The Birth of FX Futures

By: Leo Melamed, Chairman Emeritus, CME

Few things are more symbolic of the era of flexible exchange rates than the International Monetary Market (IMM) launched by the Chicago Mercantile Exchange (CME) in December of 1971. Indeed, the birth of this futures exchange is inextricably intertwined with the death of Bretton Woods, the ideas of Milton Friedman, and the revolutionary innovations instituted at that time under the direction of Leo Melamed, chairman of the CME.

The genesis of the post World War II era of fixed exchange rates was July 31, 1945 in a small resort town in the mountains of New Hampshire. The Bretton Woods Agreement, signed there by President Truman and representatives of most Western European nations, established a narrow band of fluctuations between European currencies and the U.S. dollar. The Agreement specified that the U.S. dollar would be tied to the price of gold, with its value set at $1/35^{th}$ an ounce of gold. All other nations' currencies were fixed in relation to the dollar's gold content. Variations were limited to only plus or minus one percent.

These fixed exchange rate bands remained in place until August 15, 1971, when President Nixon dropped the U.S. dollar convertibility to gold and devalued the dollar to $1/38^{th}$ an ounce of gold. The President's actions led to an irreversible breakdown of the system of fixed exchange rates and opened the door to the free float of the major world currencies.

Milton Friedman predicted this result from the beginning:

> ..., From the time Bretton Woods became effective, it was inevitable it would break down... It tried to achieve incompatible objectives: freedom of countries to pursue an independent internal monetary policy; fixed exchange rates; and relatively free international movement of goods and capital...As one of the architects of Bretton Woods, Keynes tried to resolve the incompatibility by providing for flexibility of exchange rates through what he intended to be frequent and fairly easily achieved changes in official parities. In practice, this hope was doomed because maintaining the announced parity became a matter of prestige and political controversy. Countries therefore held on to a parity as long as they could, in the process letting minor problems grow into major crises and then making large changes...[1]

President Nixon's 1971 actions had one additional effect: It gave rise to the necessity for a public futures market in which to hedge currency fluctuation risk. At least that was the belief and opinion of the chairman of the CME, Leo Melamed. However, his idea ran counter to status quo. Futures markets were from time immemorial based on agricultural products, not financial instruments. The concept of

1 There's No Such Thing as a Free Lunch, International Economic Policy, Milton Friedman.

currency futures was antithetical to the accepted norm and represented a change in status quo. The financial community by and large scoffed at the idea.

The concept of a market in currency itself was not new. A forward currency bank market, known as the *Interbank Market*, an outgrowth of the Bretton Woods Agreement, was in existence. But as its name implied, the Interbank Market was limited to banks acting for themselves or their global institutional clients. An individual, regardless of his standing, purpose, or wealth, or businesses that did not measure up to the "international commercial" standards demanded by the banks, were barred from participation. In a well-publicized story, in 1971 when Milton Friedman attempted to go short the British pound, banks refused him the right to do so on the basis that "Friedman did not have the necessary commercial interest to deal in foreign exchange."

The Bretton Woods script of fixed exchange rates was clearly not written in the context of 1970 world realities. Over the course of the two and a half decades since the end of World War II, the planet had grown smaller and major nations, ravaged by the war, were restructured and bigger. New technologies made it possible for news to travel at the speed of light. Information effecting currency valuations, real or imagined, was available in terms of days, hours, and minutes, rather than weeks or months. The growth and interrelationships of private sector industries grew to a magnitude that enabled them to play as big a role, if not bigger, than the central banks in determining currency supply and demand. The right of individuals to participate in the ebb and flow of currency values could no longer be ignored.

Thus, quite apart from Milton Friedman's undeniable logic that values of products are best determined by the forces of supply and demand in the free marketplace rather than by the dictates of government, the realities of the 1970s made a system of fixed exchange rates completely unmanageable. It became increasingly difficult for a government to hold its currency at the agreed valuation rate when economic and financial forces dictated a higher or lower value. It became increasingly futile for one or a number of central bankers to maintain a given currency at a pre-determined level when a majority of global commercial forces believed differently. This reality was unlikely to ameliorate. The different external and internal interests of nations, their different rates of economic growth, their different fiscal and monetary policies, beholden to different forms of governments, their different work force considerations, their different election timetables and political pressures, all would combine to destroy a system dependent upon a unified opinion regarding respective exchange values.

Having long before become a disciple of the free market principles espoused by Milton Friedman, the idea for an FX futures market that would determine currency values on the basis of supply and demand seemed obvious to the CME chairman. Other CME officials joined him in this opinion. But there were two major imponderables: First, it was uncharted territory. Was there perhaps an inherent economic dictate that would prevent FX from succeeding within the arcane dynamics of a futures arena? And, second, could someone beat the CME to the punch? On the second point someone almost did. In April of 1970, the New York Produce Exchange renamed itself the International Commerce Exchange (ICE) and offered for trade tiny futures contracts on currencies. The ICE idea was more or less a glorified currency-exchange in foreign currency geared for small-time gamblers. This, of course, was galaxies different from the global FX futures market envisioned by the chairman of the CME. Indeed, the ICE quickly failed and closed its doors.

The answer to the first question was critical and much more difficult to resolve. There were many knowledgeable people who implored that the CME not do it, that it would serve to undermine the reputation of the exchange. Many of these people were experts in foreign exchange and meant to give the CME their best advice. Futures markets, they warned, were suited for traditional agricultural products and little else. They could never be applied to the sophisticated maneuvers utilized by world banks and financiers. Besides, they pointed out, such an experiment had already failed in New York. If it could not work in the U.S. capital of finance, how could it work in the second city? Their arguments were powerful, sensible and sounded convincing.

How then could the idea for an FX futures market gain credibility? Who could overcome the weighty objections of so many? Who could answer with any degree of certainty whether there was an inherent economic flaw to prevent FX from being a successful product on a futures exchange? For the CME chairman there was only one person in the world who could settle the issue: his mentor, Milton Friedman. The answer by this noted economist would go a long way in determining whether or not the CME would launch the world's first financial futures instrument.

The CME chairman, together with its president, Everette B. Harris, met with Milton Friedman for breakfast at the Waldorf Astoria in New York in November of 1971. Professor Friedman responded to Leo Melamed's question without hesitation. "Your idea for a futures market in foreign exchange is wonderful," he stated emphatically. "Its success depends only upon how fast the Bretton Woods Agreement is suspended." In his opinion that might not happen for a year or two. Upon further discussion, the CME chairman asked Professor Friedman whether he would consider putting his opinion in writing. Friedman, smiled and nodded affirmatively, "Yes, but I am a capitalist." They shook hands agreeing that for a fee of $7,500 Friedman would write a feasibility study on "The Need for a Futures Market in Currency."

Professor Friedman's paper submitted to the CME in December of 1971 gave the concept for currency futures academic credibility of the highest order. The most influential economic mind of the 20th century said all he needed in eleven pages and provided the CME with the intellectual foundation upon which to build its financial futures superstructure. Emboldened by this endorsement, the CME chairman proceeded with his plan to create the IMM as a separate corporate division specifically designed to exclusively specialize in futures trade of instruments of finance. Milton Friedman's words were succinct and to the point:

> Changes in the international financial structure will create a great expansion in the demand for foreign cover. It is highly desirable that this demand be met by as broad, as deep, as resilient a futures market in foreign currencies as possible in order to facilitate foreign trade and investment.
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> Such a wider market is almost certain to develop in response to the demand. The major open question is where. The U.S. is a natural place and it is very much in the interests of the U.S. that it should develop here.[2]

As history is witness, Milton Friedman was wrong about one thing. The end to Bretton Woods came much faster than even he imagined. Barely a month after the Waldorf Astoria lunch in July, President Nixon's closed the gold window and effectively ended the fixed exchange rate regime. It sent markets into turmoil and caused a seismic shock to the world, unleashing economic and political reverberations which changed the financial order forever. The CME could not have written a better script as a backdrop for the inauguration of a futures market in foreign exchange. As it is said, *necessity is the mother of invention*. On May 16th 1972, the IMM launched seven currency futures contracts: British pounds, Canadian dollars, Deutsche marks, French francs, Japanese yen, Mexican pesos, and Swiss franks.

2 The Need for Futures Markets in Currencies, Milton Friedman, 1971

Years later, Milton Friedman asked Leo Melamed whether the CME ever grasped the magnitude of the innovation the IMM represented? In responding, Mr. Melamed pointed to his own statement to the membership in the IMM's 1972 Annual Report:

> We believe the IMM is larger in scope than currency futures alone, and accordingly we hope to bring to our threshold many other contracts and commodities that relate directly to monetary matters and that would complement the economics of money futures.

Easier said, than done. To state that the concept of a futures market in currency was not widely embraced by the world's financial community is to understate the truth by an order of magnitude. Derogatory comments, defamatory innuendos, false accusations, is leading opinions, and half-truths, had from time immemorial been the burden and fate of futures markets. Not only was the IMM a revolutionary departure from the traditional commodities traded on futures exchanges, it was viewed as treading on the financial turf normally reserved for institutions in New York and London. Thus, the IMM concept was berated and ridiculed. "The New Currency Market: Strictly for Crapshooters," warned Business Week, "if you fancy yourself an international money speculator but lack the resources...your day has come!" And a prominent New York foreign exchange expert summed up the antagonism with this widely quoted sentiment: "I'm amazed that a bunch of crapshooters in pork bellies have the temerity to think that they can beat some of the world's most sophisticated traders at their own game."

But the detractors were all wrong. What they failed to understand or foresee was that changing economic realities of the 1970s were creating conditions with new risks for business, banking, and finance. That in an age of historic transformation, uncertainty and increasing globalization, the newly created financial futures contracts held unparalleled potential in meeting the risk management needs of financial managers.

The history of the International Monetary Market and the start of financial futures trading is as much a story of persistence, determination and conviction as it is one of timing, insight, and inevitability. Milton Friedman made an incredible difference. His paper was the equivalent to an invincible super weapon. With it in hand, Melamed and the CME leadership, as well the likes of noted economist Beryl Sprinkel who joined the first IMM board, criss-crossed the nation scores of times, addressing audiences large and small, and were able to convince government officials, bank presidents and the brokerage community that the market in currency futures was an idea whose time had come.

The reaction of George P. Shultz, who became U.S. Secretary of Treasury shortly after the launch of the IMM market, and the first government official to be visited by Leo Melamed, was typical. Although highly doubtful that the idea would ever get off the ground, Mr. Shultz offered immediate support. "If it's good enough for Milton, it is good enough for me," he quipped with a broad smile.

Not only was the CME and Leo Melamed on target in embracing Milton Friedman's prescient belief in floating exchange rates, the IMM's financial markets offered the single most effective remedy for the dramatic shocks of the next decade and a half. It ultimately transformed futures markets and proved that these markets can provide individuals, banks, corporations, and financial institutions with a better method to manage inherent price risks in foreign exchange — and later in host of other financial instruments — than anything then available. In doing so, the IMM made an incalculable contribution to the U.S. economy and spawned a new industry that was emulated the world over.

Could that have happened without the endorsement of Milton Friedman? Perhaps, but that is not the opinion of the CME chairman, his disciple and close friend. At the Tenth Anniversary celebration of the IMM, a black tie gala event held on June 4, 1982 at the Conrad Hilton Hotel in Chicago, Leo Melamed, in introducing the guest of honor, Milton Friedman, explained it to the CME members in the following manner:

> Among us all, one person stands out.
> One person who is in a category all by himself.
> The one among us who counted most.
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> For when we said the IMM was a great idea whose time had come, the world yawned or laughed. When he said it was so, the world took notice.
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> Could the IMM have succeeded without the backing of Milton Friedman?
> I doubt it. Oh, I know he may stand up here and deny it.

He may tell you he had but a small role, don't you believe it!

Milton Friedman, our guest of honor, is the man who made the difference every time. His paper, written at our behest in 1971, explaining why a futures market in currency was necessary was the single most important factor in giving our idea the credibility it had to have. His name was, and is magical. People who would otherwise not listen, because of his paper, gave us an audience. Officials who would otherwise not have approved, because of his paper, gave us approval. Presidents, financial ministers, central bankers, businessmen who would otherwise not have given us the time of day, or would never have allowed us near their door, because of his paper, opened the door for us.

It was magical. Little does he know or realize how often and to what extent his name made the difference. If we were told fixed exchange rates are coming back, we responded, Friedman said they are not! If we were told our market was just for speculators, we responded, Friedman said that is important! If we were told that we were crazy, we responded, Friedman did not think so! And each and every time his name made a difference!

I remember the Winter of 1971. We went with Dr. Beryl Sprinkel and Mark Powers to visit the likes of Arthur Burns, George Schultz, and Paul Volcker to talk about currency futures. How did we do? Darn well. Friedman's message got there before we did.

I remember the winter of 1975. Alan Greenspan instantly loved the idea of T-bill futures. The fact that Milton Friedman loved it too did not hurt. When the CFTC would not approve our the contract unless the William Simon, the Secretary of the Treasury acquiesced, Milton Friedman telephoned him. Our contract was approved the same day. Milton Friedman, you will recall, did the honors of ringing the opening bell on the IMM's first interest rate contract.

I can go on and on with memories of a multitude of other occasions, but you get the point. Milton Friedman is not only the best friend of free enterprise, he is the best friend the CME ever had. So if he now stands up to tell you otherwise, no matter how convincing he may be, don't you believe it!