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On Oct. 19, 1987, the stock and index futures markets suffered their worst single-day declines in history - worse than the stock market crash of 1929. When the sun set on that "Black Monday," more than $500 billion in paper value - a sum equal to the entire gross national product of France - had vanished, leaving Chicago's multibillion-dollar futures markets reeling. The crash was "an accident waiting to happen," Alan Greenspan later told Congress. Leo Melamed, the visionary Chicagoan who pioneered the modern futures industry, describes the tense days leading up to the inevitable crash in this excerpt from his new book, Leo Melamed: Escape to the Futures (John Wiley & Sons, Inc., $27.95).

It was a perfect fall day that Monday, Oct. 19, 1987 . . . . Shortly before 6:30 a.m., my car phone rang. On the other end of the line was New York Stock Exchange Chairman John Phelan Jr., and I knew he wasn't calling to chit chat.

"Leo, have you heard the news? It looks like we're in for a very bad day," he vexed. Phelan was alerting me to news I had anticipated. He told me that an inordinate number of sell orders were gathering on the NYSE, set to hit the market. Our conversation took place more than two hours before the NYSE was to open. Normally, the Exchange did not see that kind of order flow that early. I realized it was going to be a rough day, picking up where it had left off on Friday when the Dow Jones Industrial Average sank 108 points, pushing the market to the edge of the abyss.

. . . The stock market had been spiraling upward for years, and nothing goes up forever. Overlooking that fact (or because of it), the U.S. was an overextended threadbare trillionaire; the market was overvalued, overbought and overwrought. And the crash served as a stark reminder: Markets wane as easily as they wax with a power to change minds - and empty pockets in a flash.

One thing is certain. The crash was not a random event. Most informed observers agree that its cause can be found in the underlying economic conditions of that time frame. Alan Greenspan, chairman of the Federal Reserve Board, would later testify before Congress that the 1987 crash "was an accident waiting to happen." There were, of course, more than one who had seen it coming.

"How bad do you think it will be," asked Martin Feldstein, the former chairman of the Council of Economic Advisers under President Ronald Reagan. It was about a week or so before the crash and Feldstein had come to my office to chat. He, too, feared market conditions and agreed with my assessment that we might be in for a bad time. "I don't know for sure," I responded, "but I would buy some insurance." Feldstein smiled, "Oh, I already did; I bought OEX puts at the (Chicago Board Options Exchange)." It turned out to be a very wise move. Another who saw it coming was Beryl Sprinkel, who was steeped in the Chicago school of economics. In 1987, Sprinkel, then chairman of the Council of Economic Advisers, was one of the precious few at the highest levels of government who understood the supply and demand fundamentals that made financial markets move up and down. And what he'd seen was making him very nervous. U.S. monetary policy was definitely too tight in his view. U.S. financial markets could buckle if things didn't change.

Sprinkel recognized that the tightening wasn't as much the doings of Alan Greenspan, the newly appointed chairman of the Federal Reserve, as it was of Treasury Secretary Jim Baker's. Sprinkel respected Alan Greenspan and knew that his economic credentials were solid. Baker had no formal economic credentials. Baker was a smart guy and had been an outstanding chief of staff at the White House, but when the President agreed to the game of musical chairs with high government officials, it spelled trouble. Baker became Treasury Secretary and made a deal in Paris with the Germans, the so-called Louvre Agreement, to defend the dollar and stop its fall.

Sprinkel knew this agreement was fatally flawed and spelled danger for financial markets.

. . . As October 1987 approached, Sprinkel became increasingly frustrated. The first meeting he had with the President and the relevant government officials to warn of the negative effects of the Louvre Agreement had not produced any changes in U.S. tight monetary policies. In his view, time was running out. Of special concern to him was the fact that soon he would be leaving the chairmanship of the CEA. An illness in the family had forced him to submit his resignation to the President.

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. . . Sprinkel went to Howard Baker, President Reagan's new chief of staff, and told him that a second meeting had to be held right away. "The president must be made to understand the urgency of the situation."

The meeting was held in the Oval Office of the White House on Oct. 16, 1987, the Friday before the stock market crash. When President Reagan arrived, all the government movers and shakers of the American financial system were present: Jim Baker, the Secretary of Treasury; Alan Greenspan, chairman of the Federal Reserve; Beryl Sprinkel, chairman of the CEA; Howard Baker, chief of staff; as well as Baker's deputy chief of staff.

(At the meeting, Jim) Baker assured the president that the U.S. financial markets were stable and that he saw no reason to be concerned. The Louvre Agreement on foreign exchange, which he had fashioned, was taking hold. "The dollar has stabilized," he said, and the recent drop in the U.S. stock market was nothing to be concerned about.

Baker then turned to the chairman of the Fed and asked, "Alan, do you agree with this assessment?" At the time, Alan Greenspan was the new kid on the block. He had only been in office several months. According to Sprinkel, it seemed that the Fed chairman was not prepared to fight openly with the Treasury secretary so early in their official relationship and offered some "Fedspeak."

Sprinkel was disappointed. He had hoped that Greenspan, of the same economic and philosophical persuasion, would come to his assistance. When Howard Baker asked Sprinkel whether he agreed with the assessments made, Sprinkel adamantly demurred.ing tight monetary policy of the Federal Reserve, forced by the Treasury, has put the financial markets in a very precarious situation from which there could be a perilous fall."

The meeting went on for a while longer, but nothing was decided. The President would take things under advisement, which meant either he didn't understand the situation or couldn't make up his mind . . . .

The following week would begin with Black Monday, Oct. 19, 1987.

On that fateful October morning, I knew it was going to be an awfully long and painful day based on what had already occurred in the overseas markets. I had been following the markets in other parts of the world and the news was dismal. That morning in Tokyo, the Nikkei 225 Stock Average, Japan's equivalent to the Dow Jones Industrial Average, fell 2.5 percent. Panic struck the Hong Kong Stock Exchange where the Hang Seng index dropped 133 points in the first 40 minutes of trading. The FTSE index in London, which was six hours ahead of Chicago, had slipped 10 percent by midday. From all indications of the activity in the London market at 5 a.m., traders were estimating the Dow Jones Industrial Average 200 points lower on the NYSE opening, a n unprecedented expectation. The large U.S. brokerage firms with overseas branches knew that further selling by foreign investors was on the way to both the cash and futures markets back in the United States, not to mention the overb! ought American pensio n funds and institutions. As it turned out, it was grimmer than anyone expected.

. . . Before the opening, I went into the pit to get a pulse on the market and give some comfort to the broker community that was brave enough to take the deluge of sell orders that were coming at them. They all gathered around me. There was anxiety in their eyes. No one was certain how much lower the market would open, but things looked bad. We would have to hear where the buyers would be willing to buy. It was the scariest moment of my life. Brokers are responsible for the prices they report on executed orders. If they miss an order, execute it incorrectly, buy instead of sell, fill at the wrong price, or do any one of a hundred other things that can wrong in the stress of a pit situation, they are held responsible. And on that mornin g, errors would mean many thousands, even hundreds of thousands of dollars. Some brokers and traders elected to stay away. Still, the bulk of S&P traders, like very brave soldiers ready for battle, were there. I remember the brief conver! sation I had with John Overman, an old-hand S&P broker.

"What do you want us to do, Leo?" he asked, as if I had a magic solution. I knew pandemonium was about to break loose.

"Do the best you can," I quietly responded, our eyes meeting for a brief second in mutual understanding of the difficult situation.

. . . The S&P futures market opened on time at 8:30 a.m. CST, and a price between buyers and sellers was instantly established. It wasn't a pretty price and at first I even had trouble understanding what it was showing. How much lower is that? My God, is that possible? The SPZ (December) futures contract had opened at 261.50, down 20.75 points from Friday's close.

In Merc terminology, the market was down over 2,000 points. None of us had ever seen anything like it. But my reaction was more than shock. It was genuine fear.

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Unbeknownst to me, at that very moment, the Washington muck-a-mucks were again meeting with President Reagan, but this time in emergency session. The markets were in free fall and alarm bells were sounding around the world. The plunge that had begun in the Far East with the Tokyo markets had spread like a viral disease to London, and now had infected New York and Chicago. The discussion centered on the question of whether the financial markets should be closed down. Richard Darman, the Deputy Secretary of the Treasury, made the case in favor of closing.

Sprinkel exploded: "Mr. President, that's crazy. If you close the markets down, you will lose the ability to interpret what they are telling us. The markets must be left open."

Greenspan (out of town at the time) emphatically agreed with Sprinkel. The emergency meeting ended with two objectives: keep the markets open and pump money into the system.

. . . On Oct. 19, 1987, both the stock and index futures markets suffered their worst single-day declines in history. The Dow plunged 508 points, a 22.6 percent drop. This was nearly double the previous record of 12.8 percent drop on Oct. 26, 1929, and nearly equalled the two-day drop of Oct. 28 and 29, 1929, of 24.5 percent. More than $500 billion in paper value - a sum equal to the entire gross national product of France - had vanished in a sea of orders totalling a record 608 million shares. In Chicago, the derivatives markets took a beating down the line. The Merc's S&P 500 futures contract fell 80.75 points, a 28.6 percent decline. The CBOT's MMI index future, comprised of 20 stocks, 17 of which were in the Dow Jones Industrial Ave rage, sank 24.38 percent. And the most popular index option for retail investors, the CBOE's S&P 100 index (OEX) contract, lost 21 percent of the value of the underlying index.

When Monday's final bell sounded at 3:15 p.m. CST, I said a silent prayer. I didn't know whether we had survived, but at least the market couldn't go any lower that day. The pain would stop for a little while. As I looked down on the S&P pit from the balcony, there were hundreds of jarring human portraits, a sea of traders and their clerks in a state of disarray, confused and anxious over dreaded out-trades, those trades that do not match between buyer and seller. They milled about the S&P pit with dazed expressions caused by a war of nerves in a market skewed and fragmented. . . .

(Greenspan called later that night.)

"Will you open tomorrow morning?" he asked, both of us understanding that this was the most crucial question.

As long as the Merc's trades cleared, as long as all the market positions were paid to the previous day's closing settlement price, as long as buyers and sellers got their money, the Merc would open the following morning on time. But there were an awful lot of ifs. Unlike the securities industry . . . all accounts had to be settled in cash, every winner had to be paid by every loser, before trading resumed the following business day. And John Davidson, our clearinghouse chief, told me that the settlement sum for Oct. 19 was a tremendous record: a total of $2.53 billion, versus $120 million on a normal trading day. In other words, as a result of the crash, the longs owed the shorts some $2.5 billion.

Wall Street's major investment bankers had been among the biggest players that day. The Merc owed $670 million to Goldman Sachs and $917 million to Kidder Peabody on one side of the equation. On the other side, Morgan Stanley owed the Merc some $1 billion. . . . With such huge numbers at stake, settlement banks became extremely cautious and slowed the credit approval process significantly. The Chicago banks such as Continental Illinois were unwilling to complete transactions from member fi rms until they had verification that funds had reached Chicago from the New York banks involved.

At about 3 a.m., Davidson told me he suspected there might be a delay in the payment by Continental because Morgan Stanley's money was slow to come in. It scared me half to death.

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. . . Just before 7 a.m., a half an hour or so before the opening (of the Merc), I left (an executive) meeting to call Wilma J. Smelcer, Continental Bank's financial officer in charge of the Merc's account. I had to know the answer to Greenspan's critical question, would we open. . . . (She told me) we were still short some $400 million. She couldn't tell me who was causing the shortfall because of the bank's confidentiality rules, but of course I had a pretty good idea who the custom er was.

"Yes, Leo, but not good enough."

"Wilma," I responded, getting agitated, "I am certain your customer is good for it. You're not going to let a stinking couple of hundred million dollars cause the Merc to go down the tubes, are you?"

"Leo, my hands are tied."

"Please listen, Wilma. You have to take it upon yourself to guarantee the balance because if you don't, I've got to call Alan Greenspan, and we're going to cause the next depression."

There was silence on the other end of the phone as Wilma hesitated. . . .

"Hold on a minute, Leo," she shouted into my earpiece, "Tom Theobald just walked in." Theobald was then the chairman of Continental Bank.

A couple of minutes later, but what seemed to me like an eternity, Smelcer was back on the phone. "Leo, we're OK. Tom said to go ahead. You've got your money."

I looked at the time, it was 7:17 a.m. We had three full minutes to spare before the opening of our currency markets when I signaled John Davidson that we were all right. The world never knew how close we came to a serious problem. The money from Morgan Stanley actually came into Continental about 20 minutes later. But in reality, there never should have been a problem. The money was always there but tied up in positions at another exchange.

It was one of the most important lessons of the crash: to make the settlement banks aware of all the customer's positions at other markets. There were, of course, many other lessons to be learned from this episode in history. But the value of these lessons would come much later, when we could contemplate the future by learning from the past. During the course of the storm, I wasn't so sure that there would be a future. Was this the end of our futures markets, I sometimes wondered silently, or the end of the world?

Years later, Jens Carsten Jackwerth, a post-doctoral visiting scholar, together with professor Mark Rubinstein (who received the International Association of Financial Engineer/SunGard Financial Engineer of the year award in 1995), would offer incontrovertible proof that Oct. 19, 1987, didn't happen. According to their probability formula, the likelihood for the crash to have occurred was (infinitesimal).

"Even if one were to have lived through the entire 20 billion year life of the universe, and experienced this 20 billion times (20 billion big bangs), the probability that such a decline could have happened even once in this period is a virtual impossibility." I wish I had known this comfortable piece of wisdom at the time of the crash.

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Leo Melamed was a small boy when he and his parents fled Poland ahead of the Nazis in 1939. Eventually they settled in the United States. He grew up in Chicago, near Division and Kedzie.

His life changed unexpectedly one day when, as a law student, he answered a classified ad for a part-time job and walked through a door onto the floor of the Chicago Mercantile Exchange. "There was a life force on that floor that was magical and exciting, and though I didn't understand what was going on, I wanted to be part of it," he would recall.Melamed got his start as a pork belly trader and went on to conceptualize and pioneer the modern futures industry, transforming the Merc from an agriculture-based marketplace to an international financial futures market.

The 25 years during which Melamed chaired the Merc is "a real Chicago story," he says. "It is unique to the business world that an industry created by a handful of people in Chicago is now worldwide."

The moral of the near-disaster of 1987, Melamed says, is that politics and finance do not go hand in hand.

"What's best for the country financially isn't always good politics. In a free society, where (politicians) have to get elected, the consideration of the politician is his own re-election. This is not the consideration of the people that do business."

Asked whether President Ronald Reagan understood the peril ahead when he and his advisers gathered on the Friday before Black Monday, Melamed said, "I suspect he didn't."

"The conditions were already in place. I knew that for six, seven, eight months before. The business community suspected we were in dangerous waters. But the business community isn't in control of these things.

"The message here is that what caused the crash was an attempt to shore up the value of the dollar. And in order to do that, we had to raise interest rates. It was not warranted for any other reason. So a political decision - literally - to hold the dollar fictitiously high resulted in a dangerous financial situation. The message here is if you let free market forces work themselves out, and let the politicians keep their hands out of it, you are much better off."

Melamed retired as Merc chairman in 1991, but continues as Chairman Emeritus. He remains an active futures trader as chairman and CEO of Sakura Dellsher, Inc., a global financial firm. He served on the steering committee that built the U.S. Holocaust Museum.

Melamed lives in a Chicago suburb. He has two sons, one studying to be a film director and one who wants to be a trader, and a daughter who is an attorney on leave raising a family.

For pleasure, he likes to jog and write. He is contemplating a sequel to his 1987 science fiction novel, The Tenth Planet. He wrote Escape to the Futures with Chicagoan Bob Tamarkin, former reporter for the Chicago Daily News and Wall Street Journal and the author of six books, including The Merc and The New Gatsbys.