FOREIGN EXCHANGE FLUCTUATIONS

Discount Rates and Their Influences—The Bank of England—Marketing Bullion

The rough division of bills of exchange into two great classes, namely, commercial and finance bills (although there were some which partook of the nature of both classes), correspond to a similar division in the monetary relations between one country and another, remarked Mr. Hartley Withers, in a valuable address before the British Institute of Bankers. These relations depend largely on (1) the exchange of goods and commercial services; (2) the exchange of securities and financial services. Of these two divisions, the first was, on the whole, much steadier and less liable to fluctuation, and also much less susceptible to control by those whose business it was to watch exchange fluctuations and influence them when they needed control.

It was difficult, continued the lecturer, to draw the line between commercial and finance bills, but the following definitions might be assumed: (1) Commercial bills were those drawn in the first place against goods exported; secondly, against any services rendered in connection with the interchange of goods such as freights, insurance and brokerages on produce, and thirdly, against any services rendered. All these ebbed and flowed in a more or less constant stream. (2) Finance bills were drawn against the export of a promise to pay, whether in the shape of a government loan or a railroad bond having a hundred years to run, or the implied understanding that the drawer would put the acceptor in funds to meet the bill before its maturity. According to this division, bills drawn in anticipation of shipments of goods were pure finance bills. The ebb and flow of the stream of finance bills had all the suddenness and strength of a freshet, and their effect upon exchange rates was very marked.

Influence of Discount Rates.

There was a close connection between market rates of discount and the creation of finance bills. The finance bill in its simple form, i.e., one that was drawn on an English correspondent by an operator abroad, who wanted to finance himself for a time, would, as a rule, only be created when the rate of discount in London was lower than that at home.

This rule also held good in the case of bills drawn on London by American or English houses under instructions from English firms who wanted to lend money in the United States or in France.

The same applied to a third class of finance bills, i.e., those drawn to supply a demand for exchange and in anticipation of an increase in the supply of commercial bills later on—obviously high discount rates made inroads into the profits of exchange.

As to bills drawn against exports of the more permanent kind of investments, a low rate of discount in London tended to stimulate the creation of fresh securities. In so far as these were foreign or colonial securities, the creation of finance bills was implied, the sale of which in the countries where they were drawn would turn the exchanges against England. Contrariwise, an abnormally high rate of discount would stop the import of this kind of security altogether.

Cheap and Dear Money.

As regards commercial bills, cheap money stimulated imports and a ready demand for foreign goods, followed by free drawing of bills on England and a downward tendency in the exchanges, while dear money would bring out the goods of English merchants and send them abroad for what they would fetch and turn the exchanges in our favor. Since, however, the price of a credit was a much smaller item to a merchant or a manufacturer than to a financier who was drawing accommodation bills, the effect of money rates on international trade was much slower than on international financing.

It followed then, continued the lecturer, that those who had to study and forecast exchange fluctuations must master the movements of discount rates. Conversely, those who wanted to forecast discount rates must watch the rates of foreign exchange, the action and reaction of these two rates on each other being constant and effective.

As regards the influence of exchange on discount rates, when the former moved against us, discount rates would inevitably tend to rise, because a large supply of bills for discount in London would be expected, and bankers and discounters would raise their rates in anticipation. Another reason was that if the exchanges fell sufficiently, exports of gold from London would be threatened.

Demand and Supply of Bills.

Discount rates were established by demand for and supply of bills. The batches of bills that arrived by the various mails day by day were, after acceptance, usually sold to a billbroker or a discount company, who usually held a large stock of bills of various maturities to suit their customers—the banks—but, in the main, acted as intermediaries. Any slackening in the demand of the banks for a certain class of bills tended to throw an additional burden on the billbroker and discount houses, who generally financed themselves by borrowing at call or for short periods from the banks. This was another influence exerted by bankers on the price of bills.

Discount rates thus depended, in ordinary times, on what the managers of the clearing banks thought ought to be the price of bills, but sometimes the sceptre of the discount market passed into the hands of the Bank of England, which watched over the money market and regulated its rates, with a view to influencing exchange rates, and protecting London's reserve of gold, which was in its keeping. This it did, either (1) naturally, when the excess of supply of bills over demand sent people, who had bills to sell, to borrow on them at the bank, which thus got control of the market; (2) artificially.

When the bank thought discount rates too low, in view of the state of the exchanges or of the size of the reserve and its proportion to their liabilities, it would secure control by borrowing money from the market, and so create a scarcity of funds. When market rates rose in response, the bank was said to make its rate effective. Students of exchange had to take into account such interventions by the Bank of England. As under the English system we worked on a much smaller gold basis than any other leading financial nation, and at the same time were always prepared to hand the metal out when asked for, there was twofold need for vigilance on the part of those who kept our reserve. Hence it was that discount rates in London were so sensitive to foreign exchange movements.

Methods of Bank of England.

The rise in discount rates, continued the lecturer, would, for reasons already given, be probably followed by a favorable movement in the foreign exchanges, owing to a decrease in the amount of finance bills drawn on London, and to the inducement offered to English and foreign capitalists to employ their floating supplies of credit in London.

Such was the method by which the Bank of England tried to keep the foreign exchanges above the "gold point," i.e., the point at which it was theoretically more profitable to send gold instead of buying a bill. In practice gold shipments from London were made by firms who specialized in it, and bought up bills on London so as to put themselves in funds there to meet their purchases of gold. By buying the bills, they prevented the rate from falling far below gold point.

As regards a rise of the exchanges up to the incoming gold point, it was by no means certain to be followed by imports of gold.

In the case of the United States, it was generally possible to get gold certificates, and turn them into gold at the sub-treasury. In the case of France, the Bank of France charged a premium on gold when it chose, and Germany took measures which were so effective that the theoretical gold point was often reached without gold being shipped. In other centres the theory only worked partially.

As regards a fall in the exchanges, it was safe to assert that when the point was reached at which it paid better to ship gold from London than to buy a bill, gold would go, but experts always differed as to when that point was reached, and, moreover, gold often left London long before there was any question of it being the more profitable form of remittance. The latter kind of export was made for a variety of reasons, e.g., for the sake of the advertisement gained by the importing firm; to produce a stimulating effect on stock markets by making credit cheaper and more abundant; to enable bankers to lend more freely at attractive rates. The effect of movements of gold on the exchanges was, of course, the same as those of other commodities; an import turned them against us, and an export turned them in our favor.

Trading in Precious Metals.

For purposes of export, bar gold was preferred to sovereigns, or better still, coins of the country to which the gold was to go, and as the Bank of England was entitled to meet demands on its store in sovereigns, which were usually below full weight, and involved loss on recoinage, it could fix, within certain limits, the price at which it was prepared to supply bars or foreign coin.

The bullion market consisted of three or four firms, which specialized in trading in gold and silver. Arrivals of gold were sold to the highest bidder, two buyers being always constant in their demand, namely, India and "the trade," i.e., the goldsmiths.

Bar gold could not fall below £3 17s. 9d. per ounce, because at that price the bank was bound to buy any amount offered to it, and the mint would coin it at the price of £3 17s. 10½d., the difference of 1½d. being the demurrage charge.

In conclusion, the big lesson we learned from the exchanges was that every nation that bought must also sell, and vice versa. Finally, the lecturer hoped they had seen how important and useful the foreign exchanges were, and what an interesting job all who worked in and around Lombard Street were engaged on.