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AN INTERVIEW WITH LEO MELAMED

Founder of the International Monetary Market

The financial futures revolution probably owes more to Leo Melamed than any other single individual. He presided over its creation on the Chicago Mercantile Exchange (CME) in the early 1970s – in the face of enormous scepticism – and has been a vigorous advocate on its behalf ever since, helping to attract thousands of new participants to the market and to generate a spectacular growth in trading volume.

Born in Poland, Melamed arrived in the US as a boy refugee in 1941 after his family had trekked across eastern Europe and Asia, escaping from the Nazis. They settled in Chicago. Later, while studying law, Melamed worked as a runner for Merrill Lynch at the CME and, just before graduating, became a member of the exchange. After building up a successful law practice he decided he preferred trading and, in 1966, established Dellsher Investment Co., which now specializes in trading financial futures and options on behalf of institutional clients.

From 1969 until 1977, Melamed was chairman of either the CME or of its International Monetary Market (IMM) division. Since 1977, he has been the CME's special counsel, while continuing to trade whenever possible.

Both his parents were teachers – the word 'melamed' is Hebrew for 'teacher' – and, as he put it, "in a figurative way, I've also been a teacher, in terms of futures markets, all my life."

For more than a hundred years, futures markets were largely an American, even a Midwestern, phenomenon, and they were based on agricultural products. Now all of a sudden, it seems they are international and are mainly based on financial instruments. What happened?

What happened was that Victor Hugo was right. Necessity *is* the mother of invention. Let me explain.

Futures markets have, of course, been in existence for a very long time and working well. But they always involved agricultural markets. The first of these, in a centralized way, began in Osaka in 1650. Some 200 years later, the grain markets of the Board of Trade were organized in Chicago.

In the early 1970s however, the world economic climate changed dramatically and demanded a risk transfer mechanism for finance similar to the kind futures provided for agriculture. You will remember during those years the gold standard was abandoned, fixed exchange rates were coming to an end, and the world was about to enter an era of uncharted financial waters. Indeed, it was to be an era of great financial volatility, major price fluctuations and substantially different, as well as new, supply/demand equations. These situations created the need for a risk transfer mechanism such that futures could provide.

How was the idea of currency futures born?

It was really the result of a combination of factors. First, because I and some of my close friends, who were also fellow traders, perceived a financial opportunity in currencies. Specifically, we thought at the time, that was 1971, that the British pound was substantially over-valued and that we could make some money being short sterling. Unfortunately, for us, however, we were excluded from participating because the banks demanded a *commercial* reason to accept our short position. The foreign exchange interbank market was then exclusively for commercial transactions, which excluded speculative or investment motivations. In my opinion, this was unfair.

Secondly, as chairman of the CME, I had come to realize that, throughout the history of our institution we were captive of a *single market*. The institution had begun life as a butter and egg futures market thus its markets were of a singular nature and totally dependent upon the cyclical price fluctuations of dairy products. When the egg market production cycle flattened, so did the price movement of eggs and the need for a futures market in this product. The CME almost died as a result.

By 1969, the Merc had become a meat futures exchange and, although this was a successful futures product, it was again of a singular nature. The Merc was now dependent on the fluctuations and supply and demand factors of meat related products. It was again deeply vulnerable.

I knew that to be a truly successful futures exchange we would need a diversified mix of futures instruments. We had to avoid the fate of those who were dependent on any one market. I was therefore motivated to find new products or instruments – ones which would lend themselves to a futures market and which were substantially different from the existing meat products.

The third factor which led me to currency futures was the fact that Professor Milton Friedman, an economist whom I greatly admired, and destined to be a Nobel Laureate, was publicly proclaiming the end of the Bretton Woods fixed exchange rate system. If he was right, and I had little doubt he was, then a futures market in foreign exchange was a viable possibility. It was precisely the type of market I was looking for. When we asked Professor Friedman what he thought of this idea, he embraced it unequivocally and agreed to write a feasibility paper toward that end. His stamp of approval of our idea thus gave us enormous credibility. With it, we could more credibly discuss the idea with top Washington officials, as well as banks and bankers the world over. In other words, Professor Friedman's paper became a key which we used to open many doors –

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doors that might have otherwise been shut to us.

Did you have any idea that currency futures might open the floodgates to all these other products?

Actually, I did. When we launched the currency markets, I recognized that if the experiment worked, we were on to something big; it would work in every area of finance. As I specifically said to our members then, if our currency markets succeeded, then they would become the first step in a long journey within the financial world. "The sky's the limit," I told them. If it failed in currencies, I doubt very much whether it would have worked in anything else.

It took several years to get off the ground. There was even one year when trading volume fell sharply. Did you ever think it might not succeed.

This may sound foolish to you now, but I actually never doubted it. However, I suspected it would take a very long time. We had no community of users, we had not established our credibility in the financial community, we had no educational tools to promote the concept and teach people how to use these things. Moreover, the world wasn't accustomed to currency fluctuations. All of this would take a long time to bring about. It did. It took a good four or five years. But I never for a moment believed it would be anything but a success.

I'm not saying there weren't times when I felt bad or didn't like the immediate picture. Surely, there were those moments. I worried about the price of memberships falling. I worried about volume statistics. I worried about bank participation. But the deep-seated belief never changed that the idea would work if it was given enough time and energy and people. Clearly this required an army of traders. If I were to hand out any congratulatory awards, it would be to those traders who had a belief in this idea and were willing to spend the time, energy and money in the pits trading these instruments during the early days.

Was there any single event that helped promote their use?

There were many. One that stands out was an event which occurred in 1976. It proved to the banking community that our futures exchange was a sound institution, one with which they could do business.

In 1976, the Mexican peso was severely devalued overnight. The event sent shock waves throughout the foreign exchange markets and closed the peso interbank market. The only institution to keep trading in the Mexican peso was the IMM. We continued to provide spot and forward prices. Indeed, the transfer of hundreds of millions of dollars between the longs and the shorts effected by the devaluation, went smoothly. Our system proved sound and our markets viable. It was an impressive performance and gave us world credibility.

Government intervention in the pricing of one of your products seems to defeat the whole purpose of futures trading . . .

The CME building

That's very true. Actually, the Mexican peso was the only fixed-rate currency we were still trading and we recognized the danger in it. It was always my personal view that we ought not to be trading in something where the price is determined by a government or committee. Futures need a floating system or at least enough of a float to reflect market value. The peso was not. So I always believed that peso trading would diminish over time, as it has.

Do you see any similarities with the ECU which the CME plans to introduce, whose component currencies are subject to realignment by governments?

No. The ECU price will not really be controlled by any government. As long as the instrument is real rather than fictitious and so long as its pricing is determined by economic factors of supply and demand, then it can become a futures market instrument. While it is true that governments are involved with the ECU, the actual value is determined by supply and demand in the open market. If the governments try to fictitiously manage it, then you're right, we won't touch it. It would fail in any event.

Another characteristic of the ECU is that its value tends to move in tandem with that of the Deutschemark, so won't you have two products that are basically the same?

The Deutschemark is, of course, an actual currency; the ECU is not. In other words, longs who stay for delivery get physical possession of Deutschemarks. So while it is true that the Deutschemark will track the ECU generally, it will be sufficiently different to give the ECU a reason to succeed.

The CME trades both three-month T-bills and Eurodollars, and T-bill volume has declined over the past couple of years. Is that an example of product duplication?

I don't agree that the T-bill and the Eurodollar is an either/or situation. If you said the CD and the Eurodollar or the CD and the T-bill, you might have been right. In my opinion, there will always be a T-bill market in addition to the Eurodollar market. They are two different instruments and they don't track each other identically. There's a lot of swap and spread trading that goes on because the spread relationship between these two markets changes constantly. So I believe those two markets will continue to exist and grow. Now, if you ask me whether there's room for a third 90-day interest rate market, then I have to admit – the jury is still out. So far, however, we've maintained a pretty good CD market.

Why has T-bill volume been on the decline?

T-bill volume was high at a time when its yields were high. That's because high yields cause high volatility. Today, the yield is much lower and, of course, volume is a factor of volatility. The other reason is that right now the centre of attraction happens to be the Eurodollar market. It is the benchmark in terms of short-term interest rates, worldwide. But that's not to say that, at some point in the future, T-bills might not again rival Eurodollar volume.

The Eurodollar contract is now tremendously successful, but it was slow to develop. Why was that?

Well, in the first place, Eurodollars were a comparatively new instrument. Eurodollars, unlike T-bills, didn't have as long a history of cash market movement or a complex network of cash market trading. Moreover, much of the business in Eurodollars was in Europe. The IMM had to gain credibility within the European community and educate its foreign users before we could achieve success in this market. This took a long time. We were, however, confident because the underlying cash market in Eurodollars was so big we knew it would inevitably translate to a successful futures market.

Do we know what makes a successful product?

That is the most critical question asked by market innovators and exchange administrators. No one has the precise answer. I don't. I have a feel for it, but I'm never certain. As I've said many times, there are probably 12 known elements for a successful market and then there's a thirteenth – I don't know what it is – but that's the most important element of them all.

Perhaps it is environment or just plain marketing or perhaps it is totally inexplicable. The other 12, of course, are well-known.

What are the most important of those?

Well, the obvious ones are that it must

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represent an instrument of trade whose prices are predominantly determined by the free market; it must have commercial viability and be or become an important tool of the business community; it must be an instrument whose price fluctuations and volatility are such that there is great risk to commercial users and great opportunity for speculators; it should be an instrument that cries out for a risk transfer mechanism. Then, of course, futures contract specifications must be created commensurate with existing commercial standards. In other words, the contract size, delivery dates, minimum tick fluctuations and so forth must be commercially viable.

A few years ago, it was thought that virtually everyone with any exposure to financial risk would use these markets. That hasn't happened.

That's right. It's not for everybody. As far as speculators are concerned, it is limited to those who have to have risk capital which they can afford to lose if they are wrong. If a loss means a change in lifestyle or an inability to pay one's alimony or mortgage payments, then these markets are not for that person. Of course, this means that there are people who will be excluded from futures. I don't mean by an act of law, but I mean by virtue of good sense.

As for commercial hedgers, the answer is not always the way we thought. First, let me say that, when we launch a new product, we always carry out an analysis identifying the uses and applications. But we know that, only after a new product is listed and trading will we see the real uses. This is so because it takes the real market with live applications to produce a clear understanding of the product. It is only then, when the market is trading and viable, that the commercials for whom the market was created can find out how it best serves their needs. Theoretical economic justification isn't enough. The market itself is the only true economic justifier.

In addition, we have found that there is considerable indirect use of the markets. This is distinguished from direct use, such as when a bank or financial institution hedges its proprietary risks in our markets. The indirect use is when a bank or financial institution uses our markets to lay off a position it has assumed for a customer, ie, the end user. Today, the banks have become natural intermediaries for corporate treasurers. The bank will create the product mix its client needs, then lay off on our market, the risk gaps involved.

How would you assess the performance of the Singapore International Monetary Market (SIMEX)?

Well, it's far too early to make that determination in terms of SIMEX itself. But, conceptually, the system of mutual offset between two different exchanges in two different time zones is unquestionably an overwhelming success. And I think it is already the model for many, whether futures markets or securities markets or cash markets, who are moving towards a 24-hour trade system. In this respect, as I said our experiment is already very successful.

In terms of volume, the jury is still out. As I have often said, one should not measure the success of SIMEX in this respect until several years, maybe five, have elapsed. Its success will depend on how well the business institutions and banks in the Far East accept Singapore and the SIMEX as a futures exchange. This will take time.

Trading outside the US is still small compared with the volume of activity in Chicago. Is the Chicago experience exportable?

That's a question that many people have asked me. So far, the answer has been a qualified one. It has not been very exportable. London has been successful, but only to a moderate extent. SIMEX is off to a slow start, although at this point I'm satisfied. I maintain that the experiment in southeast Asia ought to be the one that succeeds because I believe that the Asian pyschological make-up and personality are very compatible with these markets and are very similar to those found in America and, particularly, in Chicago. So if these markets are going to succeed anywhere outside the US, I think one of those places will be Asia.

Some people question the need for a 24-hour trading day . . .

I, too, question it in terms of human physical applicability. People like to sleep and relax and engage in activities in the evening that aren't connected with business. So what do you need 24-hour trading for? But, unfortunately, it isn't an issue geared to human desires or customs. Rather, it's a question of market forces. The markets have shown us that the world has shrunk so that price changes in one time zone immediately affect prices in the next time zone. Whether we like it or not, that is a fact of life and since commercial activities are determined by price changes and volatility, we have to find a way for commercial users to connect into those price changes.

How do you view the introduction of options on futures?

That is one of the growth areas that is very much on the front burner and has proven a successful addition to the other markets that we had in place. I maintain that this exemplifies the difference between the 70s and the 80s. In the 1970s, we invented new markets, horizontally so to speak. In other words, we broke completely new ground: interest rates, currencies, equities, and so on. In the 1980s, however, we see a vertical growth. In other words, new markets are piggy-backing onto markets invented during the 1970s. Options fit that pattern.

Looking to the future, can you see a time when there might be just three centres of futures trading in the world, say in Chicago, London and the Far East, one in each major time zone?

I think that's reasonable. If you're looking way, way down the road, something like that might happen. But there are some markets in New York which have found a very successful niche and will probably stay in business. I salute them for their success and believe, more likely than not, they will continue to be successful. For instance metals have found their niche at the New York Commodity Exchange; energy futures have found a niche at the New York Mercantile Exchange, even when the Chicago Board of Trade and the Chicago Mercantile Exchange tried to wrest it away.

Mainly due to financial futures, the industry's trading volume has been growing rapidly. Could we be at a peak? Or, putting the question a little differently, could we look back in 50 years time and find that the volatile exchange rates and interest rates of the past few years were an aberration. Will the bubble burst?

Well, that's a difficult question to answer. First of all, I can't predict anything 50 years from now. I can't predict 50 weeks. So you're asking a nearly impossible question. But, of course, many people in the 1970s thought the markets then were a bubble that would burst – but it didn't. As the uses of these markets became more and more widely accepted and understood, so did our universe of users. These users have found many applications for our markets and, thus, have increased our volume. This volume is now not merely a function of volatility. This process hasn't ended yet. At the same time, we continue to invent products vertically. This expands our universe of users who, in turn create more volume irrespective of price volatility.

Volume and rates of growth in futures and options