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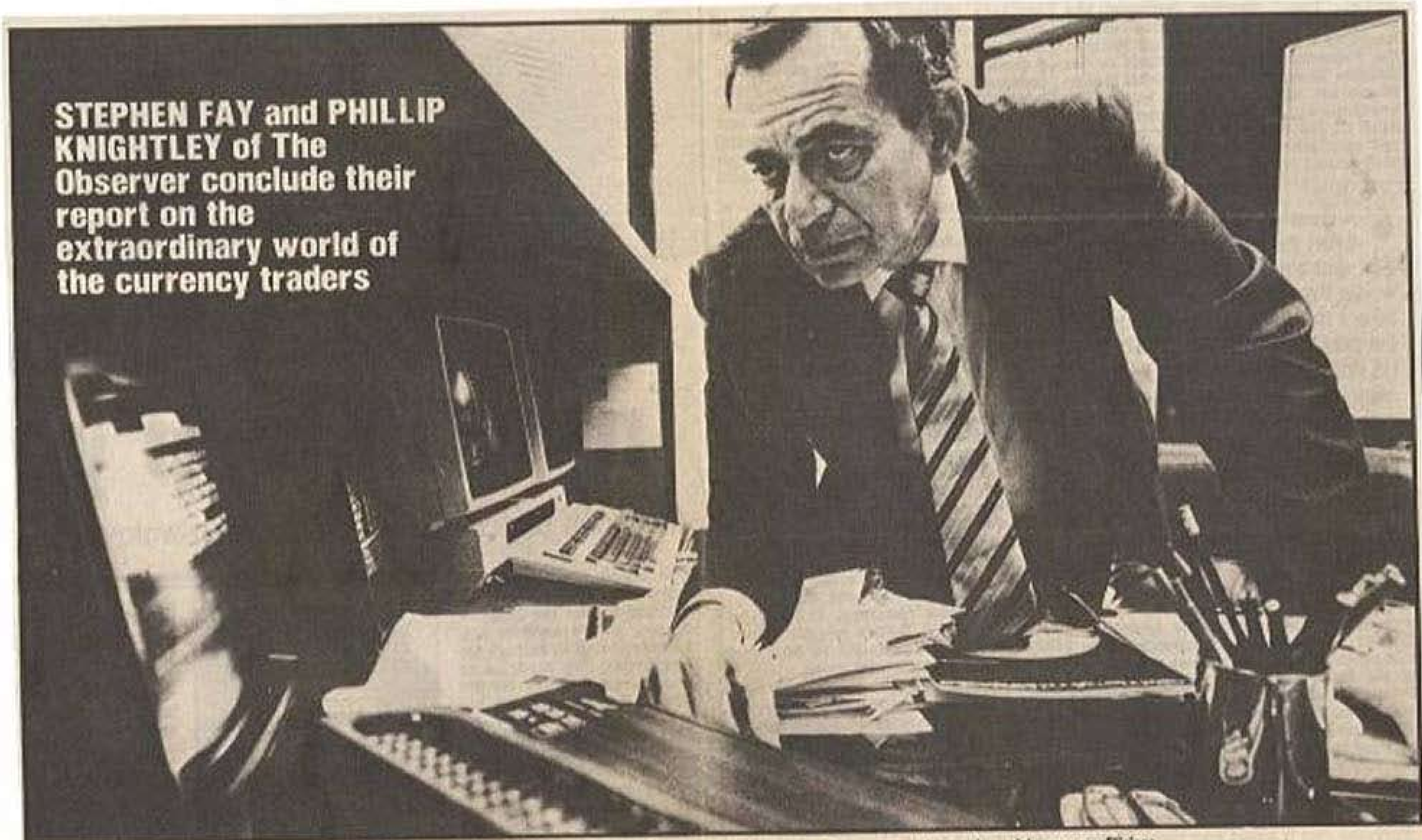
RISE OF THE PORK-BELLY CRAPSHOOTERS



Leo Melamed, the "outsider" who launched a market that causes uncertainty among economists and anguish among politicians

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THE conference session on international financial markets at the Mayflower Hotel in Washington comes to an end. On the platform, the speakers stretch their legs and smile at friends in the audience — except for the principal speaker, a thin man with large spectacles and an expressionless face. He reaches into his briefcase, takes out a portable telephone, runs up the aerial, and taps out a long-distance number. He can be heard murmuring a number of questions: "D-mark? Yen? Dollar-pound?" Then he says "Fine", puts the telephone back in his case and leaves quickly.

Everyone in the room follows him with their eyes. This is Leo Melamed, a former taxi-driver from Chicago who launched the foreign currencies futures market which now causes such confusion among travellers, uncertainty among economists and anguish among politicians. This is the man who made it possible to trade a nation's reputation as though its currency were just a share price that might be worth a flutter.

Mr Melamed is a first-generation American, a Jew from Poland who fled through Russia from the Nazis with his father and escaped from Japan shortly before Pearl Harbour. He settled in Chicago and drove a cab to help pay his way through university, where he studied law and psychology, and also to help pay for his education on the Chicago Mercantile Exchange, where they traded everything from eggs to pork bellies (or bacon as it is called outside the trading "pits").

Finally, Mr Melamed's father lent him the money to buy a seat on the exchange. Once in, he found the men who ran it stuffy and unambitious. His attempts to change things were not welcomed.

Milton Friedman, the professor of economics at the University of Chicago, was an outsider, too. The architect of monetarist economics, he was the scourge of the central bankers and finance ministers, a mischief-maker. In the autumn of 1967 events conspired to bring the two outsiders together and change, perhaps irrevocably, the international monetary system.

Prof Friedman did not simply indulge in economic theory. He played the market. In the autumn of 1967 he became certain that the British government was about to devalue the pound. He was so convinced of this that he was prepared to gamble with US$300,000 (S$630,000) of his own money so that he would make a profit when the pound did come down.

If the pound went from US$2.80 to US$2.40 — as Prof Friedman calculated it would — then this profit would be a handy US$42,811. But there was a catch. The deal had to be done through a bank, and when Prof Friedman went to his bank manager with security for US$300,000 he was turned away. This sort of dealing was not for individual customers, the manager implied. This was banking business, and only for banks.

Prof Friedman was outraged. He believed in free markets and the right of the individual to invest in them. When he met Mr Melamed he found a kindred spirit. Why not trade foreign exchange futures on the commodities exchanges just as if money were a commodity? they asked each other. After all, the futures market is one of the greatest inventions of the capitalist system. It allows farmers to sell their crops and food manufacturers to buy at a price that is agreed upon before the crop has even been harvested.

This gives both the farmer and the manufacturer security and transfers the risk of price fluctuations to traders who are prepared to gamble on which way the prices might move. The farmers and the manufacturers are "hedging"; the traders are speculating.

Prof Friedman and Mr Melamed agreed that, for importers and exporters, foreign currency was a commodity not unlike wheat. Why couldn't importers and exporters "hedge" against currency fluctuations by being able to buy foreign currency three months or six months before they needed it, at a price agreed upon now, and let the trader take the risk that the rates might change in the meantime?

Mr Melamed went ahead and formed the International Monetary Market in 1971. Ignoring the sneers of the blue-blood East Coast bankers who wanted to know what "pork-belly crapshooters from Chicago" could possibly know about foreign exchange, the IMM opened for business in May 1972.

It proved a propitious time. Since 1944, the Western world had had a neat system for fixing exchange rates called the Bretton Woods agreement (after a hotel in New Hampshire where the agreement was hammered out). Under this system, the United States agreed to deliver gold in return for foreign-held dollars whenever the holder required it. The rate was one ounce of gold for US$35 — a figure said to have been decided by President Roosevelt, who got it from a Red Indian friend, who pulled it out of the pipesmoke.

Bretton Woods was finally subverted by the inflation that began in America when President Johnson decided he could finance the Vietnam War without raising taxes. There were so many dollars around the world that the ability of the United States to deliver gold in exchange for foreign-held dollars could no longer be maintained. The system was abandoned, and after 1973 the world's major currencies were left to find their own levels or to float.

So, after a shaky start, the IMM took off. "The banks who had shunned us now joined us," Mr Melamed recalls. "They knew that the crapshooters of Chicago were on to something big." The central banks were less happy. IMM was a free market, out of their control. But determining the value of currencies by market forces was Prof Friedman's objective. An open market in the currencies of the world was an outsider's revenge on the orthodoxy of the economic establishment. The IMM became the world's largest financial market of its kind.

Mr Melamed still runs hard like an outsider, though he moves in a different class. He stays in spacious hotel rooms and his suits are of the finest cloth. He is alert and wary. He could retire and cultivate his laurels, but he has the restlessness of a market trader. Having created the financial futures market, he trades in it, being hit by it (wrong about the American dollar in 1984), or making money out of it (right about the American dollar in 1985). And he suffers the neurotic uncertainty of any man who trades on his own account. "My ability is based on the need to survive," he says. "That's the real discipline."

Moreover, Mr Melamed never forgets what he calls the Bialystok syndrome. The Jews, burned by the Nazis in the ghetto of the Polish town of Bialystok on June 28, 1941, included his grandmother and his aunts. His family's experience has made him deeply pessimistic by nature.

Although reliable statistics are difficult to come by, a recent estimate for the world's leading 30 industrial nations concluded that turnover in foreign exchange markets was US$150 billion a day in 1984 — double the figure for 1979. Among the trading centres, London has a clear lead, trading US$49 billion a day, followed by New York (US$35 billion) and Zurich (US$20 billion).

Foreign exchange dealing has made speculation respectable, even by the most prudent financial institutions. The market does lubricate international trade, but nine out of 10 deals, or 19 out of 20, depending on who is guessing, are speculative and each speculative trade is supposed to be a zero-sum game — for each winner there is a loser. Perhaps it is because the players dare not admit defeat that there appears to be more winners than losers.

"It's like pass-the-parcel and a bit of a mystery to me how the pluses and minuses work out," says a senior foreign exchange expert at the Bank of England.

Lord Lever, the former Labour Treasury Minister, is blunter. "Though the turnover in the currency markets is enormous," he says, "virtually all of it is self-balancing froth." It contributes absolutely nothing to Gross National Product.

That may be, but the effect of the market activity is undeniable. "The market is like a predator," says Mike Beales, who left the Bank of England's own dealing room to run Westpac's in the City of London. "It looks around for a vulnerable currency and strikes it unmercifully, like a cobra."

These currency strikes have dumbfounded prime ministers. When the pound fell under the Labour government, Mr James Callaghan complained, "there used to be a little man in the Bank of England who dealt with this kind of thing." Mrs Margaret Thatcher's belief that the foreign exchange market could be left to find its own level — a view that, as a Friedmanite, she had to hold — was cruelly exposed as imprudent when the pound plunged towards parity with the dollar early in 1985 and the Chancellor of the Exchequer was forced to stop the fall by raising interest rates by 4 per cent. Equally, President Reagan's explanations for the strength of the dollar show that he is no wiser.

A currency is vulnerable when the market decides that it is; and small countries fare worse than large ones. It might take a thousand trades to move the pound, and 3,000 to shift the dollar, the yen or the German mark. Usually this is enough to make the movements of these currencies fairly orderly. But much smaller trading can hit what the traders call "exotic currencies" with a blow that is devastating.

Friday, July 19, 1985, is known in Italy as "Black Friday." When trading opened, the value of the lira was 1,840 to one US dollar. When trading was suspended six hours later, the lira was down to 2,200 — a decline of 19.6 per cent. The government had been thinking about a formal devaluation, but not of this order, which explains the Italian Prime Minister's impotent rage. That day's trading on the money markets, he said, had been monetary "terrorism."

Yet it turned out that Black Friday's sensational run on the lira had been sparked off by the action of an Italian company, ENI, the state fuel corporation. ENI, the third largest non-American corporation in the world, chose July 19 to buy US$135 million. A dollar purchase of that size in London would cause only a tremor. In Milan the market erupted, especially when it became clear that the Bank of Italy would not intervene to stop the slide.

Later investigations concentrated on the charge that ENI had been tipped off about the proposed devaluation and used this inside information to make a large speculative gain. But the conspiracy theory ignored the more significant lesson of this story: That the foreign exchange markets effectively removed from the Italian government the power to determine the value of its own currency.

In Australia, the pain of this realisation has been more prolonged. Like his Italian counterpart, the Australian Prime Minister, Mr Bob Hawke, was utterly perplexed by the clobbering of the Australian dollar in February last year. He believed that he had done everything the market required to keep the dollar strong.

His government had devalued when it first took office; then it had allowed the dollar to float like other currencies; exchange control was ended; and, finally, banking was opened up to newcomers. It was the most liberal exercise in financial deregulation anywhere and, apparently, it worked.

American traders looked at Australia's foreign debt, saw that in per capita terms it was the second largest in the world, and spoke of Australia as being "the Argentina of the Pacific". But throughout 1984, the Australian dollar shrugged it off, and the Bank of America predicted that parity between American and Australian dollars was not far off.

A poll of financial experts published in the Sydney Morning Herald on Jan 2, 1985, predicted an average exchange rate for the rest of the year of A 85.4 cents against the American dollar. The Australian dollar then stood at 82.78 cents, and experts were confidently talking of an imminent increase to 84 to 86 cents.

The customers believed them. Importers due to pay bills in US dollars did not bother to hedge against a fall in the Australian dollar; indeed, some exporters hedged against an increase in the Australian dollar. A few clever property developers borrowed Swiss francs at 8 or 9 per cent rather than Australian dollars at 13 per cent.

The crash came with volcanic ferocity. On Feb 5, Alan Woods, who runs a foreign exchange consultancy service in Melbourne called Systec, sent out to his well-heeled clients a special update to his January newsletter, in which he had reinforced the predictions of a stronger Australian dollar. Now he reversed track. Financial markets were awash with liquidity, the US dollar was surging, Australian interest rates were suddenly going down. Woods concluded that the Australian dollar was about to "plunge", and added the titbit that he believed the government would do nothing to prevent the dollar's fall.

It does not take much to shift the Australian dollar. A couple of US$10 million sales will move it substantially — and by now two sales had already occurred. No trader or banker will admit who made them, but market rumours identify the first big sale as originating in the London dealing room of the Chemical Bank of New York, acting on behalf of a large Australian corporation.

As the hours passed and the market moved to New York, big American banks with large Australian holdings noted what had happened in London and began to sell — Banker's Trust, Citibank and Morgan Guaranty.

By the time the Sydney market closed on Feb 5, the Australian dollar was quoted at 77.6 cents, down from 80.18 the night before. The psychological level — the point at which the market begins to panic — had been defined at 80 cents. By the end of that week it was down to 76.10. This was "uncharted territory."

When the collapse continued the following week, currency became front page news, and still the Australian dollar fell. "It was moving on shadows," recalls Art Brown, the Commonwealth Bank's chief dealer in Sydney. On the night of Feb 19, the price dropped by more than two cents in London. In New York, the Australian dollar fell below 70 cents for the first time.

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It was clear to Mr Brown that, as he says now, "nobody wanted to hold the bloody ball", so he telephoned Bruce Chegwin, his opposite number at the ANZ bank in Melbourne, said he thought that the fall had reached ridiculous proportions, and proposed that they get together to do something to stop it.

They did, employing a technical device known as "widening the spread," which made the price of buying Australian dollars too high and the price of selling them too low. The dollar bottomed out that day and by the end of February it had recovered to 71.40 cents. But the impact had been staggering.

Australia was an innocent in the world of currency speculation. Most of Australia's top 40 companies lost money in the collapse. Some, like CSR, Tancred and the Electricity Commission of Victoria, confessed their losses. Others spoke of them only in whispers. Most set about developing their own foreign currency departments so as not to be caught again.

Speculators began it, but the first stage of the Australian dollar's decline was caused mainly by importers rushing into the market to buy US dollars, or pounds or marks to pay debts already incurred or shortly due. All that the shrewd speculators had to do was to order their brokers to sell Australian dollars and keep selling.

What made the experience so painful for the victims was that they did not fully understand why it had happened. "It all hit us a bit too soon after the float," says Phil Henshaw, chief New York trader for the Commonwealth Bank. Mr Henshaw had discovered that some Americans had apparently not heard of the Australian idea of a "fair go": During the worst days of the crisis banks like Citibank and Banker's Trust would sometimes refuse to trade Australian dollars in New York, while their Australian branches were making hay in Sydney. "It was a very steep learning curve indeed," says Mr Henshaw ruefully.

As for Mr Hawke, he did not cause the slide of the dollar. He was blamed for publicly conceding to the Left of his party over the issue of MX missiles tests in the South Pacific. But the run had begun before that. Mr Hawke's only crime had been to draw the attention of London and New York financiers to his balancing act following an unconvincing election victory. He took comfort from the knowledge that a lower dollar would help sell a record wheat crop. It was an episode that could be put down to experience, as long as it did not happen again. But it did.

Five weeks later, the Sydney foreign exchange market was, in the technical jargon, "thin," meaning depressed and easily moved. Then a large trade deficit triggered a couple of critical editorials in the Financial Review (according to the Reserve Bank, the most influential maker of market opinions among Australian newspapers). A new slide began and, on April 22, the Australian dollar reached a new record low against the US dollar — 62.90 cents.

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The Labour government had to perform a ritual act of obeisance to the money-market men. It had happened to Left-wing administrations before, to the British Labour Party in 1976, to the French socialists in 1983. The Australian Labour Party promised spending cuts and publicly denied that it was a creature of the trade union movement. But the Prime Minister still failed to understand what was happening to the Australian dollar. He spoke to his advisers as though he were the victim of a conspiracy. "Why are they doing this to us?" he grumbled.

In the ensuing months the battered Australian dollar climbed back slowly above 70 cents without inspiring any conviction that it would stay there. Those who paid were the customers who found that their import bills had soared and those who had less to spend when they travelled abroad. Those who gained were the speculators. Big speculators made fortunes. Who were they? The big banks — Commonwealth, Westpac, ANZ.

The old Bretton Woods system was orderly and stable. According to Mr Melamed and Prof Friedman, it was also a sham, designed by governments and their central bankers to disguise the true state of their economies.

But order has been replaced by instability. This may suit the money-changers. It does not improve the economic well-being of the mass of ordinary citizens who find it hard to understand what it is all about. Tough luck, says Mr Melamed: "Speculation is a product of our times." He says it only became fashionable when money began to lose its reliability as a store of value. The great inflation of the late '70s and early '80s sent prudent investors running for cover in the foreign exchange markets. "I have the 'right' to protect myself," Mr Melamed says.

Henry Jarecki of Mocatta Metals in New York has a more elementary explanation for what has happened. "It's a symptom of an amoral society," he says. "One created by high taxes and black money. People look around for a way of using their money that will keep its value. But something is wrong. There's a sham going on."

The US Federal Reserve apparently agrees. In the summer of 1985 it undertook an internal inquiry into the unexplained strength of the US dollar in relation to other currencies. It concluded that the only explanation for this strength was a vast speculative bubble. In September, the world's five leading financial nations, known as the G5, decided to try to burst it.

The US Treasury ignored its strict policy of non-intervention on foreign exchange markets and for the first time in five years, together with the central banks of Japan, Germany, Britain and France, sold US dollars heavily. When the speculators continued to buy, the central banks simply sold more.

The dollar came down and the concerted action by governments revived the notion that they could act to restore stability to foreign exchange. The US Treasury Secretary, Mr James Baker, began to talk about a new Bretton Woods agreement, and critics of free foreign exchange markets, who had been silent for years, began to speak out again.

Mr Edward Heath, the former British Prime Minister, addressing a symposium of foreign exchange traders in London in November, bravely told them that they would not be in business much longer because governments would demand a fresh version of Bretton Woods to reimpose control of exchange rates.

Mr Melamed laughs. "Hogwash," he says, perhaps forgetting his own rule that disaster always threatens, especially when things appear to be going well.