

THE NEED FOR FUTURES MARKETS IN CURRENCIES

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Under the Bretton Woods system, the central banks of the world undertook to keep the exchange rates of their currencies in terms of the dollar within ± 1 percent of the par value as determined by the official values of gold registered with the International Monetary Fund. In practice, the central banks generally kept the margins even narrower: $\pm \frac{1}{2}$ of 1 percent or $\pm \frac{1}{4}$ of 1 percent. So long as they had confidence that these limits would be maintained indefinitely, persons engaged in foreign trade were subject to negligible risk from fluctuations in exchange rates. Even so, large traders with sharp pencils found it desirable to hedge any future transactions by buying foreign currencies forward to meet commitments coming due or selling foreign currencies forward to match scheduled receipts. These forward transactions were handled by the large commercial banks, often with the active participation of foreign central banks in the forward market.

Episodically, confidence that the par value could be maintained waned. Whenever this occurred, there were major movements of funds both in the spot and futures markets. Since there was seldom any doubt which way the exchange rate would be changed, if it were

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changed, the movement was in one direction only, and the funds could be absorbed only by large scale central bank operations in both the spot and futures market. The most recent episodes of this kind were in the spring of 1971, when appreciation of the German mark became widely expected; and after President Nixon's August 15 measures, when appreciation of the Japanese yen became widely expected. The German central bank bought something over \$5 billion before finally letting the mark float; the Japanese central bank [bought] a similar or even larger sum before letting the yen float. In both cases, the currencies appreciated promptly by over 5 percent as soon as they were permitted to float and then continued to appreciate subsequently.

Under the system of rigidly fixed rates that do not change—the ideal envisioned by some supporters of Bretton Woods—there is only limited room or need for a broad, resilient public futures market in currencies. The central banks plus the large commercial banks can readily provide the need. Under a system of rigidly fixed rates subject to large jumps from time to time—the Bretton Woods system in practice—there is great need for a futures market in currencies to permit foreign traders and investors to hedge against the occasional large changes that will occur. But it is almost impossible for such a market to exist because most of the time there is little for it to do, and when there is a role for it, the speculation is one-sided.

The End of Bretton Woods: An Opportunity for a Vibrant Futures Market in Currencies

Bretton Woods is now dead. The president's action on August 15 in closing the gold window was simply a public announcement of the change that had really occurred when the two-tier system was established in early 1968. No one can be sure just what kind of a system will develop in coming years—whether the world will continue on a dollar standard or whether a substitute international standard will emerge; what role the International Monetary Fund will play; whether the formal agreement among the Group of 10 on a pattern of exchange rates will last, or will be extended to a broader group of countries, and so on. But two things do seem clear.

First, even when central banks establish official exchange rates, they will permit a wider range of fluctuations about them—the recent agreement provided for a range of ± 2.25 percent instead of

± 1 percent. This reflects the widespread acceptance of the view that greater flexibility is essential to avoid repeated crises.

Second, the official exchange rates will be less rigid, will be changed in responses to much less pressure, and transitional floats will probably be resorted to as the chief device for shifting from one level to another.

The German Central bank in the spring of 1971 in effect paid well over \$500 million to postpone the floating of the mark by two weeks—this minimum estimate assumes that it purchased only \$5 billion to hold the earlier par and that it will be able to dispose of these dollars at a mark exchange rate appreciated only 10 percent above the prior par. Similarly, the Japanese central bank paid a comparable price to postpone floating the yen for about two weeks. Once bitten, twice shy. It is hard to believe that any foreign central bank will again be willing to pay so high a price for so trivial a gain.

Transitional floats have now become respectable. In mid-1970, almost any U.S. banker would have been willing to give heavy odds against what actually occurred: a situation a year later when the mark, the guilder, the Canadian dollar, and the Japanese yen were all floating. No one will any longer be surprised at such developments.

The Need for a Satisfactory Futures Market

Whatever else happens in international financial arrangements, these two changes create a major need for a broad, widely based, active, and resilient futures market. Foreign trade is often conducted on narrow margins. A range of ± 2.25 percent in exchange rates offers a risk to a trader selling goods for future payment that he may receive 4.5 percent less—or more—than he might judge from spot rates. This could make a substantial difference to the profitability of a trade. The actual risk may be even greater if he is operating in different currencies. If the pound and the mark, for example, are each held within 2.25 percent of a par stated in terms of the dollar, the cross-rate between the pound and the mark can vary within ± 4.5 percent (from the pound at top of its range and the mark at the bottom, for example, to the other way around). And the occasional transitional floats add to the possible exchange risk.

Foreign trade will not be hampered by these risks if, and only if, there is a futures market in which they can be hedged. There is such a futures market now—in London, Zurich, New York—but it

has neither the breadth, nor the depth, nor the resilience that is needed.

A really satisfactory futures market cannot depend solely on hedging transactions by persons involved in foreign trade and investment. Even though foreign payments are in balance so that, over a long period, forward sales of currencies for hedging purposes just balance forward purchases for hedging purposes, there is nothing to assure such a balance within short periods of time or for each foreign country separately. The market needs speculators who are willing to take open positions as well as hedges. The larger the volume of speculative activity, the better the market and the easier it will be for persons involved in foreign trade and investment to hedge at low costs and at market prices that move only gradually and are not significantly affected by even a large commercial transactions.

Fortunately, the same features that make a futures market so essential for foreign trade assure that it will also attract speculators. The wider range of fluctuation even when central banks are pegging and the occasional transitional floats provide much greater and more continuous opportunity for profitable—or interesting—speculation than has hitherto existed.

The demand that will arise for forward cover under the new circumstances, and the greater opportunities for speculation, mean that the present futures markets are bound to expand—soon and rapidly. The only question is where—in London, Zurich, or the United States?

The Case for a U.S.-Based Futures Market in Currencies

The U.S. is in many ways a natural place for the major futures markets to develop and it is very much in the national interest that [a futures market in currencies] should develop here.

The U.S. is a natural place for the futures market because the dollar is almost certain to continue to be the major intervention currency for central banks and the major vehicle currency for international transactions. Exchange rates will almost surely continue to be stated in terms of the dollar. In addition, the U.S. has the largest stock in the world of liquid wealth on which the market can draw for support. It has a legal structure and a financial stability that will attract funds from abroad. It has a long tradition of free, open, and fair markets.

It is clearly in our national interest that a satisfactory futures market should develop, wherever it may do so, since that would promote U.S. foreign trade and investment. But it is even more in our national interest that it develop here instead of abroad.

As Britain demonstrated in the 19th century, financial services of all kinds can be a highly profitable export commodity. The development of the Euro-dollar market abroad is a cautionary tale. It developed abroad largely because of the imposition of a Regulation Q ceiling on interest rates that commercial banks could pay on time deposits and of controls on foreign lending and investment. The result was a seriously disturbing element for U.S. monetary policy as well as the loss of profitable business. If the futures market develops abroad, it will encourage further expansion of the Euro-dollar market. On the other hand, if it develops here, it will not only yield earnings from the export of services, it will also encourage the return of international financial business of all kinds to the U.S. and the gradual reduction of the Euro-dollar market.

As the British example illustrates, there is a high degree of complementarity among different financial activities connected with foreign trade. If we develop an active futures market [in currencies], it will be used for hedging by traders involved in deals between two other countries and this in turn will attract them to the U.S. for still other financial services.

The development of an active futures market in the United States would ease the problem of executing monetary policy in several ways. In the first place, it would reduce the problems that have been raised by the growth, and more important, the fluctuations in the Euro-dollar market. The Euro-dollar market would decline in importance. In the second place, if the futures market develops mostly outside the United States, its operations will produce flows of dollar funds out of and into the United States as speculation waxes and wanes in non-dollar currencies, because the dollar will continue to be the vehicle and intervention currency for such transactions. If the market develops in this country, the effect will mostly be to transfer existing balances from one account within the United States to another. In the third place, a minor by-product of the development of a futures market here would be the further broadening and strengthening of the money market in this country in which the Fed now conducts its open market operations.

The Issue of Destabilizing Speculation

The one objection that is sometimes made to encouraging a futures market in foreign currency is that extensive speculation will prove destabilizing and will lead to wider fluctuations in exchange rates than would otherwise occur. There are three answers to this objection.

First, a more active and broader market will unquestionably develop in any event; certainly its being in the U.S. rather than abroad will not make it more destabilizing.

Second, the behavior of the current exchange rate depends on actual spot transactions, not on future transactions, and a futures market has no direct effect on spot markets. Consider, for example, a wholly separate futures market in which in practice all contracts are settled in dollars so that delivery of a foreign currency never occurs. Such a market would clearly have no direct effect on spot exchange rates since it would provide neither a supply of spot currency nor a demand for spot currency. The linking of such a futures market with a spot market and the settling of some transactions by delivery does not affect the basic situation. No participant needs to accept spot delivery unless he wishes to possess the currency involved. Hence, the linking of the two markets simply leads some transactions to take place through delivery on the futures market that would otherwise have taken place on the spot market. Insofar as the availability of hedging facilities provided by the existence of the futures market expands trade, it leads to a larger volume of commercial transactions that are surely stabilizing. In addition, the futures market may have an indirect effect insofar as it leads speculators to hold changing spot inventories of foreign exchange to take advantage of abnormal spreads between spot and futures prices. These too are almost surely stabilizing. Only insofar as the futures market somehow leads speculators to hold widely varying open spot inventories of other currencies is there even a possibility of a destabilizing effect.

It is worth noting that in general speculation can destabilize exchange rates only if speculators buy spot to hold when prices are high and sell spot out of inventories when prices are low. In that case, speculative transactions do make the swing in rates wider—but also speculators lose money. The belief that speculation is destabilizing is therefore largely equivalent to the belief that speculators on the

whole lose money. It is not easy to accept such a view, but if it were true, the speculators' loss would be the trader's gain.

Third, a great deal of empirical evidence has accumulated in recent years, particularly on the basis of studies of Canadian experience with flexible rates, indicating that speculation stabilizes exchange rates and reduces their fluctuations, rather than the reverse. Canada had floating rates from 1950 to 1962 and again since 1970. After the first few years, the Bank of Canada almost completely stayed out of the foreign exchange market. The rates have been highly stable and show no signs of the erratic behavior that some critics of floating rates have feared. More important, studies of the detailed pattern of rate changes, in accordance with the analysis of the preceding paragraph, demonstrated that there was no systematic opportunity for profitable speculation based on the pattern of the rates sufficient to offset trading costs. The clear conclusion is that speculation was stabilizing.

Conclusion

To summarize this analysis: Changes in 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. 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. Its development here will encourage the growth of other financial activities in this country, providing both additional income from the export of services, and easing the problem of executing monetary policy.

