THE BANK OF ENGLAND RATE.

Purpose and Result of Advancing the Official Discount Rate—Another of a Series of Special Articles on the World-Relations of the London Money Market.

On Thursday of last week, the Bank of England raised its official discount rate from 4½ to 5½ p.c. On Monday of this week, another advance was made to 6 p.c., while yesterday brought fulfillment of the rumour that a further increase to 7 p.c. would be made. That the aim has been to check the drain by America on London's gold supply is universally recognized. But just how this simple act on the part of the Bank's directors would effect that purpose may not be so generally understood. Indeed, it is doubtful whether a clear explanation of underlying principles could be given off-hand by the majority even of those conversant, in a practical way, with market conditions.

GOLD IMPORTS AND FOREIGN EXCHANGE.

A clear understanding of the matter is dependent upon keeping in mind the details of foreign exchange procedure. Between the United States and Great Britain reciprocal payments for exports and imports are being constantly effected by transfers of credit from one country to the other; balances only—under normal conditions—being paid in gold. The process in its essential steps is as follows:

A New York exporter, when sending wheat or cotton to England, draws a bill of exchange upon his consignee or the latter's banker—payable at sight, or thirty, sixty or ninety days after sight. Instead, however, of sending this bill abroad for collection, he sells it—after endorsing it—to a New York banker. The latter, having paid the exporter, sends the bill of exchange to his London correspondent, getting credit with him for the amount —and the London correspondent makes the collection at the bill's maturity. Similarly in the case of the British exporter, the converse process is carried out. The bankers' compensation is involved in the price at which the bills are bought and sold—in other words in the rate of exchange.

The law of supply and demand regulates this rate of exchange as it ultimately does all other prices. Let us see how it works out in this case—bearing in mind that the equivalent of £1 at par is taken as $4.866. Suppose an American exporter to have drawn a sight bill for so many pounds sterling on his British customer. Whether he will get more or less than $4.866 per pound for it from his banker depends upon circumstances. If there has been more exporting than importing, involving more payments due from England than from New York, the supply of sterling bills will be greater than there is a demand for at par—and the exporter will have to take less than $4.866. Exchange is then spoken of in New York as having fallen. From the London viewpoint, of course, it is looked upon as having risen.

Coming back to the New York exporter who is offered less than par for his sterling bill. How much less he will receive will depend upon the cost to him, or in practice to his banker acting for him, of actually bringing over payment in gold. Freight charges, insurance, interest for time in transit, and allowance for abrasion are all elements in this cost. When sight bills go much below $4.85—say $4.845—they will not ordinarily be sold. Instead, arrangements will be made for importing gold by bankers—who will buy the bills at a rate to give themselves a profit and will then draw bills on their own credits in London to pay for the gold —remitting the original bills of exchange to their correspondents. Ordinarily, at a time of large dues from London to New York—making exchange low at the latter place—rates for money are apt to be higher in America than in England, thus also facilitating the transfer of gold. The process of importing gold will normally proceed until the balance of supply and demand is sufficiently restored to raise the rate of exchange to the point where it will be more advantageous to sell bills at the current price than to go to the expense of importing gold.

Supposing conditions to be reversed, and that New York owes more to London than London to New York, sterling exchange will go up—rising until it becomes cheaper to ship gold from America than to pay the price for bills. This point is normally before sterling goes much above $4.88.

HOW INTEREST RATES AFFECT EXCHANGE.

And now, as to the important question of the relation between foreign exchange, the Bank of England's official discount rate and the movement of gold. Hitherto, reference has been made only to New York and London. It is to be remembered, however, that all money market changes are really international in their scope. While the recent flow of gold has been visibly one to New York from London, that is because the latter centre is the world's one free market for gold. The immediate effect of a rise in the Bank rate is perhaps more readily understood by considering the course of events which it is calculated to bring about between, say, London and Paris.

If the market rate of discount for first-class paper is higher in London than in Paris, the continental banker will earn more interest on his money if he buys London bills than if he buys Paris bills —provided the difference in discount rates is sufficiently great to allow for exchange. If French exchange is low, and the rate of interest ruling in London is higher than that in Paris, there is, of course, an additional incentive for the continental banker to invest in English bills. Not only is there the greater rate of interest in his favour, but also the chance of a rise taking place in the rate of exchange before the purchased time bill mature. Since a bill when it falls due may be sold as a "sight draft," an increased rate of exchange at maturity would be to the banker's gain.

From this it comes about, as Straker points out in his "Money Market," that when *interest* in London is *higher* than that ruling at foreign centres, and exchanges on that market are comparatively *low*, a heavy investment demand from continental bankers sets in, in order to take advantage, not only of the higher interest obtainable in London,