CHAPTER VIII

THE DISCOUNT MARKET

A LARGE part of the world's overseas trade is financed, as we have seen, by bills drawn upon London, that is, either on London banks or Accepting Houses, or on the London offices of foreign or English overseas banks. These all have to come to London for acceptance, and when accepted usually stay there till they are due to be presented for payment. This represents a large amount of capital locked up during the currency of the bills. The owners of the bills generally can find a good use for this capital elsewhere, if they can borrow it at reasonable rates on the security of the bills. On the other hand, the banks and great financial houses of London are usually the depositaries of large amounts of floating capital for which they are anxious to find an employment by lending on securities for a short period.

There is no class of security for an advance which suits the banks better for temporary employment of their funds than the commercial bill. It has a definite period to run, and can therefore be bought so as to suit the convenience of the banker to meet at its maturity the obligations which he can foresee as falling due at definite future dates. In addition to this advantage, the large majority of bills created in foreign trade are, under normal circumstances, as they appear on the London market, above suspicion where the solvency of those who are responsible for their liquidation is concerned. They may be drawn upon one of the Accepting Houses, or upon a large London joint-stock bank, where the signature of the acceptor is sufficient guarantee; or they may be drawn indeed upon an acceptor of less standing or at least on a name less generally known, but they come with the endorsement of one of the large Exchange Banks, who have bought them in the market in the East and forwarded them for discount to their London office. All these come under the general designation of "Bank Bills," and command, in virtue of their unsurpassed credit, the very finest rates of discount current at the time. In addition to these, there are always afloat on the market, since the beginning of the war, large amounts of Treasury bills, issued by the Government from time to time, and tendered for by the banks and discount houses. Some of them indeed are taken by private firms as a temporary reserve for superfluous cash; but the gross amount thus held is comparatively small, and the fact that they are not issued in smaller denominations than £5,000 makes them hardly available for the small investor. Thus they do not seriously compete with the deposit accounts which the banks open for their customers, though the rates at which they change hands are somewhat higher than those allowed by the banks for deposit accounts.

It is the large amount of these floating Treasury bills which explains the chief alteration in the aspect of the discount market brought about by the war. It is largely by the issue or withdrawal of its Treasury bills that the Government controls the market, and carries out its policy of inflation or deflation. During the period of inflation the amount of this floating debt grew by leaps and bounds. In the earlier stages of the process the banks used to wonder whether the market was not being flooded with Treasury bills beyond its power of absorption. But it soon became apparent that the money thus borrowed was only a creation of credit; the sums borrowed were at once disbursed to the public, and came back to the banks in the form of additions to their customers' deposits, and so the circle went on continually expanding. The amount of Treasury bills running grew as follows during the period of inflation :

		£
December	1914	99,000,000
	1915	380,000,000
	1916	1,116,000,000
	1917	1,058,000,000
	1918	1,095,000,000
	1919	1,107,000,000

The process of deflation began in 1920 and proceeded thus :

		£
December	1920	1,102,000,000
	1921	1,060,000,000
	1922	719,000,000
	1923	652,000,000
	1924	626,000,000
	1925	635,000,000
March 31,	1926	565,000,000

It will be seen that the amount of bills outstanding has now remained almost steady for four years.

It is to the tenders for Treasury bills that one looks as the best index of the state of the market from time to time, the relation, that is, between the money which is seeking temporary employment and the openings for using it in the discount of bills. When the supply of disposable capital falls short of the demand, the price offered for Treasury bills falls, that is, the rate of interest at which they are discounted rises. The tenders are made at rates minutely discriminated. For instance, on 9th April, 1926, Treasury bills to the amount of £40,000,000 were offered for tender. Tenders at £98 18*s*. 1*d*. or above received allotment in full, and the average rate worked out at £4 7*s*. 6·01*d*. per cent.—a rise of 4·03*d*. as compared with the figures for the previous week.

The tenders for Treasury bills form the machinery by which the Government policy of inflation or deflation now controls the market. The Government offers certain amounts for tender; these amounts may or may not exceed the total of bills which are maturing at the same time. If a smaller amount is offered than is running off, the Government are diminishing the total amount of bills on the market; that is, they are paying off so much of the floating debt and to this extent deflating. The policy of the Governor of the Bank of England in raising or lowering his rate is primarily governed, under existing conditions, by the necessity of protecting his stock of gold, that is, by the rate of the foreign exchanges. But at the same time he has to keep his eye on the ruling rate of discount for Treasury bills; for this shows him whether his rate is "effective." If the rate for bills is much below the bank rate it shows that he has lost command of the market, and has to face the possibility that those who are lending in the market may not be content with the rates they are getting for their money, and, if they are foreign lenders, as, for instance, the American banks, may withdraw what they have placed in English bills and transfer their balances for investment in New York rather than in London. Thus his bank rate may not be able to control his gold reserve; for the transference of balances from London to New York means that the American exchange goes against London; in other words, dollars are in demand and sterling is being offered for sale, so that sterling depreciates in terms of dollars. And as the exchange falls it tends to encourage the transfer in actual gold.

The means which the Bank of England can take to make its rate effective are somewhat of a mystery; they are indeed commonly known in the market as the "hidden hand." The method consists, of course, in the selling or buying of securities, according as it is wished to take cash off the market, or to put more cash on it. In old days the usual process was what was called "lending and borrowing on Consols." Consols were before the war so large a stock that quite large dealings in them, whether for cash or "for the account," could be effected without calling the attention of the public. When the Bank wished to "borrow on Consols," thus taking cash off the market, the practice was to sell Consols for cash, which was always possible, and to buy them back in advance for the next settlement, which might be as much as a fortnight later. Thus the money was taken off the market only for a few days; but if it was desired to continue the process, it was, of course, always possible to sell them again at the next settlement. When it was desired to make the market easy by putting cash into it, the process was reversed; Consols were bought "for cash" and sold "for the settlement." Now that the amount of Consols has been reduced to a fraction of what they were before the war, other stocks have to be used. But the discount-market and the banks are always large holders of the stocks known as "floaters." These are various stocks, not merely of the British Government, but others of the highest class—principally those which have been issued by the Bank of England itself. The Bank is always prepared to deal in these, taking them as security for loans or selling them through the Government brokers; and it is likely that it is chiefly by dealing in floaters that the Bank can, in fact, if it wishes, control the market. It may, however, be said that the Bank in practice uses its power much more freely in helping the market in times of stress than in creating an artificial scarcity of money.

The importance of the Treasury bills is, however, a development due to the war. The discount market existed for long without them, and still exists, mainly on the financing of international trade by the discounting of commercial bills. It may, in fact, be described as a large reservoir into which are poured the vast proportion of foreign bills drawn upon London.

But before we consider it in greater detail, a word must be said as to the bills which do not come into this open discount market. The banks discount a great number of bills directly for their customers. These are mostly bills drawn in the ordinary course of trade by comparatively small houses on others whose names do not figure among the large acceptors. A bank is willing to take them, from its knowledge of its customer and from experience of the manner in which his drafts are regularly met by those on whom they are drawn. But the open market prefers to deal with bills which are of unquestioned and well-known standing, whether through their drawers, acceptors or endorsers.

It must also be pointed out that the number of bills which are drawn in payment for the transactions of our internal trade is now very small. Some fifty years ago the " home bills " of the large wholesale warehouses, drawn on their retail customers throughout the country, formed an important element on the discount market. Now they are rarely seen. They used, with few exceptions, to be drawn at three months' date from the first day of the month, so that, with the three days of grace allowed by English law, they used to fall due on the fourth of the month; and the result was that half a century ago "the fourth of the month" was always a heavy day at the Clearing House, from the number of home bills passing through it. Now the home bill has almost disappeared, and the fourth of the month is no heavier than any other day. The general tendency of the home trade has been towards the accumulation of capital by the retail houses, leading to more rapid payments for cash, in place of the three months' acceptance which was once normal. That a retail house should require to take advantage of the full three months' credit by acceptance would now be regarded almost as a reflection upon its solvency.

As the deposit banks make a rule of never re-discounting bills, none of those which they discount for their own customers ever come upon the discount market at all. Thus it follows that few home bills are ever seen outside the bill-cases of the banks, and even of bills drawn in the foreign trade a certain number are taken directly by the joint-stock banks, and remain with them till maturity. But even after deducting these, the mass of commercial bills which come to London from abroad is so large that they maintain an active market consisting of houses who make it their practice to deal in them. The discount houses include several large joint-stock companies, as well as a number of private firms. They make it their business to go about the City seeking for bills to discount.

The resources which they use for the purpose of lending on the security of bills—which is, of course, what is meant by discounting—come from three origins. In the first place, they have their own capital, which in the case of the largest houses is very considerable. In the second place, they take deposits from the public on the same lines as the banks, but they give a slightly higher rate of interest. They have to attract these deposits from the public at large, and have not the wide clientele to draw from which the joint-stock banks possess in their own customers. If they are to attract deposits, therefore, it is necessary for them to outbid their large rivals. As a matter of fact they generally advertise a rate of one-quarter to one-half per cent. per annum more than the joint-stock banks.

The third source from which they draw funds for the discount of bills, and the most important one, is the borrowing of money for the purpose from the joint-stock banks themselves. The banks and the discount houses work, in fact, in a sort of partnership. The discount houses borrow funds from the banks at a cheap rate, and employ them in discounting bills. In this capacity they act as brokers in the strict sense, and the term "bill brokers," by which they are generally known, is strictly applicable. The banks entrust them with funds which they proceed to invest in bills, taking the profit which comes from the fact that they are able to get a better rate for the bills than they pay to the banker. The ordinary term for which these advances are made is one week. In addition the bill brokers make a practice of going round towards the end of the business day and asking if the bankers have any surplus money over after making up their balances for the day. If so, they are often ready to take it till the next day at a somewhat lower rate. This is known as "night" money.

The brokers have in reserve a further source of funds in the fact that the banks are from time to time ready to re-discount the brokers' bills, and put them in their own bill-case. It is a great convenience to the banks to be able to a great extent to choose their own time for filling their bill-cases, as they are apt to have large amounts of bills running off together to meet periods when cash is particularly needed, for instance at the end of the year. Early in January the banks are usually discounting brokers' bills very readily, as those which they have been holding will have been bought so as to mature within a day or two of December 31 to meet the calls of that very heavy day. The brokers have been fulfilling a function which is very useful to the banks, in holding over bills till the bankers are in want of them. The discount market serves thus as a great reservoir in which bills can be stored up in time of flood, to be released when the banks are ready to find a permanent home for them.

The bill brokers are valuable to the banks also because they guarantee the bills which they discount with the banks. They are not endorsers technically, but they have a standing agreement with the banks that they will be responsible for the bills which they bring in. If one of their bills is not paid when due, the bank can call upon the broker who has discounted it to take it up. The brokers may thus be regarded as specialists in credit acting on behalf of the banks. Of course the banker does not rely upon the broker's judgment entirely, and exercises his own judgment on all the bills which are brought him, and occasionally will throw out of a parcel brought him by a broker acceptances which he does not like the look of. There is a working alliance between the brokers and the banks for their common advantage. The brokers will consult the banks, for instance, as to the amount of acceptances afloat in the name of one particular house—"Do you think there is too much of So-and-so's paper on the market?"—and the like. Thus a careful and expert watch is kept up which forms a most valuable safeguard against any undue speculation in the acceptance of bills.

The main source of profit to the bill-broker is the difference between the rate at which he can borrow from the banks for a week and that in which he can employ his money in discounting bills. The margin is not a wide one, and calls for a high degree of skill and foresight. On the one hand it is evident that the bill broker can never get, at least for the fine bills with not more than three months to run which form the bulk of his business, anything higher than bank rate; for bank rate means the rate at which the bank announces its willingness to discount such bills itself. And if the bank rate of discount offers an upper limit to the market rate, the rate allowed by the banks for deposits offers a lower limit. The banks will not lend to the brokers at short date at a less rate than they are paying to their customers for the money placed with them at short date. In fact they are not prepared to lend at the same rate; they always charge a margin for profit. The margin between the rate of interest allowed on deposits and the market rate of discount affords, to some extent, a measure of the profits which the banks are likely to be making over a given period.

It will be noticed that the ordinary term on which the banks receive their London deposits is at seven days' notice, and is the only one which they publicly advertise in common. It is of small moment that they are prepared to take deposits "at call" at a somewhat lower rate, and in some cases advertise their willingness to do so; here, of course, there is no competition. That comes in only where they are prepared to give higher rates to attract money, and this they are not precluded by the agreement from doing provided they require a longer notice for its withdrawal.

The reason for the choice of this special length of notice is that it is the same period, seven days, which is commonly chosen for the loan of money to the bill brokers; it is necessary for the banks to have a good reserve of deposits fixed for the same period at which they are lending large amounts. And thus it is that the rate of money on deposits at seven days' notice fixes the rate at which money is lent in the market. Before the war, as we have seen, the deposit rate was always fixed at 1½% below bank rate; but the difference has now been fixed at 2%.

A consequence of this widening of the margin is that the Governor of the Bank of England finds it more difficult to "make his rate effective"; there are times when, with his eyes on the foreign exchanges, the Governor may wish to see a higher rate for money in London, while, owing to some temporary circumstances, there is a rush to lend money, and rates are depressed. If the banks, owing to competition, are in a position to lend money at more than 1½% below the bank rate, it is evident that the Governor can do little to control rates. Under the old system, when the total margin between deposit rates and the rate for money could not show a difference of as much as 1½%, and practically always showed less, it was always possible to stiffen the market by a gentle use of the "hidden hand." In order to meet the views of the Bank of England, and assist it in keeping command of the market, it has now become the practice that, when the banks meet for the purpose of fixing their rate of interest, they also fix the minimum at which they will lend to the bill brokers for the week. This rate is fixed, roughly speaking, at about what the rate would have been under the old system—if, that is, the deposit rate had been at 1½% instead of 2% below bank rate; but there is no rigid margin, and the rate agreed upon depends rather upon the needs of the situation, with regard mainly to effective support of the policy of the Bank of England.

It is worth pointing out that it is only in respect of the rate on London deposits at seven days' notice that there is anything of the nature of an agreement between the banks in restriction of competition; and that this agreement is imposed upon the joint-stock banks by the policy of the Bank of England. This policy the banks regard it as their duty to support, though they have no voice whatever in shaping it, and indeed have no more knowledge of the steps which the Governor proposes from time to time to take than "the man in the street." Any of the accusations which from time to time are heard, to the effect that "the banks" have formed a "money trust," can be based only upon this statement, upon the loyalty, in fact, with which the banks support the national system of banking, as laid down by law. In all other respects competition between the banks is unrestricted, and is carried on with the greatest keenness.

The way in which the bill market works is then as follows. The Overseas banks, including the foreign banks, and the Merchant Bankers are continually receiving from abroad supplies of bills which are sent to London for acceptance and ultimate payment. The bill brokers are in constant touch with all the sources from which bills are likely to be on offer, and, especially when the market is easy, will go round asking to be allowed to offer. Most of these bills are due within three months. These are the bills which form the market, as the Bank of England will not discount bills with more than ninety days to run. In some trades, however, it is not unusual to draw bills at longer "usance" up to six months. The bill broker is, as a rule, willing to take a certain amount of these and to sit upon them till they come within the three months' limit. On these he naturally gets a considerably higher rate; but it is not wise for him to invest in this way more than the capital he has actually invested in the business, and such deposits as he may have from the public fixed for some considerable time ahead.

But for the bulk of his business he depends upon the money lent him by the banks. Every morning the bill brokers call upon the managers of the large banks. The manager who has the responsibility for the "till" will, as we said in Chapter V, have started by estimating his needs for the day. When these are ready he is prepared to receive the bill broker, and tell him how much he is prepared to lend him for the next week.

A certain amount lent to the broker a week ago will be running off to-day. If he is prepared to renew this, well and good. But he may have found that in order to provide a sufficient balance at the Bank he cannot afford to renew, and he will therefore "call" the whole or a part of what is falling due. The bill broker will then find his power of discounting bills reduced by so much; and if the banks generally are short of money and are all calling at once, the market will be tight, and the broker will charge those who are offering bills for discount a higher rate. If the tightness is more than quite temporary, the rate for bills will run up to close to the figure at which the Bank of England itself is prepared to discount, and the market will look for a rise in the bank rate. The pinch for money may be such that the broker finds himself unable, from the cash at his disposal, to repay the money called by the banks. If, as is likely to be the case, the banks are not in a position to discount the broker's bills, he has no resource but to go to the Bank of England, and either borrow money from them, or discount bills with them. The former alternative is that which he will probably adopt, as paying the central institution a higher rate for money over a short period would be cheaper for him than discounting his bills, which may have a considerable time to run. He will therefore borrow from the Bank on the security of bills or "floaters." But the Bank makes a practice of not lending for a less period than seven days, or at a less rate than "one-half above bank rate." This measures the loss which the bill broker has to face. It is one of the risks of his profession. When the bill brokers are thus driven to the

Bank of England for the temporary loans which the joint-stock banks are unable to give them, in the slang of the City "the market is in the Bank."

It will be readily seen how greatly beneficial to the banks is the existence of this great reservoir of bills. While passing on the larger share of profit to the brokers, they retain for themselves a small but assured margin, and are able to adjust to the needs of the moment their daily requirements in the way of cash. The advantages of the system are the more plainly seen if we compare London with New York. In America, as has been pointed out, the accepting of bills for the purposes of international financing of trade has never struck firm root. The New York banker when he seeks to put out his money at short notice had until recently no resource other than the Stock Exchange. The practice of lending on the Stock Exchange is one resource, as we have seen, for English banks; for the American it is, or was, the only resource. The New York banks send down every morning to bid against one another with rates for their loans. The market is a narrow one in comparison with the number of competing banks, and rates vary in consequence to an extent which makes the British banker almost dizzy; and they vary, moreover, from causes which have little relation to the conditions of pure banking. When the banks are bidding for borrowers, rates depend on the conditions governing speculation in stocks at the moment. The result is that the American banks are coming more and more to employ their short money in the London bill market, for want of one of their own. The comparative rates of discount in London and New York affect the exchange primarily by this means. At times the American banks—the banks in the Middle West as well as in New York—have held very large sums on the London market; how large it is not possible to say. The withdrawal of them when, on the lowering of the English bank rate, the use of them in London became less profitable, has been a factor of unknown magnitude, which has introduced a good deal of uncertainty into the control of the foreign exchanges by the Bank of England.

The function of the bill market, from the banker's point of view, may be summed up as that of a shock-absorber, which, through the instrumentality of the bill brokers, spreads out evenly the strains which result from the irregularity of the needs of international trade, an irregularity which inevitably follows from the waxing and waning of the natural elements, seed-time and harvest, storm and calm, as well as from political factors such as strikes or wars or tariff changes. The discount houses take from the banks the more speculative part of these changes and chances, and in return are enabled to win, by the exercise of shrewdness and foresight, a larger part of the profit.