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Futures Exchanges in a Changed World Order

The futures exchanges continue to serve an important role in today's derivatives markets. **Leo Melamed, chairman emeritus of the Chicago Mercantile Exchange and founder of financial futures on that exchange, makes a case for futures exchanges, which offer deep pools of liquidity and a constant flow of bids and offers, so investors and money managers can reduce risks, diminish losses, or institute positions with a potential for profit.**

A few months ago, on May 16, 2002, the Chicago Mercantile Exchange (CME) celebrated the 30th anniversary of the International Monetary Market (IMM). It was a jubilant occasion, which included two distinctive congratulatory messages, one from Nobel Laureate, Milton Friedman, the other from the chairman of the Federal Reserve, Alan Greenspan. It also featured a keynote address by William McDonough, president of the Federal Reserve Bank of New York.

The fact that these world luminaries would take the time to honour the IMM in this fashion defines the significance of the events that occurred in Chicago in 1972. Looking back, it is easy to forget how revolutionary the concept of financial futures was regarded. Not only did the world then still distrust free markets in general, and futures markets in particular, the idea represented an unprecedented departure from its agricultural tradition. Indeed, the IMM endured a painful process of acceptance by the global financial community, especially its banking establishment.

Its eventual approbation and phenomenal success came only as a result of the stubborn determination of its market founders, early pioneers and traders, but mostly its success flowed from the simple fact that the idea was a good one. Its blueprint has since been copied and extended to every financial centre in the world. It made the CME the number one futures market in America.

Causes

Praise for futures and derivatives by these distinguished experts at this moment in history – when economic woes and financial excesses have caused a major downturn in world equity markets and when US corporate transgressions have shaken the credibility of the American corporate landscape – is by itself highly significant. For unlike past eras when any adverse financial event was reason to place blame on our markets, no one – not even the thoroughly uninformed – has pointed a finger at futures markets. Not for the bubble that was created in equity markets during the late 1990s; not for its inevitable bursting which began in March of 2000; nor for the corrupt corporate practices and manipulative accounting procedures which were employed at some firms with reckless abandon prior to their public exposure.

The causes of these corporate wrongs, while committed at but a limited segment of corporate America, were of a sufficiently serious nature to demand comprehensive reforms and were easily documented: corporate governing boards that were either in alliance with or puppets of corporate management; stock options to top executives that induced them to inflate near-term share prices regardless of long-term consequences; accounting tricks to make certain that profits met or exceeded Wall Street expectations; insider trading practices in violation of ethical standards and SEC regulations; inflated revenues by virtue of fraudulent transactions and financial shams; wildly overoptimistic price targets by analysts at many brokerage firms; forgiving loans to corporate executives and ignoring their use of corporate money for personal acquisitions such as yachts, mansions, jets and other expensive prizes; distribution of lucrative initial public offerings to company clients and friends; and a multitude of other schemes or transgressions which were camouflaged by the irrational exuberance of an unceasing rising stock market. Until the Ponzi scheme burst as it always does.

When it did, the market exposed the truth: Enron Corp structured complex financial vehicles with which to fraudulently boost the firm's cash flow. Arthur Andersen,

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Enron's auditor, aided and abetted accounting shams and later obstructed justice in an attempt to hide their misdeeds. WorldCom disclosed $3.8 billion in accounting mis-statements and later uncovered an additional $3.2 billion in accounting distortions.

The CEO of Tyco International is accused of evading taxes and conducting secret corporate deals. Cable giant Adelphia inflated financial statements and made $3.1 billion in undisclosed loans to its major shareholders. Global Crossing sold its telecom capacity in a way that artificially boosted its revenues. Dynegy and CMS Energy Corp made fictitious transactions in order to pump up its trading volumes. Xerox inflated revenue and profits by including future payments on existing contracts. Analysts employed by Merrill Lynch and Salomon allegedly misled investors for the purpose of furthering income to their firms.

All the while, the markets of futures and options, while far from perfect, continued to carry out their function as a mechanism of risk management. Indeed, the performance of world futures markets deserve the highest marks for their uninterrupted service during recent financial upheavals: 11 consecutive reductions in the US Federal Funds rate in the course of one year; market disruptions unleashed by the terrorist act of September 11th; a precipitous fall in equity prices; the ensuing war on terrorism, the possibility of new terrorist acts; the potential action against Iraq; and the mind boggling flood of corporate scandals of a magnitude not witnessed since the years preceding the Great Depression.

Risk Management

Little wonder Messrs. Friedman, Greenspan and McDonough saw fit to extol the virtues of our markets. As the chairman of the Fed recently stated, "These (derivatives) transactions represent a new paradigm of active credit management and are a major part of the explanation of the banking system's strength during a period of stress." Indeed, one has to wonder how the financial world would have fared were there not the markets of futures, options and financial derivatives to absorb the shock engendered by the afore-described upheavals. I dare say, not nearly as well.

Not only did our markets act as a font of information, continuously disseminating price intelligence with which consumers and producers could make informed decisions across a wide spectrum of business demands; not only did our markets provide easy and efficient access to everyone who sought their application; not only did our markets provide financially secure clearing and settlement procedures; but our markets served as a security blanket, offering deep pools of liquidity with a constant flow of bids and offers with which investors and money managers could interact to reduce their risks, diminish their losses, or institute positions with a potential for profit.

For it is axiomatic: the management of risk is the bedrock of futures exchanges. The prospect of any economic dislocation, the potential for any change in value or price, the expectation of any alteration in national economic policies, whether it be the result of international turmoil or the consequence of domestic business disruptions, whether it be in finance or agriculture are the natural drivers of futures business flows.

Proof of the value placed in our markets by the international business community during recent stresses can be seen in the surge of transaction volume at the world's major futures markets: At the CME a 78% gain in the year 2000, at Liffe a more than 64% increase, at Eurex a 48% increase, and at the CBOT a gain of more than 12%.

2000 increases in open interest were commensurately impressive with the CME leading the majors with a whopping increase of 87%. In 2001 the trend of volume increases continues to date: At the CME 33%, at the CBOT 23%, at Eurex 14%, and at Liffe nearly 10%.

We live in a highly complex and hazardous economic environment – where geographical borders and time zones that once could limit the flow of capital are but history, and where traditional internal protections that insulate ones' citizenry from external price influences are no longer valid. We live in a world in which competition is global, financial volatility is commonplace, and opportunities rapidly appear and disappear on a constantly changing financial horizon. We live in a world that demands products to protect against inherent risks, that demands cost-efficient instruments to adjust portfolio exposure between securities and cash, and that pays a premium for credit-worthy mechanisms which preserve credit lines. In such a world, futures and options markets are critical components of the financial establishment.

Today, the largest difference between rich and poor countries – between economic hope and economic despair for its people – is the freedom and efficiency with which they can utilise their resources. Free and efficient capital markets ensure that resources are allocated wisely. The more efficient the system, the better the allocation of these resources. Efficient markets lead to tighter bid/ask spreads, higher volumes of trading, and greater market liquidity. A liquid market reflects truer price values and gives investors confidence in the marketplace. As a consequence, the cost of capital is reduced, the standard of living is enhanced, and social order is greatly benefited.

Futures, options and derivatives markets are among the tools to achieve this national benefit. They epitomise the fundamental principles of free market processes. While these processes may not be without fault, they represent the best economic order ever devised by mankind. Consider, even as we lament the market excesses that produced the recent American equity bubble, even as we cringe and denounce the American corporate misdeeds of recent years, we must recognise and applaud the fact that the market worked. Unlike economic systems that are controlled by the heavy hand of government, the American free market system acted quickly to right the wrong. It exposed the truth and unmercifully punished both the corporate entity and corporate executives that violated the rules.

Observations

Looking forward, I would make the following observations about futures markets: what remains unalterable is that hedging activities in risk management will flow to the marketplace that is the most liquid. Second, the world today demands disclosure and transparency, whether in the execution process or in its book-keeping. Third, market participants will gravitate to the market that provides financially secure clearing and settlement procedures. Finally, the market providing the widest distribution network together with the most functional and efficient technology at the lowest cost will be the most attractive. In other words, global electronic distribution of market instruments coupled with technological competence will rule the day.

However, technology alone will not be enough to persevere in the 21st Century. Innovation is the key. Finance is, after all, a dynamic science. The pace of change has accelerated exponentially and the distinctions between types of markets are vanishing. Strategies pertaining to equity, debt, indexing, foreign exchange, futures, forwards, options, swaps and cash, are all interdependent and interchangeable. The digital age has unbundled all manner of risk and is capable of repackaging it in any form the customer wants, at the moment he wants it. Customised strategies and customised instruments of trade are today's *soup du jour*. Thus, the days of narrow-based niche market capabilities are limited. The futures exchange of tomorrow must be able to provide comprehensive risk management in every sense of the word.

Some exchanges and many electronic communication networks, so-called ECNs which were not up to the above requirements have already vanished, others are being thrust to the sidelines. For those who survive, there is bound to be massive consolidation. While there may always be regional exchanges serving a local clientele, they will be irrelevant unless they are tied to a global network. There is also little doubt that the ongoing trend of blurring distinctions between the instruments of futures and securities is continuing. The recent joint venture in single stock futures between the CME, CBOT and CBOE is a giant step in that direction.

It cannot be over-emphasised: Transformation in information technology created a world economy. It will continue to foster more globalisation, greater interdependence, instantaneous information flows, immediate recognition of financial risks and opportunities, continuous access to markets of choice, more sophisticated techniques, new innovations and intensified competition. These are the unalterable trends of the future. As a consequence, the management of risk will remain at the core of every prudent financial strategy – a reality that will continue to have the greatest impact on the use and expansion of futures, options and derivatives markets, global and around-the-clock. ■

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