas and fewer foreign articles would be bought by Americans, thus improving the U.S. trade balance. For their part, the other major industrial nations agreed to rejigger the values of their currencies upward, making them worth more in relation to the overworked dollar. This dual adjustment was designed to relieve pressure on the dollar in its reserve-currency role of being all things to all non-Communist nations.

Almost unnoticed among these historic moves was the further, complementary agreement to expand price fluctuations allowed currencies under the Bretton Woods system. This made the system more responsive to present-day economic realities. (IMF rules provided that a member-nation's currency could fluctuate in price 1 per cent on either side of its assigned, or par, value. This meant a total fluctuation of 2 per cent between a currency's "ceiling" and its "floor." At the Smithsonian meeting it was agreed to widen this fluctuation to 2.25 per cent on either side of a currency's par value, or a total fluctuation of 4.5 per cent.)

ONE group that did take notice of this bit of international financial mumbo-jumbo and figuratively (and perhaps literally) jumped with joy over it was the boys at the Merc. All this time they had been doing spadework for the establishment of the IMM, not fully convinced it was a viable concept because of the narrow price fluctuation allowed currencies under Bretton Woods. Now, with the new, wider range of fluctuation, the stage was set for some decent price action; and as the traders at the Merc knew only too well, it takes price action to make a successful futures market in any commodity, from hog innards to money.

A few days after the Smithsonian meeting adjourned, the Merc told the world about its plans for a currency futures market. A month later the IMM received its charter to do business in the State of Illinois. On May 16, 1972, the new exchange opened.

Five weeks later, on June 23, the British pound joined the West German mark, the yen and the Canadian dollar (which had been floating since 1970) as a floating currency. Suddenly, foreign exchange was a whole new ball game and the infant IMM was ready, willing and eager for players. By accident more than design, the Merc's timing had been exquisite.

The business of international finance is not conducted in small numbers, and the contract size for each of the seven currencies that began trading on the IMM was appropriately gargantuan—50,000 British pounds worth $130,000, 1 million Mexican pesos worth $80,000, 200,000 Canadian dollars worth $201,500, 500,000 West German marks worth $152,500, 500,000 Swiss francs worth $125,000, 50 million Italian lira worth $85,000 and 25 million Japanese yen worth $80,000.

(Since then, partly to reduce the greater risk inherent in the new, wider currency price fluctuations, partly to increase trading activity by lowering the amount a speculator must put up to trade, the IMM has halved the size of each of the original seven contracts except the Mexican peso. It also has added a contract in Dutch guilders that consists of 125,000 guilders worth approximately $43,150. Nonetheless, 100,000 Canadian dollars or 12.5 million Japanese yen is still an impressive sum of money.)

MONEY GAME
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Are gold futures next?

If trading ordinary commodities, such as wheat, silver, sugar, cattle or cotton, is tricky—and it is—trading foreign currencies is even trickier—and a lot riskier. The reason is not only the mind-boggling complexity of international finance and the welter of factors that determine a currency's value (everything from a country's interest rates to its cost of living) but also the deviousness with which governments traditionally handle their financial affairs.

For example, it has almost become a cliche that the more vehemently a finance minister denies there is going to be a change in the value of his nation's currency, the likelier and sooner it is to happen. Also, governments are fond of announcing changes in the values of their currencies on weekends, when foreign-exchange markets are closed. The ensuing scramble among even professional currency traders to protect their financial flanks the following Monday morning is akin to a crowd fleeing a burning theater.

STILL, for the steel-nerved and strong-hearted (and exceptionally lucky) there are fabulous rewards to be gained trading currency futures. They go, however, only to the trader who has done his homework very, very well and on whom the gods smile broadly.

One such person was a young Chicago executive who early last year decided the dollar was about to be devalued again. He also reasoned the Swiss franc would appreciate in value as a result — a good bet, because historically the Swiss franc has been one of the world's most stable currencies. Backing his conviction with cash, he bought five Swiss franc contracts (totaling 2,500,000 Swiss francs worth approximately $625,000) on the IMM and deposited $25,000 margin. (This was before the IMM lowered its contract sizes and reduced margins; today $4,000 margin is required to trade one contract of 250,000 Swiss francs worth approximately $75,000.)

As it turned out, he was right. On Feb. 12, 1973, Washington devalued the dollar for the second time in 14 months. In less than six weeks, this lucky trader made a very cool $150,000 profit. Of course, if he had been wrong, he could have lost the same amount, which would not have been very cool.

Contrary to how it may seem, the IMM was not established solely to provide speculators with another financial playground. The market does have a sound economic reason for existing. This is to provide price insurance for importers, exporters, multinational companies, banks and others engaged in international business, all of whom must deal in foreign currencies. By using the IMM to "hedge" their risks, these commercial interests can protect themselves against sudden and adverse changes in currency prices that could turn a profitable transaction into an unprofitable one. The reason the IMM unabashedly makes an appeal for speculators — and, indeed, must have them to function — is because without them the market would not be liquid enough to attract commercial hedgers. Profit-seeking speculators, protection-seeking hedgers: This is the economic *quid pro quo* of the IMM, as it is of any commodity futures market.

Considering that currency trading traditionally has been, as IMM chairman Melamed points out, "a private and sacred shrine of the banking community," the big Chicago banks have shown an astonishingly friendly attitude toward the new market. The Continental Illinois National Bank is the IMM's delivery agent. The First National Bank of Chicago is a clearing member of the exchange. Dr. Beryl Sprinkel, senior vice president and economist of the Harris Trust and Savings Bank, is a director of the IMM.

EVEN some major New York banks, many of which Melamed says originally considered the idea of a currency futures exchange "too ridiculous to discuss," are showing some interest. Both First National City Bank and Chase Manhattan, the number two and three banks in the nation, are now doing business through the IMM.

In its nearly two-year existence the IMM has toted up some impressive statistics. Through the end of 1973, trading volume totaled 581,302 futures contracts, representing a dollar volume of $47.4 billion. So far, the Japanese yen has been the most actively traded currency; the Italian lira has been the least active and was recently de-listed as a result. The IMM has 650 members, most of whom also are members of the Merc. Memberships, which originally sold for $10,000, sold for as high as $24,000 at the beginning of this month.

Currency futures, according to Leo Melamed, are only the tip of the monetary commodity iceberg for the Merc and its IMM offspring. "We're going into a consciously monetary posture," he vows. "We want a full portfolio of monetary commodities."

How full is full? Apparently the sky's the limit. Last fall the IMM added futures contracts in both U.S. and Canadian silver coins (contract size: five canvas money bags of coins with a total face value of $5,000), and trading has so far been brisk. Currently the IMM is readying a gold futures contract and hopes to get Washington's nod to begin trading, if and when Congress passes any of several pending bills to allow U.S. citizens to own and deal in gold. Beyond this there is talk at the exchange of someday listing futures contracts in such far-out (in traditional commodity market terms, that is) financial instruments as home mortgages, Eurodollars, Eurobonds, U.S. federal funds and ocean freight rates.

The old Chicago Butter and Egg Board, as the Merc originally was called, has come a long way and, says Melamed, "We haven't begun to flex our muscles."

When the IMM opened, Merc president Everette B. Harris made what at the time was probably a judiciously modest prediction but has since proved to be a gross understatement. "Our baby ought to walk and talk within two years," Harris said. At the rate it's going, the IMM will soon be in long pants, and the boys at the Merc will be well on their way to earning the highest accolade the international financial community can bestow—albeit grudgingly: the right to be called the Gnomes of Chicago.

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