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Still the wave of the futures

Merc financial contracts going strong after 20 years

By William B. Crawford Jr.

Leo Melamed, chairman emeritus of the Chicago Mercantile Exchange, sat in his office high above Wacker Drive and talked about a subject he knows well—the birth, nearly 20 years ago, of financial futures.

"There was an army of gainsayers out there who were pessimistic about our plans," said Melamed, who, with an assist from Milton Friedman, the Nobel laureate in economics, is credited with making financial futures a reality.

"Foreign exchange dealers at the commercial banks described us as upstarts and crapshooters from Chicago; a pack of pork belly traders from the Windy City who had the temerity to think we could beat the world's most sophisticated traders at their own game," Melamed said.

For the first time, on May 16, 1972, financial futures began trading on the International Monetary Market, an offshoot of the Merc created to trade only these new products. As a largely skeptical world looked on, Melamed, as IMM chairman, and a small group of allies rang in trading in seven currency futures contracts. They were the Japanese yen, German mark, Swiss franc, Mexican peso, British pound, Canadian dollar and Italian lira.

In the first year, 144,000 contracts traded, not a bad start but only a fraction of what was to come. As traders became aware of the enormous economic benefits to be gained through these currency products and as new products such as the CBOT's U.S. Treasury bond contract and the Merc's Standard & Poor's 500 stock index came on line, trading

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volume exploded off the charts.

As the Merc prepares to celebrate the 20th anniversary of the IMM, which in 1976 was absorbed into the exchange, it is almost impossible to overstate the impact of futures on the economy of Chicago, modern investment portfolio theory and other financial centers from the Pacific Rim to Europe and now the republics of the former Soviet Union. Indeed, some have compared Melamed and Friedman and their creation to Henry Ford and the automobile.

"No 20-year period has witnessed such a burst of innovative activity," said Merton H. Miller, the 1990 Nobel laureate in economics, a professor of finance at the University of Chicago Graduate School of Business and an unabashed supporter of the Merc and CBOT.

"The wonderment of Rip Van Winkle, awakening after his sleep of 20 years, and viewing the changes in his world over that interval, would pale in comparison to one of his descendants in the banking or financial-services industry who fell asleep in February 1970 and awoke two decades later," Miller said.

Indeed, two decades ago there was only a handful of futures markets throughout the world, trading so-called soft futures in everything from "greasy wool" (newly shorn lamb's wool) at the Sydney Futures Exchange to silk futures in Japan.

Since 1972, however, multimillion-dollar, state-of-the-art computer-assisted markets have sprung up from London to Singapore, offering trading in an ever-increasing number of seemingly exotic financial tools: swaps, stock indexes, currency cross-rates, Eurodollars and more.

Merc President William J. Brodsky, a lawyer by training who spent his early career as a vice president of the American Stock Exchange before coming to Chicago, calls the brief history of futures mind-boggling.

"The concept of risk reduction was an alien concept to Wall Street, and the creation of futures and options in Chicago created a legion of people who have learned to manage risk in ways they never before could have dreamed of," he says.

The success of these contracts has had a more immediate benefit—the creation of thousands of jobs in the Loop. Millions of tax and consumer dollars are pumped annually into the economies of Chicago and Illinois by the more than 5,000 brokers and traders who work in and around the Board of Trade at the foot of LaSalle Street and the Merc, 30 S. Wacker Dr.

To appreciate the enormous success of financial futures and options developed piecemeal starting in the early '80s, one need only consider three benchmarks:

- In 1990, The CBOT traded 102.4 million futures and options on its U.S. T-bond contract, up from fewer than 33,000 such contracts in 1977, its first year. Conceptually, the bond contract, considered the world's benchmark interest rate risk hedging tool, has been copied by newer futures markets in the Pacific Rim and Europe, said CBOT Vice Chairman Les Mouscher.
- While the nation's economy continues in the doldrums, trading volume at the CBOT and Merc continues at or near record highs solely because of financial futures. Last week, full seat prices at the Merc reached $550,000, tying the all-time high price set in 1989.
- In 1982, the Merc launched its S&P futures, the first of its kind. Though the index contract has been copied by markets in London, Tokyo, Australia and at the MATIF Futures Exchange in Paris, it remains the most popular index futures in the world.

The creation of the IMM and the early success of the currency futures contracts were the product of two overriding events, industry experts say.

In the early '70s came the collapse of the Bretton Woods Agreement, which for 26 years had established a narrow band of fluctuation between the values of European currencies and the U.S. dollar. When President Richard Nixon "closed the gold window" by taking the greenback off that precious metal standard Aug. 15, 1971, the rush to hedge currency risk was on.

"The end of Bretton Woods and the end of fixed exchange rates opened up a great deal of uncertainty about financial conditions in general and foreign exchange rates in particular," said Friedman.

"These products were a reaction to wide uncertainty in world financial markets, but, in turn, they have enabled the world to adjust to those uncertainties without major physical disaster," he says.

At about the time Bretton Woods was breathing its last, Melamed and several fellow traders were seeking new futures contracts to diversify the Merc's product line, generate volume and increase the value of Merc memberships. As late as 1970, the exchange was little more than a second-tier market, offering trading in only a handful of agricultural futures such as pork bellies, butter and live cattle.

But the financial futures story has not been all smooth. After the stock market crashes of 1987 and 1989, anxious leaders in Congress and on Wall Street charged that the Merc and some of its products were responsible for the unprecedented volatility.

U.S. Treasury Secretary Nicholas J. Brady argued that regulatory control over the Merc's S&P contract should be wrested from the Commodity Futures Trading Commission, a regulator he contended was too lax, and placed with the Securities and Exchange Commission. Such arguments have not been heeded.

"The facts, analysis and subsequent history of the pre-crash and post-crash era, and everything that came out of it, proved that stock-index futures were not the cause of the problems on Wall Street," said Brodsky.

"In my view, the crash, though painful, was a blessing in disguise. Stock-index futures are now a well-established part of financial management, used by some of the largest companies; every major financial center in the world has a stock-index futures contract," said Brodsky, "most of them established in the past five years."

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—Merton H. Miller, Nobel laureate

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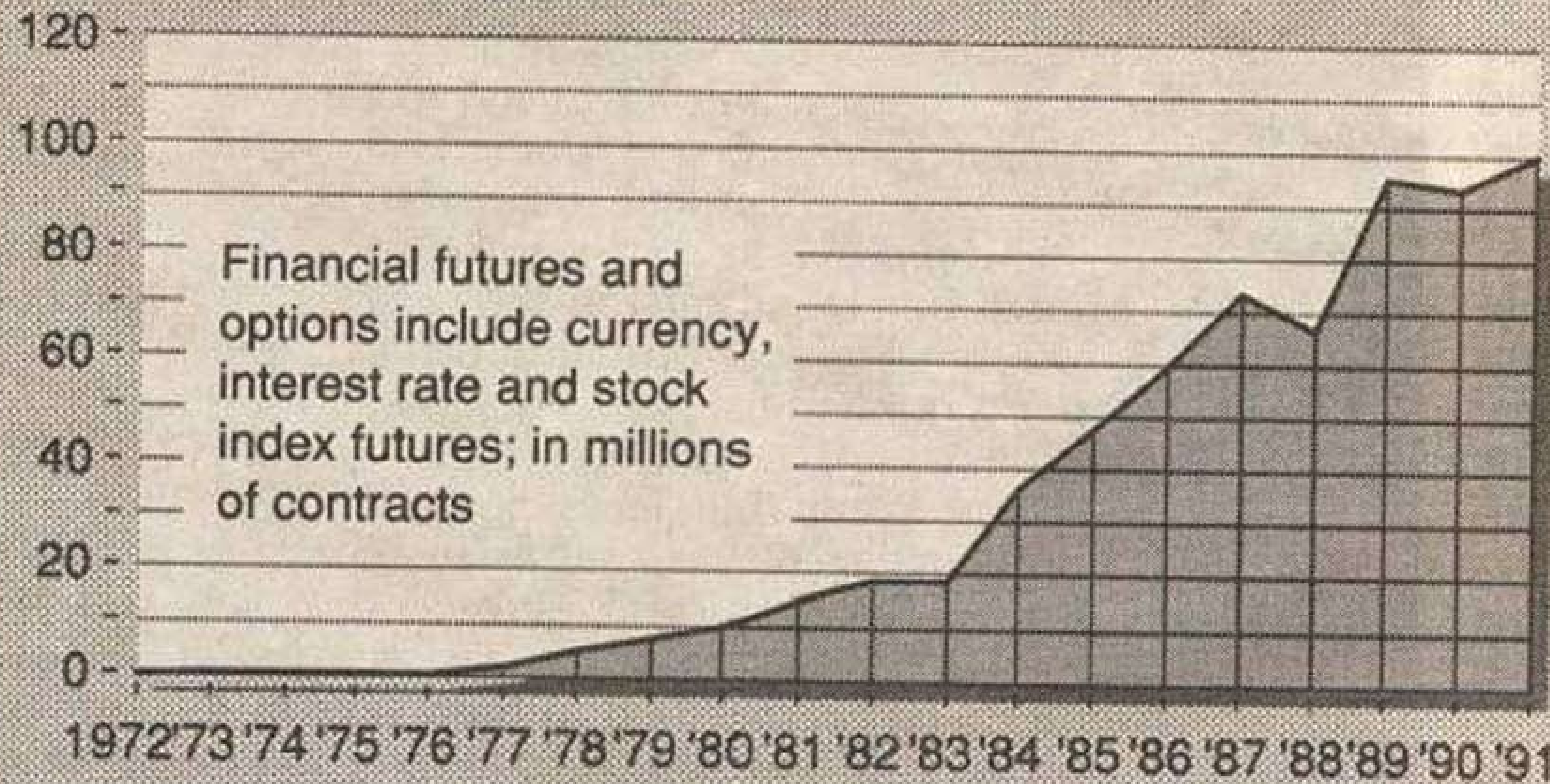
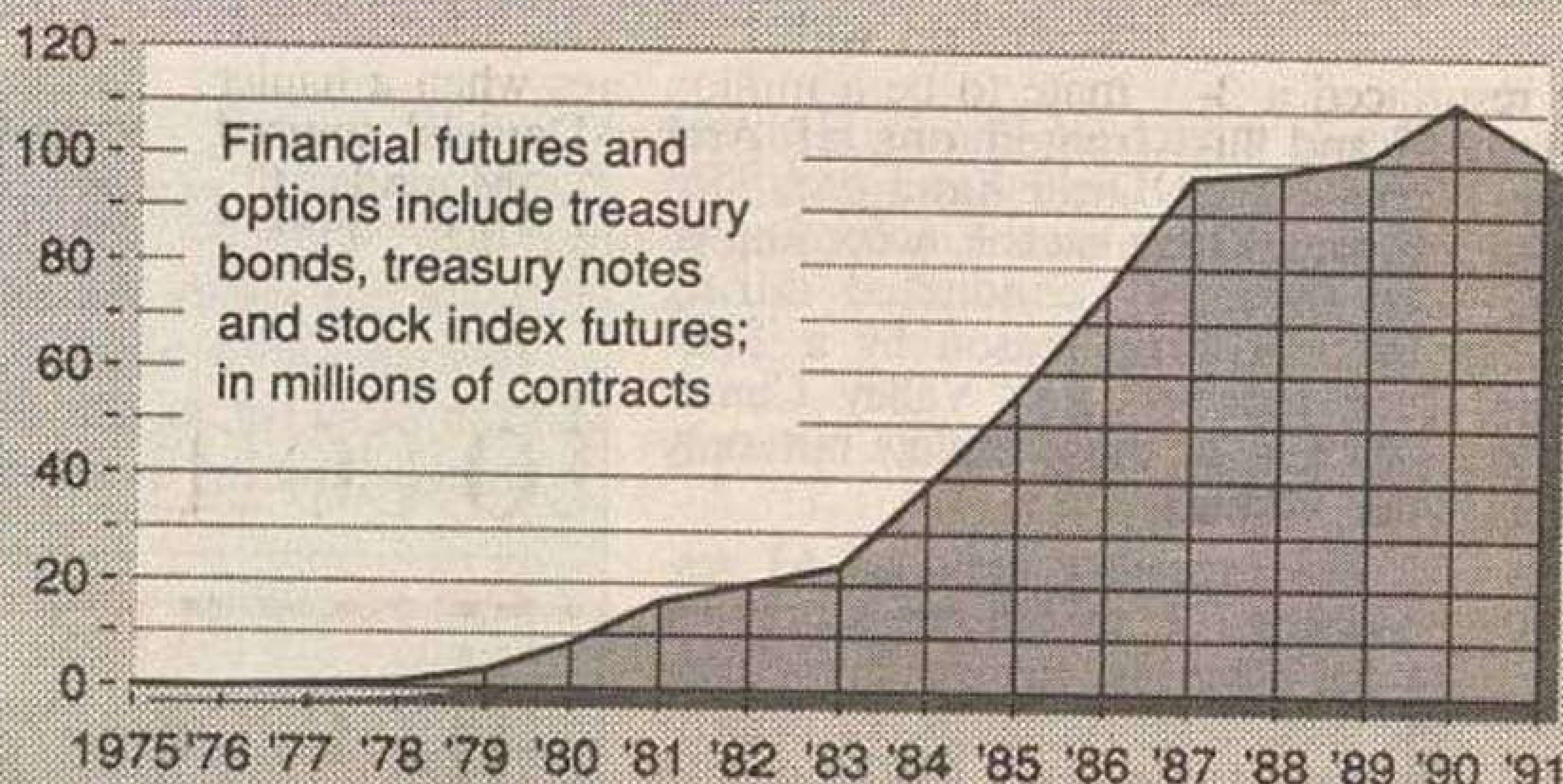
The history of financial futures and options in Chicago

The Chicago Mercantile Exchange started trading financial futures in 1972 and has since grown to a volume of almost 100 million. Financial futures at the Chicago Board of Trade began in 1975. In the early 1980's, both markets began trading options.

Chicago Mercantile Exchange



Chicago Board of Trade



Sources: Chicago Mercantile Exchange, Chicago Board of Trade

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