The man who rocked money world

BY STEPHEN FAY
AND PHILLIP KNIGHTLY
Special to The Globe and Mail

Leo Melamed at Chicago Mercantile Exchange. Former cabbie started foreign-currency futures market.

THE CONFERENCE session on international financial markets at the Mayflower Hotel in Washington, D.C., finally ends. On the platform, the speakers stretch their legs and smile at friends in the audience. Except the principal speaker, a thin man with large spectacles and an expressionless face. He reaches into his briefcase, takes out a portable telephone, runs up the aerial and taps out a long distance number. He can be heard murmuring questions: "D-mark? Yen? Dollar-pound?" Then he says, "Fine," puts the phone back in his case and leaves.

The room follows him with its eyes. This is Leo Melamed, a former taxi-driver from Chicago, who started the multi-billion-dollar business. This is the man who launched the foreign-currency futures market that now causes such confusion among travellers, uncertainty among economists and anguish among politicians. This is the man who made it possible to trade a nation's reputation as though its currency was just a share price that might be worth a quick gamble.

Mr. Melamed is a first-generation American, a Jew from Poland (Melamed means teacher in Hebrew) who fled through the Soviet Union from the Nazis with his father and escaped from Japan shortly before Pearl Harbor. He settled in Chicago but never really stopped running. He drove a cab to help pay his way through university, where he studied law and psychology, and also to help pay for his education on the Chicago Mercantile Exchange, where they traded everything from eggs to pork bellies.

Finally, Mr. Melamed's father lent him the money to buy a seat on the exchange. Once in, he found the men who ran the exchange stuffy and unambitious. His attempts to change this were not welcome. He was an outsider.

The professor of economics at the University of Chicago was an outsider, too. Milton Friedman, architect of monetarist economics, was the scourge of central bankers and finance ministers. In the fall of 1967, events conspired to bring the two outsiders together and change the international monetary system.

Mr. Friedman did not simply indulge in economic theory. He played the market. In the fall of 1967 he became certain that Britain was about to devalue the pound. He was so certain that he was prepared to gamble with $300,000 of his own money so he would make a profit when the pound did come down.

Spurned by bank

If the pound went from $2.80 to $2.40 — as Mr. Friedman calculated — his profit would be $42,851. There was one catch. This deal had to be done through a bank and, when Mr. Friedman went to his bank manager with security for $300,000, he was turned away. This sort of dealing was not for individual customers, the manager implied. This was banking business, and only for banks.

Mr. Friedman was outraged. He believed in free markets and the right of the individual to invest in them. When he met Mr. Melamed he found a like soul. Why not trade foreign exchange futures on the commodities exchanges just as if money were a commodity, they reasoned? After all, the futures market allows farmers to sell crops and food manufacturers to buy at a price that is agreed before the crop has been harvested. This gives the farmer and manufacturer security and transfers the risk of price fluctuations to traders prepared to gamble on which way the prices might move. Farmers and manufacturers are "hedging," traders are speculating.

Mr. Friedman and Mr. Melamed agreed that for importers and exporters, foreign currency was a commodity not unlike wheat. Why could not importers and exporters "hedge" against currency fluctuations by being able to buy foreign currency three months or six months before they needed it, at a price agreed upon now, and let the trader take the risk that the rates might change in the meantime?

Mr. Melamed went ahead and formed the International Monetary Market in 1971. Ignoring the sneers of the blue-blood East Coast bankers who wanted to know what "pork-belly crapshooters from Chicago" could possibly know about foreign exchange, the IMM opened for business in May, 1972.

It proved a propitious time. Since 1944, the Western world had had a neat system for fixing exchange rates called the Bretton Woods agreement (after a hotel in New Hampshire where the agreement was hammered out). Under this agreement, the United States agreed to deliver gold in return for foreign-held dollars whenever the holder required it. The rate was one ounce of gold for $35.

But the process injected enormous supplies of dollars onto the market. Most of these dollars were subsequently changed for German marks, Japanese yen, Swiss francs and sterling in the ordinary course of trade. They added to the existing overhang of dollars around the world that stemmed from U.S. overseas investments after the Second World War, and the Bretton Woods system was finally subverted by inflation that began in the United States when President Lyndon Johnson decided he could finance the Vietnam War without raising taxes.

There were so many dollars around the world that the ability of the United States to deliver gold in exchange for foreign-held dollars could no longer be maintained. Bretton Woods was abandoned and after 1973 the world's major currencies were left to find their own levels, or to "float."

So after a shaky start, the IMM took off. "The banks who had shunned us, now joined us," Mr. Melamed recalls. "They knew that the crapshooters of Chicago were on to something big." The central banks were less happy. IMM was a free market, out of their control. But determining the value of currencies by market forces was Mr. Friedman's objective. An open market in the currencies of the world was an outsider's revenge on the orthodoxy of the economic establishment. The IMM became the world's largest financial market of its kind.

Mr. Melamed is still running like an outsider, though he moves in a different class. He stays in spacious hotel rooms and his suits are of the finest cloth. He could retire and cultivate his laurels, but has the restlessness of a market trader.

Having created the financial futures market, he trades in it, being hit by it (wrong about the U.S. dollar in 1984), making money out of it (right about the U.S. dollar in 1985). And he suffers the neurotic uncertainty of any man who trades on his own account. "My ability is based on the need to survive," he says. "That's the real discipline."

Foreign-exchange dealing has made speculation respectable, even by the most prudent financial institutions. The market does lubricate international trade, but nine out of 10 deals are speculative and each speculative trade is supposed to be a "zero-sum gain" — for each winner there is a loser.

"It's like pass the parcel and a bit of a mystery to me how the plusses and minuses work out," says a Bank of England's senior foreign exchange expert. Lord Lever, the former Labor treasury minister, is blunter: "Though the turnover in the currency markets is enormous, virtually all of it is self-balancing froth."

Hits like a cobra

That may well be, but the effect of the market activity is undeniable. "The market is like a predator," says Mike Beales, a former dealer with the Bank of England's own dealing room who left to run Westpak's in the City of London. "It looks around for a vulnerable currency and strikes it unmercifully, like a cobra".

The dollar is strong, the pound is weak, a currency is vulnerable when the market decides it is. Small countries fare worse than large ones. It might take a thousand trades to move the pound, and 3,000 to shift the dollar, the yen and the West German mark. This is enough to make the movements of these currencies usually orderly. But much smaller trading can hit what the traders call "exotic currencies" with a devastating blow.

•

Friday, July 19, 1985, is known in Italy as Black Friday. When trading opened, the value of the lire was 1,840 to one U.S. dollar. When trading was suspended six hours later, the lire was down to 2,200 — a decline of 19.6 per cent. The Government had been thinking about a formal devaluation, but not of this order.

Yet it turned out that Black Friday's sensational run on the lire had been sparked by the action of an Italian company, ENI, the state fuel corporation. ENI, the third-largest non-American corporation in the world, chose July 19 to buy $135-million. A dollar purchase of that size in London would cause only a tremor. In Milan, the market erupted, especially when it became clear that the Bank of Italy would not intervene to stop the slide.

Later investigations concentrated on the charge that ENI had been tipped off about the devaluation and used this information to make a large speculative gain. But the conspiracy theory ignored the more significant lesson of this story: foreign-exchange markets effectively removed from the Italian Government the power to determine the value of its own currency.

Oil prices were the sensation of the 1970s. Currency crises are the phenomenon of the eighties. The old system started at Bretton Woods was orderly. According to Mr. Melamed and Mr. Friedman, it was also a sham, designed by governments and their central bankers to disguise the true state of their economy.

But order has been replaced by instability. This may suit the money-changers. It does not improve the economic well-being of ordinary citizens who find it hard to understand what it is all about. Tough luck, says Mr. Melamed: "Speculation is a product of our times." He says it only became fashionable when money began to lose its reliability as a store of value. The great inflation of the late seventies and early eighties sent prudent investors running for cover in the foreign-exchange markets. "I have the right to protect myself," he said.

Henry Jarecki of Mocatta Metals in New York has a more elementary explanation for what has happened. "It's a symptom of an amoral society. One created by high taxes and black money. People look around for way of using their money that will keep its value. About two years ago they began to find gold and silver too mundane. A trading object should fulfil a need. These markets didn't. Foreign exchange did. But something is wrong. There's a sham going on."

The U.S. Federal Reserve apparently agrees. In the summer of 1985 it undertook an internal inquiry into the strength of the U.S. dollar in relation to other currencies. It concluded that the only explanation was a vast speculative bubble.

Last September, the world's five leading financial nations, known as the G5, decided to try to burst it. The U.S. Treasury ignored its strict policy of non-intervention in foreign-exchange markets and for the first time in five years, together with the central banks of Japan, West Germany, Britain and France, sold U.S. dollars heavily. When speculators continued to buy, the central banks simply sold more.

The dollar came down and the action by governments revived the notion that they could act to restore stability to foreign exchange. U.S. Treasury Secretary James Baker began to talk about a new Bretton Woods agreement and critics of free foreign-exchange markets, who had been silent for years, began to be heard again.

Edward Heath, the former British Prime Minister, told a symposium of foreign-exchange traders in London in November, that they would not be in business much longer because governments would demand a fresh version of Bretton Woods to reimpose control of exchange rates.

Mr. Melamed laughs. "Hogwash," he says, sure that foreign-exchange markets and currency in futures had proved the most successful business innovation of this economic age. "An orderly world might be nicer," he says, "but that world would have to go back so far in time it would probably take another holocaust for it to happen again".