WHAT IS INTERNATIONAL EXCHANGE?

Clear Exposition of Intricate Subject by a Canadian Banker—Composition of Money Market

In the orthodox meaning of the word market there is no such thing as a money market, but the term is generally used to signify the collection of dealers in money on a large scale, explained Mr. F. L. Appleby, manager of the Foreign Exchange Department of the Union Bank of Canada, at the Toronto Y.M.C.A. Finance Forum.

Among others the money market consists of:—1. banks, chartered; 2, banks, private; 3, bill brokers; 4, discount houses; 5, insurance companies; 6, financial houses; 7, the stock exchange; 8, the government; 9, in old centres, foreign banks and the governments of overseas dominions.

A bill of exchange is the instrument by which the bulk of international exchange operations is completed, and is divided into two great classes:—1, commercial bills; 2, finance bills.

The commercial bill of exchange is again divided into two classes:—1, documentary bills; 2, clean bills.

Documentary bills mean bills having documents attached and clean bills those having nothing whatever attached. Documentary bills are again sub-divided into two classes, known familiarly as:— 1, D/A's—meaning documents to be delivered against acceptances and 2, D/P's—meaning documents to be delivered against payment.

Once a bill of exchange is negotiated, it passes through pretty much the same experience whether it is commercial or financial.

The bill of exchange first touches the money market when the drawer receives cash or credit from his bank.

The bank treats the bill, either as an investment producing —— per cent. per annum, or sells it, but in any case, without delay the bill is sent on its way to be accepted.

Become Private Bankers.

In many cases the bill of exchange is drawn on another bank, which is styled and generally known as an accepting house. Originally these accepting houses were merchant firms who traded successfully and fairly, and thus established a high reputation for credit and business morality. In the course of time, other merchants with whom they were doing business, suggested, that in exchange for a fixed rate of commission, these houses should lend their names by accepting bills drawn on themselves. This business increased to such an extent that the houses engaged in it discarded altogether the mercantile end of their business and thus became private bankers, specializing in accepting bills, and in a few other forms of banking for which their connections and experience rendered them peculiarly suitable.

Still later, the large joint stock banks decided that they might also turn their name to profitable account by accepting bills, but in spite of this competition the business transacted by these private banks is of considerable bulk.

Having been accepted, the bill of exchange next passes into the hands of a bill broker, or discount house, or still another bank, but in this case the bank would simply be acting in the capacity of the bill broker or discount house.

Taking the bill broker, we find that originally he simply acted as a broker between banks for the negotiation of bills. Later, through the increasing facilities afforded by their own market, or perhaps by the desire to make an extra profit by their special knowledge of the market, and certainly through competition, the bill broker felt that he must place every bill offered him by a bank. But this was not always easy. Occasions arose during which there were no buyers of bills, and rates mounted higher and higher in an effort to induce buying, without results.

Broker Became Buyer.

When this condition had arrived, the broker himself became the buyer, and obtained funds to pay for his latest purchase, by pawning with his own bank the bill just bought.

His bank, however, would not have been content to advance money on this bill for the whole length of time which it had to run, and stipulated that the broker must redeem his pledge when called upon.

In this way the broker's first care was that the names on the bill he bought were such that he would never experience any great difficulty in obtaining a temporary loan from at least one of the banks.

The rate of interest paid by the broker against the loan is the call money rate, and as on the yearly average, this rate is lower than the discount rate, he is in this way, able to make quite a nice profit.

However, it must not be supposed that the bill broker has ceased to transact business on a straight brokerage, as he does so whenever occasion permits.

To a Discount House.

Alternatively our bill might have been turned over to a discount house. The value of the services of the discount house cannot very well be over-estimated, partly for this reason. A discount house will buy a bill of any period—30 days, 60 days, or six months, if necessary, whereas at certain times the banks do not feel disposed to lock up large sums of money for long periods.

Here is where the discount houses step in. They will buy a six months' bill just as readily as a 30-day one, and as they have quite large resources of their own, they can thus carry the purchases without assistance. In this way they become, so to speak, warehouses for accepted bills, where the large banks can come and buy bills maturing at periods suitable to their finances. As an example, the discount house buys one bill maturing in three months; one bill maturing in four months; and one bill maturing in six months, and if in one month's time a bank is prepared to invest some of its funds for periods not exceeding 60 days, it goes to the discount house and buys that bill drawn at three months of which one month is already passed. In this way the discount house has replenished its funds and can now buy another bill of six months if it sees fit. As, every day, the discount houses are buying bills maturing at all kinds of dates, the choice they offer the large banks is very varied— from three days to six months.

How Profits are Made.

Roughly their profit is obtained in this manner:—1. Buy a long term bill at a comparatively high rate of discount (as competition is not great). 2. Hold the bill for a certain period (during which it is earning interest at the original purchase rate). 3. When nearing maturity, sell the bill at a comparatively low rate of discount.

The last is possible because of the competition among large banks to invest surplus funds for a short period. There is nothing more of interest likely to happen to this bill, which normally will be paid on due date.

Bank of England Rate.

The bank rate, is the official minimum rate at which the Bank of England will: (a) discount first-class acceptances, and (b) lend money for short periods on approved securities. However, it must not be thought that this is the lowest discount rate. Competition among the banks has brought about a generally lower rate which is known as the open market discount rate. In normal times even the Bank of England will discount at the open market rate for some of their regular customers, but at others if the Bank decides that this rate is dangerously low, they will take steps to adjust it, and this is done in the following manner:—

They will cause a demand for money until money is actually worth their own official rate. The usual method of creating this demand is: (a) sell Consols for cash; (b) buy Consols for account.

By selling for cash, cash is withdraw from the market, and if in sufficiently large quantities, money becomes scarce, and therefore worth more. By buying for account, the Consols still remain in the property of the Bank of England, therefore the two operations result in a straight borrowing from the money market at the market rate.

Lenders Charge More.

If this demand for loans be continued, the lenders charge more. The Bank of England will continue to pay more until its own rate is asked, then it is content, and when "Settlement Day" (twice a month) comes round, it pays its accounts and thus has its Consols back again, losing on the transaction the difference in the value "for cash" and "for account."

The value of Consols is quoted each day in the morning papers both "for cash" and "for account," and the difference in price varies according to the value of money, and the number of days to run before the next "Settlement Day." Usually it is about ⅛ per cent.

When the Bank of England resorts to the practice described above it is said to "make its rate effective." Generally speaking the bank rate is high in times of 1, good trade; 2,