

Chapter XVI.

Of The Foreign Exchanges.

§ 1. Money passes from country to country as a Medium of Exchange, through the Exchanges.

We have thus far considered the precious metals as a commodity, imported like other commodities in the common course of trade, and have examined what are the circumstances which would in that case determine their value. But those metals are also imported in another character, that which belongs to them as a medium of exchange; not as an article of commerce, to be sold for money, but as themselves money, to pay a debt, or effect a transfer of property.

Money is sent from one country to another for various purposes: the most usual purpose, however, is that of payment for goods. To show in what circumstances money actually passes from country to country for this or any of the other purposes mentioned, it is necessary briefly to state the nature of the mechanism by which international trade is carried on, when it takes place not by barter but through the medium of money.

In practice, the exports and imports of a country not only are not exchanged directly against each other, but often do not even pass through the same hands. Each is separately bought and paid for with money. We have seen, however, that, even in the same country, money does not actually pass from hand to hand each time that purchases are made with it, and still less does this happen between different countries. The habitual mode of paying and receiving payment for commodities, between country and country, is by bills of exchange.

A merchant in the United States, A, has exported American commodities, consigning them to his correspondent, B, in England. Another merchant in England, C, has exported English commodities, suppose of equivalent value, to a merchant, D, in the United States. It is evidently unnecessary that B in England should send money to A in the United States, and that D in the United States should send an equal sum of money to C in England. The one debt may be applied to the payment of the other, and the double cost and risk of carriage be thus saved. A draws a bill on B for the amount which B owes to him: D, having an equal amount to pay in England, buys this bill from A, and sends it to C, who, at the expiration of the number of days which the bill has to run, presents it to B for payment. Thus the debt due from England to the United States, and the debt due from the United States to England, are both paid without sending an ounce of gold or silver from one country to the other.(274)

[Illustration.]

This implies (if we exclude for the present any other international payments than those occurring in the course of commerce) that the exports and imports exactly pay for one another, or, in other words, that the equation of international demand is established. When such is the fact, the international transactions are liquidated without the passage of any money from one country to the other. But, if there is a greater sum due from the United States to England than is due from England to the United States, or *vice versa*, the debts can not be simply written off against one another. After the one has been applied, as far as it will go, toward covering the other, the balance must be transmitted in the precious metals. In point of fact, the merchant who has the amount to pay will even then pay for it by a bill. When a person has a remittance to make to a foreign country, he does not himself search for some one who has money to receive from that country, and ask him for a bill of exchange. In this, as in other branches of business, there is a class of middle-men or brokers, who bring buyers and sellers together, or stand between them, buying bills from those who have money to receive, and selling bills to those who have money to pay. When a customer comes to a broker for a bill on Paris or Amsterdam, the broker sells to him perhaps the bill he may himself have bought that morning from a merchant, perhaps a bill on his own correspondent in the foreign city; and, to enable his correspondent to pay, when due, all the bills he has granted, he remits to him all those which he has bought and has not resold. In this manner these brokers take upon themselves the whole settlement of the pecuniary transactions between

distant places, being remunerated by a small commission or percentage on the amount of each bill which they either sell or buy. Now, if the brokers find that they are asked for bills, on the one part, to a greater amount than bills are offered to them on the other, they do not on this account refuse to give them; but since, in that case, they have no means of enabling the correspondents on whom their bills are drawn to pay them when due, except by transmitting part of the amount in gold or silver, they require from those to whom they sell bills an additional price, sufficient to cover the freight and insurance of the gold and silver, with a profit sufficient to compensate them for their trouble and for the temporary occupation of a portion of their capital. This premium (as it is called) the buyers are willing to pay, because they must otherwise go to the expense of remitting the precious metals themselves, and it is done cheaper by those who make doing it a part of their especial business. But, though only some of those who have a debt to pay would have actually to remit money, all will be obliged, by each other's competition, to pay the premium; and the brokers are for the same reason obliged to pay it to those whose bills they buy. The reverse of all this happens, if, on the comparison of exports and imports, the country, instead of having a balance to pay, has a balance to receive. The brokers find more bills offered to them than are sufficient to cover those which they are required to grant. Bills on foreign countries consequently fall to a discount; and the competition among the brokers, which is exceedingly active, prevents them from retaining this discount as a profit for themselves, and obliges them to give the benefit of it to those who buy the bills for purposes of remittance.

When the United States had the same number of dollars to pay to England which England had to pay to her, one set of merchants in the United States would want bills, and another set would have bills to dispose of, for the very same number of dollars; and consequently a bill on England for \$1,000 would sell for exactly \$1,000, or, in the phraseology of merchants, the exchange would be at par. As England also, on this supposition, would have an equal number of dollars to pay and to receive, bills on the United States would be at par in England, whenever bills on England were at par in the United States.

If, however, the United States had a larger sum to pay to England than to receive from her, there would be persons requiring bills on England for a greater number of dollars than there were bills drawn by persons to whom money was due. A bill on England for \$1,000 would then sell for more than \$1,000, and bills would be said to be at a premium. The premium, however, could not exceed the cost and risk of making the remittance in gold, together with a trifling profit; because, if it did, the debtor would send the gold itself, in preference to buying the bill.

If, on the contrary, the United States had more money to receive from England than to pay, there would be bills offered for a greater number of dollars than were wanted for remittance, and the price of bills would fall below par: a bill for \$1,000 might be bought for somewhat less than \$1,000, and bills would be said to be at a discount.

When the United States has more to pay than to receive, England has more to receive than to pay, and *vice versa*. When, therefore, in the United States, bills on England bear a premium, then, in England, bills on the United States are at a discount; and, when bills on England are at a discount in the United States, bills on the United States are at a premium in England. If they are at par in either country, they are so, as we have already seen, in both. (275)

Thus do matters stand between countries, or places which have the same currency. So much of barbarism, however, still remains in the transactions of the most civilized nations, that almost all independent countries choose to assert their nationality by having, to their own inconvenience and that of their neighbors, a peculiar currency of their own. To our present purpose this makes no other difference than that, instead of speaking of *equal* sums of money, we have to speak of *equivalent* sums. By equivalent sums, when both currencies are composed of the same metal, are meant sums which contain exactly the same quantity of the metal, in weight and fineness.

The quantity of gold in the English pound is equivalent to \$4.8666+ of our gold coins. If the bills offered are

about equal to those wanted, a claim to a pound in England will sell for \$4.86. If many are wanted, and but few to be had, their price will go up, of course; but it can not go more than a small fraction beyond \$4.90, since about 3-¼ cents is sufficient to cover the brokerage, insurance, and freight per pound sterling in a shipment of gold to London. Therefore, in order to get money to a creditor in London, no one will pay more for a pound in the form of a bill than he will be obliged to pay for sending it across in the form of bullion. Bills of exchange, then, can not rise in price beyond the point (\$4.90 +) since, rather than pay a higher sum for a bill, gold will be sent. This point is called the "shipping-point" of gold. When the exchanges are at \$4.90, it will be found that gold is going abroad. On the other hand, when the supply of bills is greater than the demand, their price will fall. A man having a bill on London to sell--i.e., a claim to a pound in London--will not sell it at a price here lower than \$4.86, by more than the expense of bringing the gold itself across. Since this expense is about 3-¼ cents, bills can not fall below about \$4.83. When exchange is at that price, it will be found that gold is coming to the United States from England. This price is the "shipping-point" for imports of gold. This, of course, applies to sight-bills only.

Formerly, we computed exchange on a scale of percentages, the real par being about 109. This was given up after the war.

When bills on foreign countries are at a premium, it is customary to say that the exchanges are against the country, or unfavorable to it. In order to understand these phrases, we must take notice of what "the exchange," in the language of merchants, really means. It means the power which the money of the country has of purchasing the money of other countries. Supposing \$4.86 to be the exact par of exchange, then when it requires more than \$1,000 to buy a bill of £205, \$1,000 of American money are worth less than their real equivalent of English money: and this is called an exchange unfavorable to the United States. The only persons in the United States, however, to whom it is really unfavorable are those who have money to pay in England, for they come into the bill market as buyers, and have to pay a premium; but to those who have money to receive in England the same state of things is favorable; for they come as sellers and receive the premium. The premium, however, indicates that a balance is due by the United States, which must be eventually liquidated in the precious metals; and since, according to the old theory, the benefit of a trade consisted in bringing money into the country, this prejudice introduced the practice of calling the exchange favorable when it indicated a balance to receive, and unfavorable when it indicated one to pay; and the phrases in turn tended to maintain the prejudice.

§ 2. Distinction between Variations in the Exchanges which are self-adjusting and those which can only be rectified through Prices.

It might be supposed at first sight that when the exchange is unfavorable, or, in other words, when bills are at a premium, the premium must always amount to a full equivalent for the cost of transmitting money. But a small excess of imports above exports, or any other small amount of debt to be paid to foreign countries, does not usually affect the exchanges to the full extent of the cost and risk of transporting bullion. The length of credit allowed generally permits, on the part of some of the debtors, a postponement of payment, and in the mean time the balance may turn the other way, and restore the equality of debts and credits without any actual transmission of the metals. And this is the more likely to happen, as there is a self-adjusting power in the variations of the exchange itself. Bills are at a premium because a greater money value has been imported than exported. But the premium is itself an extra profit to those who export. Besides the price they obtain for their goods, they draw for the amount and gain the premium. It is, on the other hand, a diminution of profit to those who import. Besides the price of the goods, they have to pay a premium for remittance. So that what is called an unfavorable exchange is an encouragement to export, and a discouragement to import. And if the balance due is of small amount, and is the consequence of some merely casual disturbance in the ordinary course of trade, it is soon liquidated in commodities, and the account adjusted by means of bills, without the transmission of any bullion. Not so, however, when the excess of imports above exports, which has made the exchange unfavorable, arises from a permanent cause. In that case, what disturbed the equilibrium must have been the state of prices, and it can only be restored by acting on prices. It is impossible that prices should be

such as to invite to an excess of imports, and yet that the exports should be kept permanently up to the imports by the extra profit on exportation derived from the premium on bills; for, if the exports were kept up to the imports, bills would not be at a premium, and the extra profit would not exist. It is through the prices of commodities that the correction must be administered.

Disturbances, therefore, of the equilibrium of imports and exports, and consequent disturbances of the exchange, may be considered as of two classes: the one casual or accidental, which, if not on too large a scale, correct themselves through the premium on bills, without any transmission of the precious metals; the other arising from the general state of prices, which can not be corrected without the subtraction of actual money from the circulation of one of the countries, or an annihilation of credit equivalent to it.

It remains to observe that the exchanges do not depend on the balance of debts and credits with each country separately, but with all countries taken together. The United States may owe a balance of payments to England; but it does not follow that the exchange with England will be against the United States, and that bills on England will be at a premium; because a balance may be due to the United States from Holland or Hamburg, and she may pay her debts to England with bills on those places; which is technically called arbitration of exchange. There is some little additional expense, partly commission and partly loss of interest in settling debts in this circuitous manner, and to the extent of that small difference the exchange with one country may vary apart from that with others.

A common use of bills of exchange is that by which, when three countries are concerned, two of them may strike a balance through the third, if both countries have dealings with that third country. New York merchants may buy of China, but China may not be buying of New York, although both may have dealings with London.

[Illustration.]

A, we will suppose, is a buyer of £1,000 worth of tea from F, in Hong-Kong; B is an exporter of wheat (£1,000) to C in London; D has sent £1,000 worth of cotton goods to E in Hong-Kong. A can now pay F through London without the transmission of coin. A buys B's claim on C for £1,000, and sends it to F. E wishes to pay D in London for the cotton goods he bought of him; therefore, he buys from F for £1,000 the claim he now holds (i.e., a bill of exchange on London) against C for £1,000. E sends it to D, and, when D collects it from C, the whole circle of exchanges is completed without the transmission of the precious metals.