

SCHOOLING

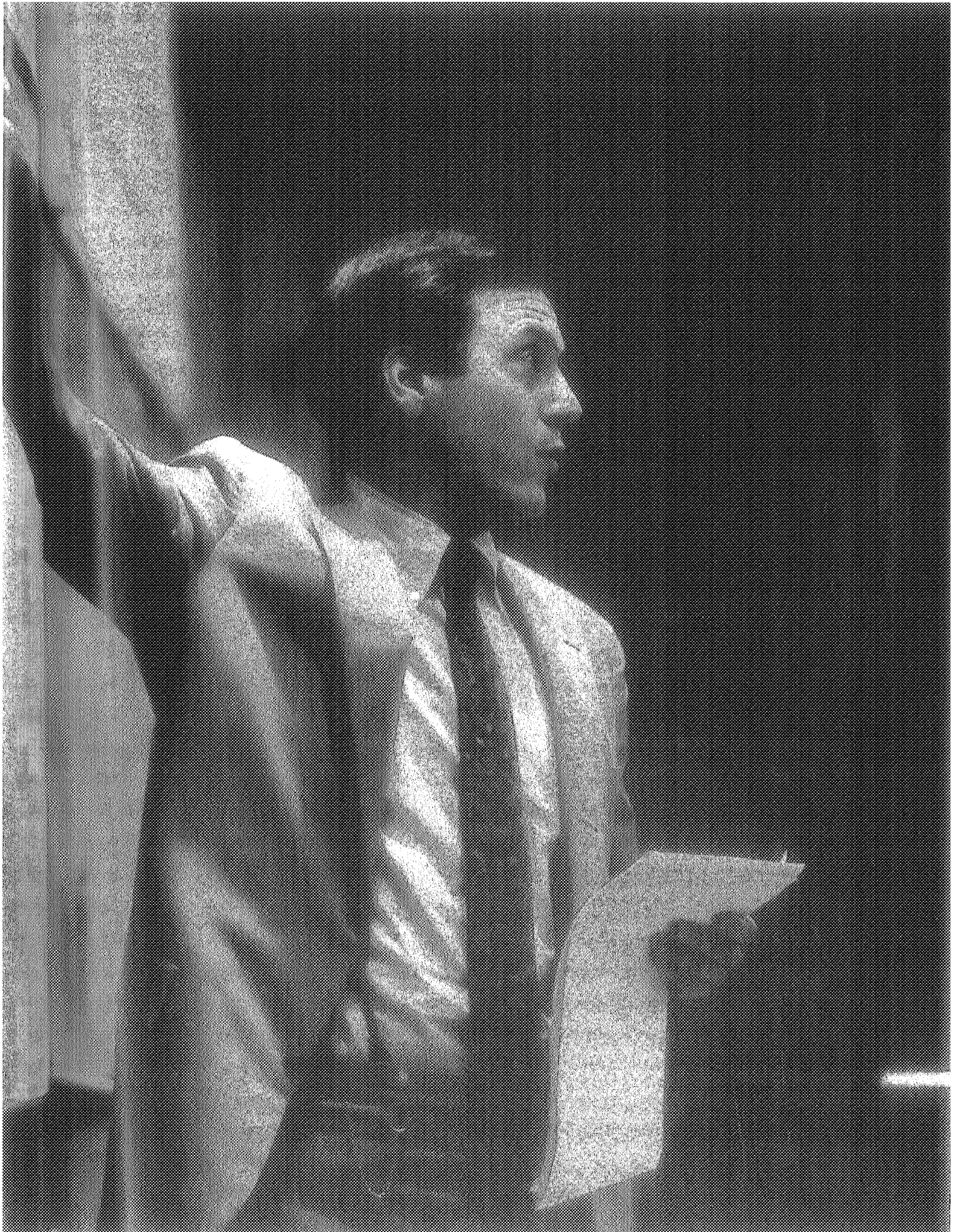
By John Boland

Back to the Futures

Dr. Steve Hanke's commodities classes are putting students out on the Street

On the Johns Hopkins University campus on a bright fall afternoon, students lazed around their shanties protesting apartheid. In the administration hall, squatters camped for a third day on the same agenda. But for Professor Steve Hanke and about 140 students, the afternoon brought business as usual. In a basement lecture room at Shaffer Hall, Hanke was sharing his passion for markets. The focus was the futures markets, where contracts change hands on everything from oats to Swiss francs.

PHOTOGRAPH BY
Jennifer Bishop





ROBERT WEBBER

Jorey Bernstein and Alan Rechtschaffen: the screaming turmoil of the trading pits comes clear—just the noise of the market.

The 44-year-old professor of applied economics brings together theory and practice in a way that's rare in Hopkins economics courses. What may dismay the dons building macroeconomic models, or expounding on the timeliness of Marxian analysis, is that each of Hanke's commodity classes has been a record breaker in student enrollment. The fall course, the Economics of Financial and Foreign Exchange Markets, attracted 144. Last spring, the Economics of Commodity Markets drew 108. Among students looking for a practical understanding of markets, Hanke is a hot ticket.

Gut courses? Hardly. By the seventh week, his undergraduates were facing a quiz on a three-way arbitrage involving the Deutschemark, the British pound, and the U.S. dollar. The readings are largely at the graduate level. And the material is so diverse as to preclude napping until finals.

One recent afternoon, while the protesters demanded that the university sell its holdings in companies doing business in South Africa, Hanke's students learned arbitrage by examples drawn from another pariah state, Chile. The theme was debt swaps. A profit opportunity existed because many nations' debt commands a lower market value abroad than at home. United States banks, for example, might value their Chilean debt at 67 cents on the dollar—pointing to doubts whether the loans will be repaid. In Chile, the debt might be worth 92 cents on the dollar. "That's because the perception inside the country is that the economy is more vibrant than it appears from the outside," Hanke observes in a drawl born in southern Iowa.

The Chilean debt swap can be engineered, he notes, because the country is one of the few in Latin America "where you don't have capital flight." Thus arbitrageurs in Chile can buy up foreign-held notes, convert the obligations through the

central bank to pesos, and buy stocks or other Chilean assets at an effective discount. Nice in theory—but what about in practice?

There Professor Hanke can put on his other hat, as chief economist for Friedberg Commodity Management Inc., a Toronto-based futures trading concern boasting a string of astute market calls. "We've been doing a lot of those swaps for the Chilean government," he says. The Friedberg firm also won points among pros a few months ago for recommending a profitable play involving purchases of Deutschemarks and short sales of sterling. Ideas make their way quickly from the trading floor to the classroom.

Is it a role of the university to train gunslingers for the futures exchanges? Well, let's say that it's at least as legitimate as training engineers and urban planners. In any case, the applications of these two courses reach far beyond the coffee pits. The appearance of such instruction around the country, usually at the graduate level—at Chicago, Stanford, and Columbia, for example—reflects the expanding economic role of futures markets. With a proliferation of contracts covering everything from interest rates to gasoline, the futures boards aid corporate financial planners in a widening array of industries. Producers and refiners can hedge in the petroleum market, for example, while concerns with large international sales can protect themselves against swings in currency exchange rates. Investment managers can buy or sell futures contracts to protect both debt and equity portfolios. For that matter, they can *create* positions through these instruments.

"There couldn't have been a class like this ten years ago," says Doug McDonald, a 28-year-old graduate student who works as Hanke's teaching assistant and grader. "Dr. Hanke focuses on the innovations that have occurred in stock index futures and financial futures."

But Hanke's ambition appears broader—and more than a little subversive to the abstract theories dominating many economics curricula. Hanke introduces his students—perhaps for the first time in their academic careers—to a broad view of how markets function, the disciplines they impose, and the effects of intervention.

While Professor David Harvey lectures students on "Marxian political economy"—and Erica Schoenberger enlightens classes on runaway plants—Hanke's curriculum challenges prevailing thought in a number of policy areas. In a course titled Benefit-Cost Analysis, the focus is the economic failure of public programs such as education, transportation, antitrust, and energy. Other courses deal with the impact of property rights on how markets allocate

resources. And the futures and commodities sections give students a day-by-day demonstration of markets in action. "Most of the economics courses emphasize pure theory and technique, and the students come away with very little grasp of how markets actually work," Hanke says. "Other courses, in the social sciences, outside the economics department, expose the students to economic analysis through a Marxist lens. With few exceptions, if you want to be a radical activist or a public sector bureaucrat, Hopkins is the place to go."

But if you want to go from the undergraduate program to a trainee program at Smith Barney, Alex. Brown & Sons, or PaineWebber, Hanke is the man to see. Jorey Bernstein, 21 years old, who will graduate in May, spent the fall semester working for J. Paul Horne, chief international economist with Smith Barney in Paris. Among his projects: evaluating international stock market indices and hedging of currency portfolios.

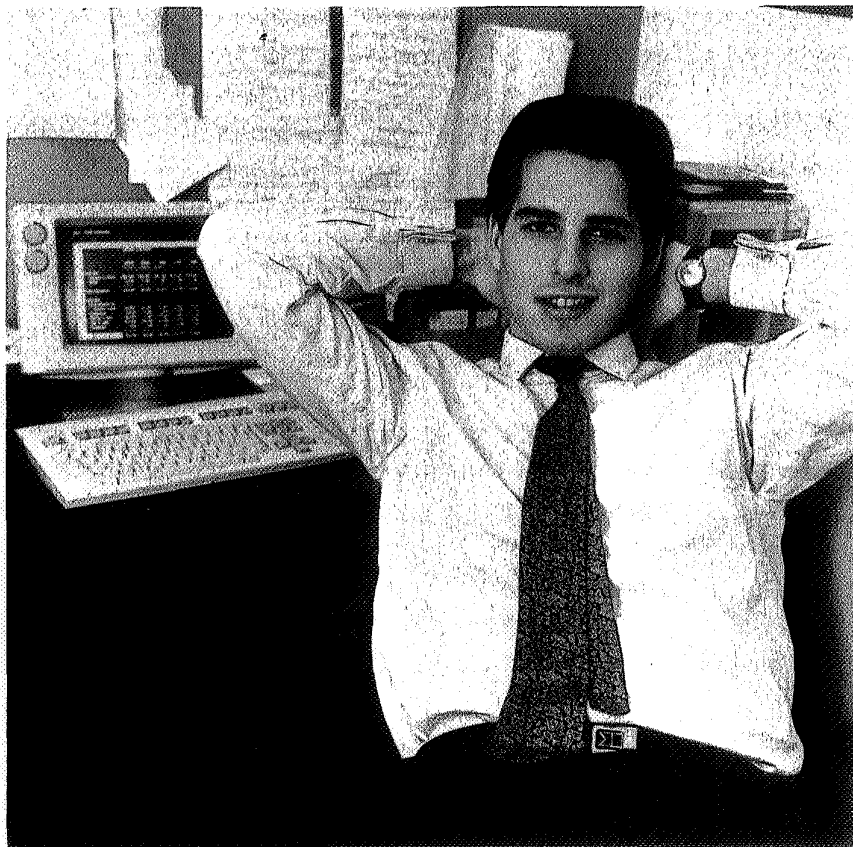
Before that, Jorey hired on for a few months at Alex. Brown. "That was a great experience," he says. "I was able to see how a firm works." Now his brother Ari, 19, is taking the futures trading course. "That's all he talks about," says Jorey, who adds, "Professor Hanke really is supportive. He's probably been the best part of my undergraduate education."

As a tenured professor since 1975, Hanke has a secure niche in a school that shares few of his views. "I've never let the hiss of the left, which represents the dominant faculty view, alter my teaching or research," he says.

He gets a wide hearing elsewhere. In a typical month, Hanke's work carries him from the Hopkins Homewood campus to Toronto for consultation with Albert Friedberg, a Hopkins alumnus who heads the commodity firm, or to New York for talks with editors of *The Wall Street Journal* or *The New York Times*, to which Hanke contributes articles on topics as diverse as private ownership of public lands and the Third World debt dilemma. In the early 1980s, he served a stint on President Reagan's Council of Economic Advisers, and since 1984 he has served as senior adviser to the Joint Economic Committee of Congress.

Over the years, he has been a visiting scholar in Austria, France, and Sweden, and since 1985 has been a senior fellow at the Ludwig von Mises Institute, a Washington think tank advancing the market-oriented Austrian school of economics.

Hanke's disdain for intervention developed largely after he joined the Hopkins as an assistant professor in 1969. He came aboard armed with a fresh Ph.D. from the University of Colorado at Boulder and with teaching experience at the Colorado



A Paine Webber research analyst since spring, Josh Olshin looks for profitable spreads. Or toward a graduate degree.

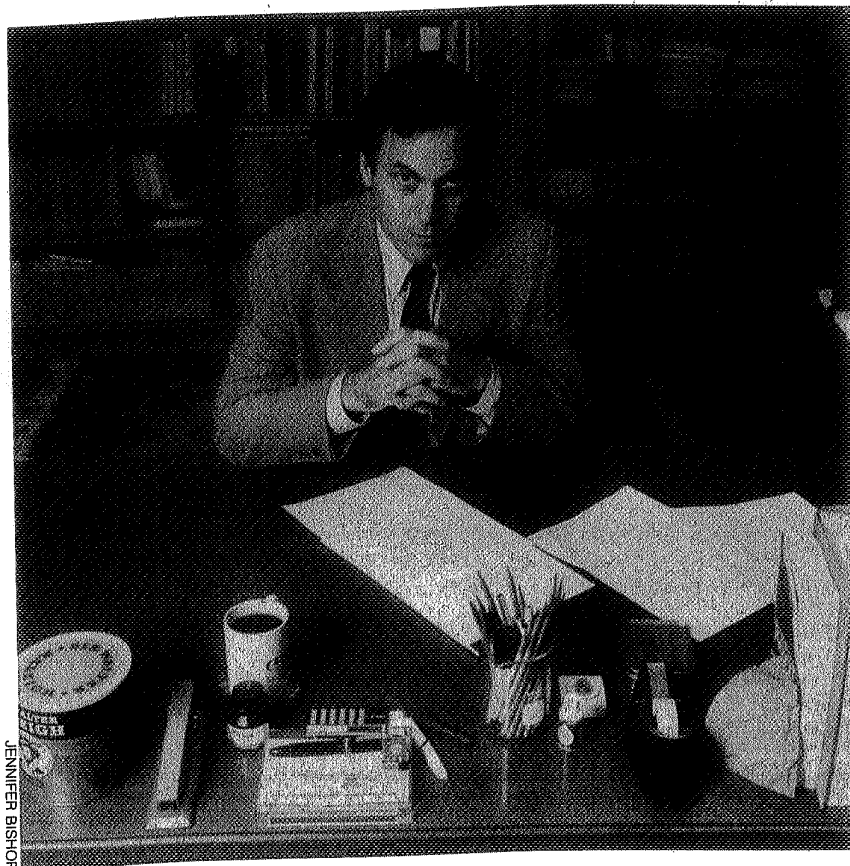
School of Mines at Golden. He was interested in resource development, with all the confidence of an efficiency-minded technocrat. "I had some sympathy for the private sector but believed that if you just had the proper technocrats in the public sector, with the proper tools, you would get a reasonable result."

But his education wasn't over. Around 1977, a French acquaintance introduced him to the works of Mises and Friedrich A. Hayek, two arch critics of interventionism. In 1978 Hanke spent a year in Austria as a resident scholar at the International Institute for Applied Systems Analysis, near Vienna. There was an irony in the experience. The institute, which had invited him because of earlier works on resource use, embodied none of the Austrian school ideas that Hanke had begun to embrace. "There are no 'Austrian' economists left in Austria; they all left before the war," Hanke notes. "But just being in the location where the ghosts were banging around

was sort of stimulating."

The institute believed—as Hanke had—that public sector programs could be made more efficient by rigorous cost-benefit analysis, borrowing the tools of the private sector to do the work of the public sector. The question was whether the tools were applicable to such a job—whether economic analysis will finally direct non-economic decision-making. Hanke was concluding that the answer was no. "This came out of the debate in the 1930s that Mises got into with the socialists, about whether you could simulate the outcomes of a market by using a series of equations to set prices. Not only can't you do it theoretically, but as a practical matter nobody's ever done it."

By the time he got back to the Homewood campus he had turned away from his earlier thinking. At the Council of Economic Advisers, he saw his old ideas in action. "A lot of conservatives in the Republican party have this notion you can make



JENNIFER BISHOP

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government efficient: if you use systems analysis and all these good techniques you can make the public sector operate like the private sector. The problem is, you don't have private ownership, which means you don't have anyone who faces the bottom line of profits and losses—and gets put out of business if he doesn't perform.

"My view became that the only way you could make the government more efficient is to get rid of it and replace it with private activity. The technocrats in private industry have to produce efficiently. If they don't they get knocked out of the market."

That principle may not operate with lightning clarity in a corporate bureaucracy—though raiders like Carl Icahn have speeded the delivery of pain to failed managements—but the corporate bureaucrat who misjudges the direction of a key commodity's price gets his comeuppance in a hurry.

In the spring course on the commodity markets, Mises' dense masterwork *Human*

Action provides material on the problems of decision-making and risk and uncertainty. Few commodity traders read Mises, but they appreciate uncertainty.

Alan Rechtschaffen, 18, who took the commodities course last year, had a special vantage for deciding whether the professor was on his toes. During intermission, he could call his father Manfred—head of the Rechtschaffen Group at Prudential-Bache Securities in New York—and bounce Hanke's ideas off another commodities pro. He came away from the class, and from his summers working for the Comex, a devout student of what market players call technical analysis, which focuses not on fundamental questions (Is the coffee crop falling?) but on trading per se (chart patterns, volume trends). "You can tell so much from the past about what's going to happen in the future—just because so many people use it," Rechtschaffen says. "There's really no other basis for it."

While the professor focuses on supply

and demand and longer-term moves, Rechtschaffen is fascinated with the moment-to-moment environment of the exchange floors. "I used to think it was barbaric, the way commodities are traded by a bunch of guys standing around screaming at each other. To an untrained ear, it doesn't make much sense. But after working down there a while, you understand it. And you see how much trading depends on other things, talking to people you know, psyching each other out, seeing who trades with whom. Most of the transactions that occur are for a matter of minutes. Long-term for most of the floor players is overnight." If a trader on the floor catches sight of a ticket with a 100-lot market order, Rechtschaffen notes, "it doesn't matter what the fundamentals are—you know the broker's going to be buying it up." Later, after the flurry of the hour or the day, fundamentals will assert themselves.

When Hanke talks about a market's fundamentals, students who have been around him for a while pay heed. "He was analyzing the world oil market last year," says Joshua Olshin, 21, who last spring completed a BA in economics and joined Paine-Webber Inc. in New York as a research assistant. "Because of the supply and demand outlook and the financial situation of the oil producers, he concluded that weaker prices were inevitable." Oil soon was in a freefall. This spring, says Jorey Bernstein, Hanke told students to watch for upswings in gold and platinum. By late summer prices were exploding.

"Dr. Hanke tries to describe the theoretical reasons you might be interested in a topic," says McDonald, "but he focuses on today's market. They learn from things they read in *Barron's*. He will outline the fundamentals for a certain commodity and a trading strategy. For example, a spread in gold and silver—or crude oil and gasoline. Last spring there was a strike by Norwegian oil workers that he thought might make a spread in near and far oil futures profitable." It was.

Of the 144 undergraduates in the futures class, few will join the screaming turmoil of the commodity pits. Few will become stock or commodity brokers. Some, like McDonald, will head for academic careers. Others will seek graduate degrees and posts in business and government. Josh Olshin, as much as he enjoys securities research with PaineWebber, looks ahead to graduate school, possibly for a joint JD-MBA degree. But he wouldn't have missed the futures and commodities regimen. "It gives you an exposure to markets and principles about markets that is important to have," he says. ■

John Boland writes the "Easy Money" column for *Warfield's*.