

Bills of exchange and the discount business

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The discounting of bills of exchange was the core business of the early Basel private banks and the principal instrument of short-term credit for the merchants and manufacturers of the city. The mechanism was simple in principle. A merchant who sold goods on credit received from his customer a bill of exchange, an order to pay a certain sum at a certain date, usually three months later. If the merchant needed cash before the maturity of the bill, he could sell it to a bank, which paid him the face value minus a discount, calculated at the current rate of interest for the remaining period. The bank then held the bill until maturity and collected the full amount from the debtor, or it rediscounted the bill with another bank.¹

The discount business required judgement. The bank that discounted a bill took the risk that the debtor would not pay at maturity. It therefore examined the bill carefully: who had drawn it, who had accepted it, who had endorsed it, and whether these persons were creditworthy. A bill bearing several good signatures was a safe investment, because each signatory was liable for its payment. The banks kept records of the merchants whose bills they discounted and exchanged information about their creditworthiness. The discount rate reflected both the general level of interest and the quality of the bill.

The discount business made the private banks the financiers of the working capital of the ribbon industry and of the trade of Basel. Manufacturers who sold ribbons to customers in Paris or New York received bills that the banks discounted. The cash allowed them to buy silk and pay their weavers. The banks, in turn, could rediscount the bills with correspondents in Paris or Frankfurt, where the money markets were deeper. The chain of discounting linked the looms of the Basel countryside with the money markets of Europe.

When central banks were founded in the nineteenth century, the rediscounting of commercial bills became one of their principal

instruments of monetary policy. The Bank of England, the Banque de France and later the Swiss National Bank set the discount rate, the rate at which they would rediscount bills presented by commercial banks, and used it to influence the supply of credit in the economy. The discount rate, which was for more than a century the central instrument of monetary policy, has its origins in the business that the private banks of Basel and other cities practised with the bills of their merchants.

1 Notes

1. On the discounting of bills of exchange as the principal form of short-term commercial credit in the nineteenth century, see the literature on banking history. To be verified. ↩

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