Futures & Options plus

A FUTURES & OPTIONS WORLD PUBLICATION

11 January 1993

Comment

Markets, speculation and memory

by Leo Melamed

At the height of last September's European currency crisis, a top-ranking official of the International Monetary Fund dared to proclaim that the unfolding chaotic events served to prove the strength of the European exchange rate mechanism (ERM). Indeed! Is there any wonder the public has become so cynical about government leadership; about the avowed policies of its officials, or the statements they utter? Is there any wonder there seems to be a global revolt against government incumbents at all levels?

The problem of course is with our memory — the essential difference between man and animal. Mankind remembers much and has the capability to transmit this store of information to the next generation. Animal, unfortunately, cannot and must learn everything anew from birth. There is, of course, a catch. As Santayana put it, "Those who cannot remember the past are condemned to repeat it." And so we do. Time and again civilization endures the masochistic ritual of adopting a failed measure and causing yet another self-inflicted wound. Unfortunately, most of us have little to say about how or why the injury came to pass. We only feel the pain and pay for the treatment.

The truth of course, as the whole world knows, was quite the opposite! The only thing that saved what was left of the ERM was the fact that the pressure was temporarily lifted when Great Britain and Italy left the system. Not until they removed their respective currencies from the constraint of unrealistic rates did the market stop its haemorrhaging. But their actions did not take place until after the British, French, Italian, Spanish and Swedish central banks together spent roughly $100 billion trying to prop up the pound, franc, lira, peseta and krona. Germany, it is estimated, spent an additional $50 billion in marks. The sum total of these failed operations cost the European taxpayers approximately $6 billion.

"How many more fiascos will it take before responsible people are finally convinced that a system of pegged exchange rates is not a satisfactory financial arrangement?" asked Milton Friedman. There is no certain answer. Perhaps Professor Friedman should first ask whether there are any responsible people around whose voices will be heard and respected? *Instead* we hear the old demagogic cry about how the speculators are bringing down financial law and order. *Instead* we hear finance ministers declare that during the French Revolution such speculators were known as *agioteurs* and promptly beheaded. *Instead* we see a step backward toward still other failed measures such as restrictions in capital movements, with Ireland, Spain and Portugal imposing controls on capital flows.

Once again the bad guys are the speculators. Those Zurich gnomes, those bank currency traders who cumulatively comprise the interbank cash market, offering the world a dealing price for competing currencies; those corporate treasurers of multinationals whose obligation is to protect the bottom line of their companies; those fund managers who are responsible for the investments of their shareholders; and, yes, those individual currency traders who risk their own capital in their legitimate attempt to enhance their estates. And those awful speculators who do not accept that value is necessarily the price proclaimed by government officials. Those are the same government officials, by the way, who publicly swear that they will never devalue — moments before they vote to devalue; who publicly proclaim that interest rates will not be lowered or raised — moments before they agree to lower or raise them; who tell you to read their lips — until they change their mind; who tell you that the system of pegged exchange rates is working just fine — while chaos reigns in the foreign exchange market as the mechanism becomes unhinged.

Thank the Lord there are speculators around to tell truth — to tell the emperor when he is without clothes. As Michael D Bordo of Rutgers University recently said, "Pegged exchange rates, capital mobility, and policy autonomy just do not mix." To those who distrust or dislike the marketplace and its speculating participants, it must be quite exacting to admit that the theories of Adam Smith and Milton Friedman seem to conform to today's global realities brought about by modern technology. How many more fiascos will it take before this truth is accepted? That depends on our memory.

Surely 1970 is not so long ago that we have forgotten the economic setting of that day and the desperate measures it demanded? Remember the US financial confidence crisis? Remember the tortuous intervention of participating members of the G-10 countries? Remember the gush of official denials about prospective devaluations moments before such devaluations were announced? Remember the central bankers cry against the "sleazy" speculators, the cause of all problems. Remember the run against the dollar? Remember how President Nixon closed the gold window and ended dollar convertibility? How different are the recent experiences of the European Monetary System (EMS)? The solution two decades ago was to abandon the Bretton Woods fixed exchange rate system.

For it is axiomatic: a pegged exchange rate cannot work in a world where participating nations are subject to different internal self-interests and different external pressures; where they are directed by significantly disparate fiscal and monetary policies and subject to significantly different inflation rates; where they are beholden to differing degrees of labour force pressures, differing elasticities of both supply and demand for their exports and imports, are at different stages of their trade cycles, and suffer from different election timetables and differing kinds of political environments.

Pity the vaunted *Economist* in its recent attempt to give validity to those central bankers whose views are out of synch with reality. Once again it suggests that interference with market values can be justified for currency markets because they are different than other markets. "To leave a price that exerts such a profound influence on every corner of an economy entirely to a market known to be unusually vulnerable to bubbles and volatility... seems, on the face of it, ill-advised." So pontificates *The Economist*. To give the devil its due, at least it is consistent. It had little praise in the 1970s for the creation of currency and interest rate futures — markets that would unabashedly opine on values of foreign exchange and the like.

But as experience has taught us time and again, the fundamental truths governing the value of money are no different than those for all instruments of trade. And even if *Economist* reasoning was valid for the world of two decades past, which it was not, it is well off the mark today. Gone are the days when government officials could unilaterally establish price or arbitrarily proclaim a financial rule; gone are the days when they could ignore their words or surreptitiously violate their edicts.

Today there are no secrets. Technology has enabled the financial markets to act as the arbiter of truth. As Walter Wriston responded to the question of who is in control: "Everyone is in control through a kind of global plebiscite on the monetary and fiscal policies of the governments ... Today, it is the traders who value world currencies and pass judgment on governments." Carry this reality to its logical conclusion and the warning by the *Wall Street Journal* to world leaders is well taken, "... Policymakers in Germany and the US have seemed to prefer to think that market reactions are somehow irrelevant to their policy objective." They most assuredly are not. Witness the Maastricht debacle and the upheavals that followed. Witness the continuing FX climate fraught with currency disorders. Witness the squirming of the EMS as the market drives it towards accepting a two-tier ERM. Clinton beware! As Messrs Bush, Major, Mitterrand and Kohl have learned, gone are the days when governments can act independently of market reactions or traders' actions.

Indeed, those among us who still nurture the belief that speculators should be beheaded, or that a pegged system can indefinitely dictate the relative values of foreign exchange have lost their memory and failed to understand what God wrought when he married the computer chip to the telephone. In international capital markets of this day and age, a pegged rate or targeted range for a currency will last for only so long as market forces agree with it and not a moment longer. As the *Wall Street Journal* succinctly proclaimed: "There is never any real escape from market forces, even if you lock all the doors and pull down the shades, as Communist countries once tried." Surely we can hold unto this truth for just a little while.

Leo Melamed is chairman emeritus at the Chicago Mercantile Exchange, chairman of Dellsher Investment Co and chairman of Globex Corp. He is best known for his pioneering work of the 1970s and 1980s at the CME, when he was a leading proponent of innovation in financial futures and options.