I'm alive! That entitles me to a commercial motivation

Much of the credit for the boom in Chicago's exchanges in the 1980s must go to Leo Melamed, 56, chairman of the Chicago Mercantile Exchange's executive committee. The spectacular growth in stock futures trading couldn't have occurred without Mr. Melamed's brilliant launching of the concept of currency futures on the Merc's International Monetary Market (IMM) in 1972. Along the way, Mr. Melamed faced formidable hurdles to convince big names in the Nixon administration to support the idea of currency futures.

I've always said that if you've traded pork bellies as I have, you've been through hell, so nobody can scare me with anything. But I remember clearly how scared I was one morning in 1972 as I waited in the anteroom of the U.S. Treasury Department, right outside the office of George P. Shultz, who then was Treasury secretary.

Sitting in those hallowed halls, a virtual non-entity, I was extremely overawed. I was relatively young, just over 30, an immigrant kid from Poland with no credentials except for being chairman of the Chicago Mercantile Exchange. Though the word "Chicago" must have identified something for George, who came from here. The exchange in those days had no importance: We were very small, a secondary futures market and a distant second to the Chicago Board of Trade. Though we were dealing successfully in cattle, pork bellies and hogs, we were a far cry from being a major force in the economy of this country.

I was there to present a completely new idea for trading in a futures market in currency. Our lawyers told me that I didn't need official permission to start such trading at the Merc, but I thought it would be presumptuous of us to begin trading in so important an instrument as currency without at least touching base with the U.S. Treasury Department.

We had to sell this idea to institutions like banks, which were hostile to it. The notion that a place like the Merc could also house such an important financial instrument as currencies gave bankers the willies. What would be our chances if our government said, "Bad idea"?

I will never forget the warmth by which George Shultz accepted Everett Harris, the Merc's president, and me. Partly it had to do with the fact that we had made a very smart move: I had asked that Milton Friedman, the University of Chicago's famous free-market economist, write a paper on the value and need for future markets in currency.

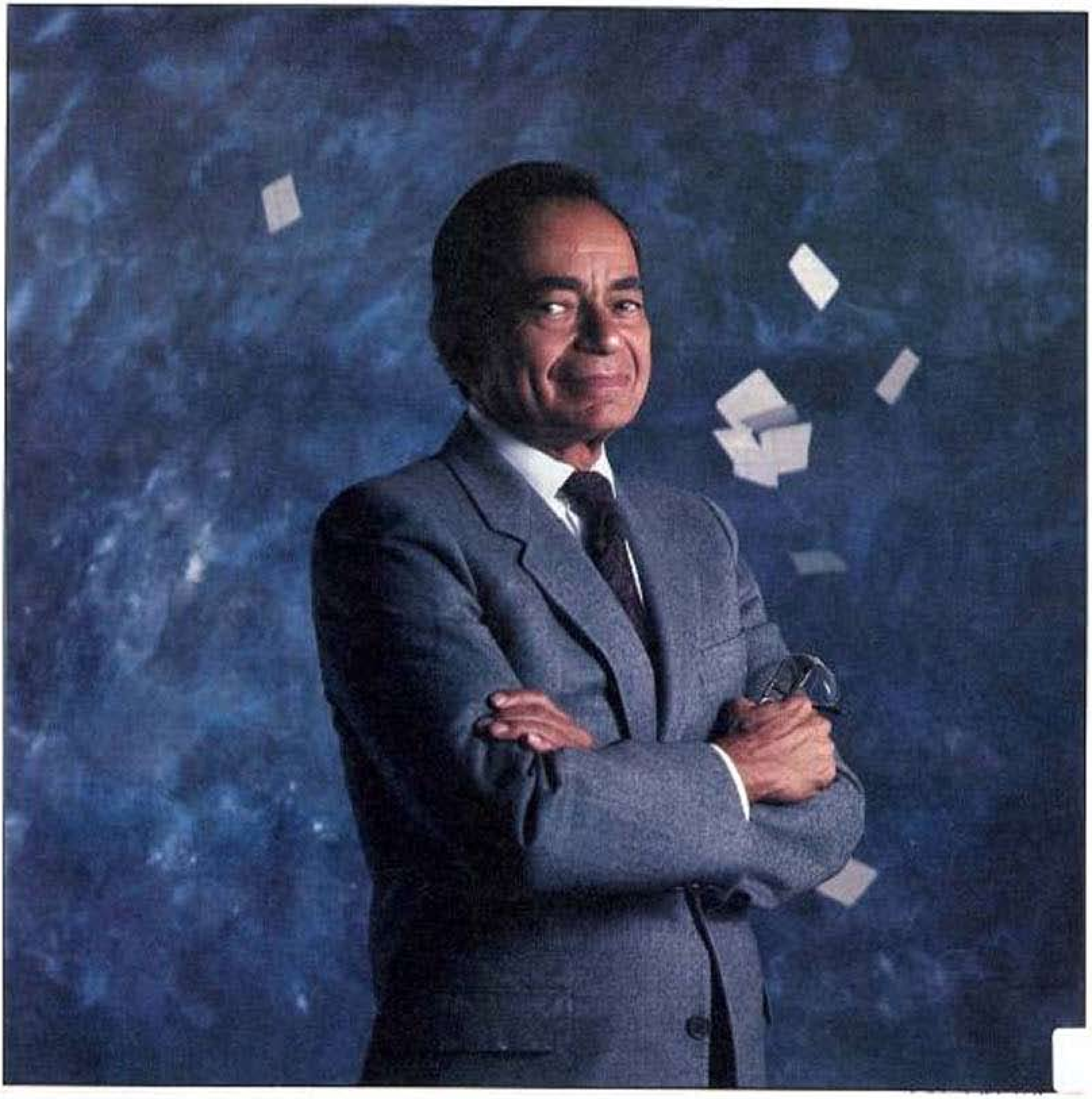
George Shultz, who favors open markets, mentioned that he'd seen the paper, and the fact that Milton Friedman approved was certainly meaningful.

I proceeded to explain that if we were leaving the era of Bretton Woods' fixed exchange rates—as we did in 1971—and we were going into uncharted waters of floating rates, we would need a new market for hedgers and speculators.

After hearing me out, he told me, "Son, the odds are probably 30-to-1 against you, but God bless you. But, it's not a bad idea, if you can make it work." At that moment, he became my hero forever.

Arthur Burns, then chairman of the Fed, was

See **Melamed** *on Page A61*



Continued...

10 YEARS OF CHICAGO BUSINESS

The triumphs, the defeats, the deals

26 who made history tell their stories

A Special Issue commemorating the 10th Anniversary of Crain's Chicago Business

Continued from Page A60

our next appointment, that same afternoon. Here I was, going from the U.S. Treasury Department to the Federal Reserve to meet the second-most-powerful person in the world—*if* indeed he is second to the president, and sometimes, that isn't clear. Now, I was really nervous.

But Arthur Burns, who had Milton's paper lying on his desk, accepted us very warmly. He said it was going to be an uphill battle for us, but that we had one hell of a good idea. I left on cloud nine, assured that the U.S. government wouldn't oppose the idea.

We went home that afternoon so I could tell my kids the story. Of course, they were just tots at the time and didn't understand, but I knew I had done something historic.

My God, I thought, this Polish immigrant kid was allowed into those hallowed halls! And he had an audience with those famous people. It was an emotional kind of watershed in my life. I was never as fresh and as young again after that.

That paper of Milton's, worth its weight in gold, had resulted from a marriage of two things: his theory and our traders' intuition.

Back in the late 1960s, a couple of my trader friends and I were interested in going short the British pound. We thought the price of the pound was being held fictitiously far above the value for the crumbling British Empire, and we were right.

But we as individuals couldn't go short because there was no futures market for currencies. We could go short cocoa, coffee, soybeans, grains, cattle, eggs, and even copper, but not the British pound.

Only large corporations could protect themselves by going short on currencies through forward contracts with the banks. One of my trader friends even suggested we lie to a bank to convince them we had a legitimate commercial reason.

But I said: "What do you mean: I'm alive! That automatically entitles me to a commercial motivation. Don't I have an estate to protect? Why am I less important than General Motors? If they have a right to protect themselves, why don't I as an average citizen?"

Not long after that, I read with excitement a cute newspaper story about how Milton Friedman also wanted to go short the British pound and couldn't. I was convinced the idea of a futures market for currencies was a good one, but who the hell was Leo Melamed? But Milton Friedman was a somebody.

He'd been lecturing that the system of fixed exchange rates, then on the threshold of being discarded, was something that should have been done long ago because it runs contrary to free-market processes that would overwhelm it in time.

I had the temerity to find a way to sit in on his lectures at the U of C without enrolling as a student. (They didn't take attendance!) I literally fell in love with Milton Friedman's philosophies. I was overwhelmed.

Finally, one day, I asked him whether he'd be willing to write a paper for the Chicago Mercantile Exchange to endorse the idea that the world would need a futures market in currencies if we were going to go to an era of floating exchange rates. He agreed, and I used that paper throughout the formative years of the IMM.

Still, initially I got laughed out of New York when I visited all the big banks there with the idea. "Are you kidding?" they said. "A futures market in currency? And in Chicago?! If *ever* such a market is going to have a chance, it must certainly be in the capital of finance of the world: New York."

Fortunately, the bank situation in Chicago was much different. The major local banks, particularly Continental, First National and Harris, were very important in helping us launch the IMM. They had lived with the exchange's agricultural markets for many years, the market participants were good customers of the banks, and the banks understood the need for hedging and futures.

For instance, Continental Bank helped us create a mechanism for the delivery of the various foreign currencies as contracts came due. If, for instance, someone bought deutschemarks futures on our exchange and held the contract until expiration, he'd have to get the actual deutschemarks delivered to his bank account in Germany.

The Merc couldn't handle that procedure, but Continental could. At the time, Continental was Chicago's largest bank, with branch offices or correspondents in every country in the world—so, it was the likely candidate to act as our delivery agent.

First National was similarly accommodating. I wanted to create a board of directors as the Merc's showpiece of credibility to the world, and I needed names, big names, and who did I get? Robert Abboud, then chairman of First Chicago, joined our first board of directors. I am forever indebted to him for that. Similarly, at the Harris, Beryl Sprinkel, then the bank's chief economist and now chairman of the Council of Economic Advisors, lent his name and advice as a board member. His contribution was invaluable and still is today.

Outside Chicago, though, particularly overseas, we didn't fare so well at first. A case in point was our first European trip to promote the IMM in the summer of 1972, shortly after the IMM's official launch that May.

Besides meeting with central bankers in the European countries of the currencies that we were trading or intending to trade, we also offered seminars for the financial community.

But the eight board members of the IMM who embarked on the journey would invariably outnumber the audience. No more than two or three people ever showed up, and it was hard, very hard for me, not to break into laughter at the sight.

Nevertheless, there were early signs that we might make it. Of importance to me personally was the time, a year after the IMM's launch, that I was in New York to visit Merrill Lynch's senior executives.

We were trading just seven or eight currencies at the time, with very little volume, maybe a couple thousand trades a day, not much for a successful new contract these days. But as I entered Merrill Lynch's lobby, I couldn't believe my eyes: There, across an entire wall, for all the world to see, was a tote board, showing the change of prices of currencies being traded in Chicago.

However, it wasn't until three years later that I knew for sure the IMM had arrived. The occasion was the Mexican government's decision to devalue the peso on Sept. 1, 1976, its first major devaluation in decades.

In the aftershock of that action, hundreds of banks in the interbank market quit trading pesos because they didn't know how to price the currency. That meant that the interbank market—huge by comparison to the IMM—couldn't continue making a cash market in pesos for their major corporate customers. The problem was that, while the Mexican government had devalued the currency by 30%, the world believed that maybe it was really a 50% devaluation.

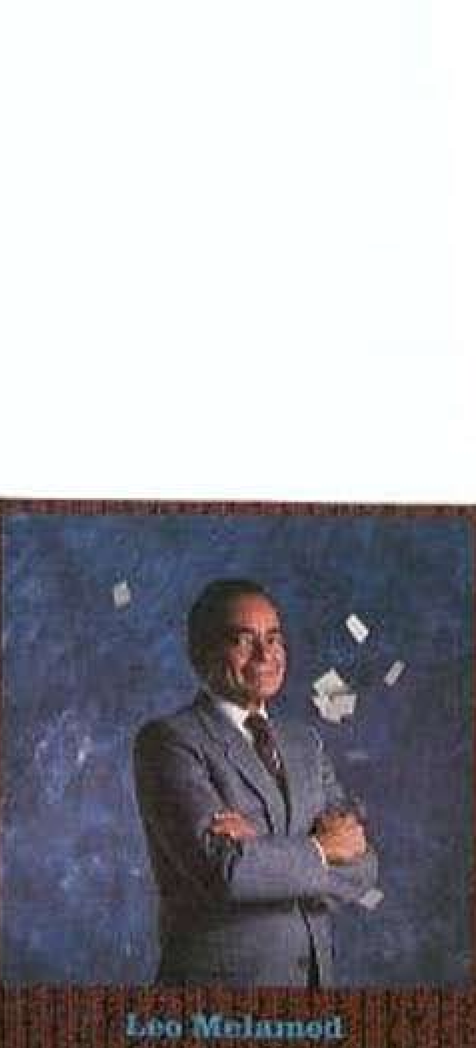
The IMM remained open throughout that upheaval as the only available market in the world for Mexican peso currency. The night of the devaluation, the largest shift of money ever encountered by the IMM until then took place—$100 million, a small change by today's standards—as investors long in the currency lost that much and those short earned as much.

Because we had to settle that night before we could open the following morning, I started to get calls from bank executives in Chicago and New York asking whether the Chicago Mercantile Exchange needed help to accommodate the sudden shift of money. I was able to say to them, "Thank you, but no thank you." The money is in, everybody paid and the exchange is in perfectly good health.

The system held together, encountering its first major test. That rang a bell in the financial community around the world, proving our fiscal integrity and value as a price discovery mechanism. We had stayed in business, we'd continued to have bidders and offerers in pesos.

And the banks had used our futures price as a pricing guideline for their own forward contracts. I was inundated with calls congratulating us on the performance of the IMM during its first major crisis. I heard from bank presidents at Chase Manhattan, Citicorp, Continental, Harris, Morgan Guaranty. All took note and either mentioned it to me personally or through someone else. The word went out that we had done well, our market was of real value, because when there wasn't any world price in the peso, we provided a market and a price. #

Interview by Barbara Marsh



Leo Melamed