The Sterling Area and Economic Disintegration

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The imperative to coordinate international economic relations was one of the fundamental lessons learned from the inter-war great depression and the profound military conflicts that ensued, first in East Asia in the 1930s and then in the global war of 1939-45. Famously, Keynes criticised the punitive economic peace settlement after the Great War of 1914-1919 for creating the conditions for renewed economic and political conflict.[1] Accompanying the interwar reparations-war debt cycle was the disastrous mismanagement of the international monetary system, which by Eichengreen and others blame for prolonging and spreading the interwar Great Depression.[2] Efforts in the 1920s to coordinate the reestablishment of the gold standard in a revised form that reduced the role of gold and increased discretion ultimately failed, due in part to the politicisation of the exchange rate that exposed the dislocation between economic and political objectives.[3] Kindleberger's classic account of the causes of the interwar depression argued that the failure of international leadership from the USA as the world's dominant economy left a vacuum of power and influence.[4] The result was an uncoordinated system prey to inappropriate exchange rates that were defended through a retreat to economic nationalism. Gardner and others have shown that several lessons were learned as a result, including the need for careful planning and

[1] J.M. Keynes, *Economic consequences of the Peace*, New York, 1920.
[2] B. Eichengreen, *Golden Fetters: the gold standard and the great depression 1919-1939*, Oxford, 1992.
[3] The classic account for the UK is D. Moggridge, *British Monetary Policy 1924-1931; the Norman conquest of 4.86 dollars*, Cambridge, 1972. See also, J.M. Keynes, Economic Consequences of Mr. Churchill, 1925. For the broader context, B. Eichengreen, *Globalizing capital; a history of the international monetary system*, 2 ed., Princeton, 2008, Chapter 3.
[4] C.P. Kindleberger, *The World in Depression 1929-1939*, London, 1986.

forethought in the design of a lasting peace, the need for an independent arbiter to overcome nationalist tendencies (and to avoid domination by a single state) and the importance of economic cooperation for political cohesion and peace.[5] Like their predecessors after the First World War, the consensus among planners in the 1940s was that a pegged exchange rate system that stabilised the prices of national currencies offered the best prospect for predicable and efficient international trade and payments, and therefore the best prospect to reap the gains from trade and ensure prosperity for beleaguered populations.[6] Given the perils of the interwar gold standard, a stable international payments system was considered a vital foundation on which to promote freer and non-discriminatory trade. Without convertible currencies at stable exchange rates, the international trading system could not be rebuilt along a multilateral system that would ensure equal status for all partners, and the greatest freedom to exploit the gains from trade through international specialisation for mutual benefit. After the protectionism and conflict of the interwar period, economic and commercial cooperation was considered vital to a sustained peace. But there were limits to the extent of economic integration that was supportable in nation states committed to ambitious plans for popular welfare programmes, growth and full employment that mitigated against the devolution of sovereignty required by economic integration.[7]

At a global level, the momentum toward a more open and carefully managed international economic system evaporated quite soon after the end of the War. The International Trade Organisation was still-born in 1947, leaving the less institutionally robust

[5] R. Gardner, *Sterling Dollar diplomacy: Anglo-American collaboration in the reconstruction of multilateral trade*, Oxford, 1956. C. Schenk, *International economic relations since 1945*, Routledge, 2011.
[6] See, Horsefield, *The International Monetary Fund 1945-65*, Vol. III for the various wartime plans.
[7] A.S. Milward, *The European rescue of the nation state*, Routledge, London, 1992.

General Agreement on Tariffs and Trade as the functional route to trade liberalisation.[8] The collective desire for supranational institutions to govern the international economy did not survive much beyond 1945, but more progress was achieved for the international monetary system, partly because the negotiations on this topic concluded earlier than for trade. The Bretton Woods conference in 1944 established the key institutions; the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development, which would provide the leadership and coordination of the system, but the underlying mechanics were flawed.[9] The war had not yet officially ended, but it was clear that the economic damage had been considerable due to the diversion of resources, the dislocation of markets both nationally and internationally and the reshaping of economic power. The Bretton Woods delegates recognised the need for a period of transition from the end of the war before the controls on convertibility of currencies at stable exchange rates could be removed, but they underestimated the length of this transition. Instead of a swift adoption of the requirements for open multilateral trade, the wartime institutions that focused on regional systems had to persist.

For Britain, the empire and the Commonwealth this meant that the controls protecting the international role of sterling before and during the war were continued. Convertibility was extended only to the central banks of a group of countries that agreed to peg their exchange rate to sterling and economise on their use of dollars and other foreign exchange by imposing controls on their residents. The 1947 Exchange Control Act established a set of Scheduled Territories where freer trade and payments prevailed, a group that quickly became known as the Sterling Area. This group grew out of, but was not identical to, the

[8] T.W. Zeiler, *Free Trade, Free World: the advent of GATT*, University of North Carolina Press, 1999.
[9] Schenk, *International*. H. James, *International monetary cooperation since Bretton Woods*, 1996.

interwar Sterling Bloc, which was a much broader and loosely organised group of countries in Europe, the Commonwealth, Latin America and the Middle East which pegged their exchange rate to sterling and enjoyed freer payments with the UK.[10] The postwar Sterling Area, by contrast, was legally identified in the Exchange Control Act and focused on a narrower range of countries that included the Commonwealth (except Canada) and British colonies, Burma, Ireland and Iceland and various Middle Eastern states including Iraq, Kuwait, Persian Gulf emirates. It thus overlapped with, but was not identical to Britain's imperial reach.

The Sterling Area persisted as a legal entity for over a quarter of a century after the war, despite dramatic changes in the international monetary system in which it operated and the dismantling of the British empire. The longevity of this grouping, which was essentially borne from the maelstrom of wartime and post-war global uncertainty and dislocation, is remarkable in itself. It was formally dissolved only in 1972, by which time there had been a dramatic reconfiguration of the international monetary system. The sterling area survived the short-lived convertibility debacle of 1947, the advent of current account convertibility at the end of 1958, the weakness of the gold value of the dollar from 1962, Britain's repeated applications to join the European Economic Community (EEC) and finally the suspension of gold's role in the international monetary system from 1968-1971.[11] It was finally ended as a minor element in Britain's move to a floating exchange rate in June 1972, which marked the end of the UK's adherence to the Bretton Woods ideal of stable exchange rates. The post-war history of the sterling area thus offers an interesting case of prolonged disintegration of monetary relations. Its longevity is best understood by recognising that it was a relatively

[10] I.M. Drummond, *The floating pound and the sterling area: 1931-1939*, Cambridge, 1981.
[11] A. Cairncross and B. Eichengreen, *Sterling in Decline: the devaluations of 1931, 1949 and 1967*, Blackwell, Oxford, 1983. For an overview of the post-war international economic relations that provide a context for this paper see C. R. Schenk, *International Economic Relations since 1945*, Routledge, 2011.

open and unbinding network that adapted to the changing balance of influence in the international economic system. It conferred benefits on the British at its centre, but also for the participants themselves in an environment of complex and changing global economic relations.

The disintegration of the sterling area can be periodised as follows. From 1946 to 1952 the system operated as a relatively closed structure, while from 1952-1958 trade and payments were liberalised. From 1959-1967 countries diversified their economic relations and tensions emerged about the role of sterling, which resulted in the formalisation of these relations from 1968-1972 in transparent contractual exchanges of letters between Britain and each of the 34 members of the sterling area. The following sections will address each of these periods in turn.

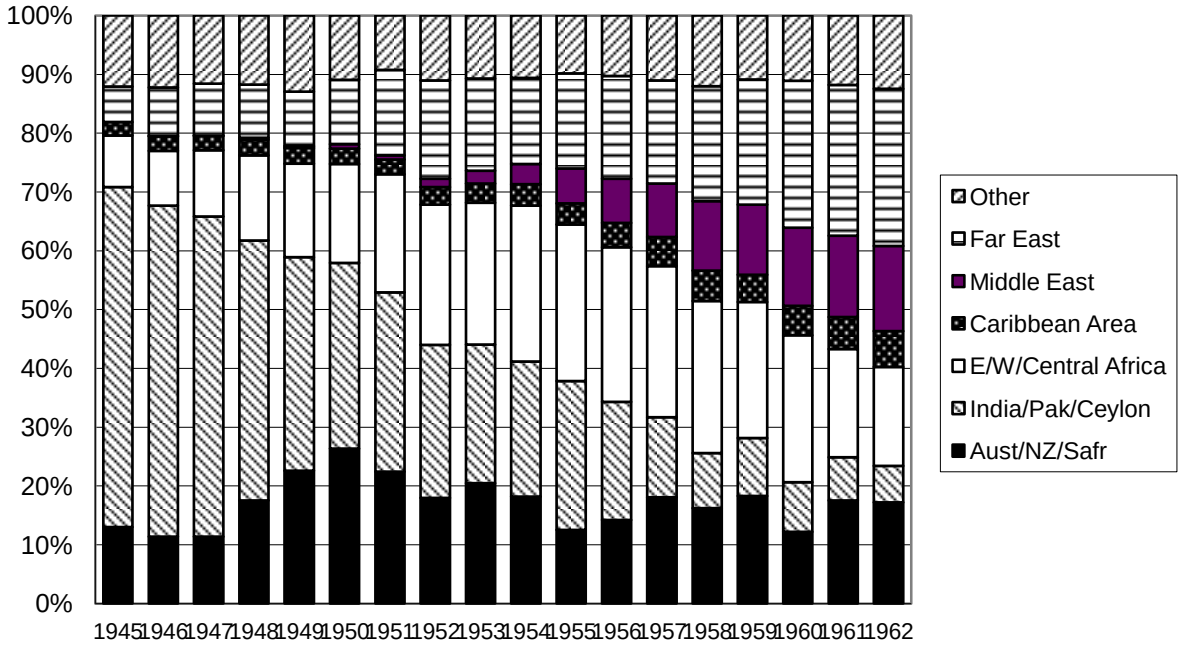
I The Sterling Area in the 1950s

As part of the war effort, British expenditure in the Commonwealth and empire was increasingly paid for through the accumulation of British government securities by the creditor. This resulted in exceptionally large war-related liabilities by the end of 1945 concentrated in the South Asian colonies that achieved independence in the late 1940s; India, Pakistan and Ceylon. The accumulation of external sterling liabilities exceeded the foreign exchange reserves held in the Bank of England by about four times, so clearly allowing this sterling to be converted to dollars or other foreign exchange had to be prevented. There followed a series of bilateral negotiations with substantial sterling holders

through the five years after the end of the War to mutually agree the pace of convertibility and spending of these wartime accumulations of sterling assets.[12]

As a result of spending by Britain's largest creditors and accumulations by others in the primary product boom of the early 1950s, the geographic distribution of national holdings of sterling was transformed. Figure 1 shows that the war debts to South Asia were replaced by accumulations in Africa and the Far East and then by oil producers in the Middle East during the 1950s. The distribution of sterling held in foreign exchange reserves thus reflected post-war commodity booms and the rise of East Asia rather than the legacy of the Second World War. Through this process, the particularism of the post-war settlement receded as a binding rationale for the sterling area.

Figure 1: Distribution of Sterling Area Balances 1945-1962



Source: Treasury Historical Memorandum, History of the Sterling Balances since 1945.

[12] H. Ellis-Rees, 'The convertibility crisis', Treasury Historical Memorandum. B.R. Tomlinson, 'Indo-British relations in the post-colonial era: the sterling balances negotiations 1947-49', *Journal of Imperial and Commonwealth History*, 13(3) 1985, pp. 142-62.

The immediate post-war years were characterised by tight exchange controls on convertibility for all European currencies, so sterling was not exceptional in this respect. However, the use of sterling in international payments by third countries combined with the large volume wartime debts made controls on sterling's convertibility a particular focus of Anglo-American relations after the war.[13] As a quid pro quo for the July 1946 loan of $3.75 billion, the US insisted that sterling should be convertible within one year to ensure timely progress toward the multilateral payments system devised at Bretton Woods. In the end, the drain on the central reserves in July and August 1947 required the quick suspension of convertibility and this disastrous experiment encouraged all European governments to postpone the transition to full currency convertibility. Instead, a controlled process of liberalisation of trade alongside more tentative and limited current account convertibility of European currencies ensued with the establishment of the GATT in 1947 and the European Payments Union in 1950.[14]

The sterling area system moved into a period of greater coordination to cope with the imbalance of the global economy after the war and the dollar shortage. At the July 1949 Commonwealth Economic Conference, finance ministers of the Commonwealth members of the sterling area agreed to coordinated import targets to economise on the dollars available for the sterling area as a whole, by following the British example of a quantitative cut of 25% on imports from the USA.[15] This resolution was quickly overtaken by the devaluation of sterling by 30 per cent in September 1949, which aided the countries in achieving their

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[13] L.S. Pressnell, *British external economic policy since the War*, HMSO, 1987. A. Cairncross, *Years of Recovery; British economic policy 1945-51,* Methuen, 1985. B. Eichengreen, *Globalizing capital: a history of the international monetary system*, Princeton, 2008.

[14] Kaplan and Schleiminger, *The European Payments Union*, B. Eichengreen, *The European Economy since 1945; coordinated capitalism and beyond*, Princeton, 2007, pp. 79-85. W Asbeek Brusse, *Tariffs, Trade and European Integration 1947-57; from study group to Common Market*, St Martin's Press, 1997.

[15] Schenk, *Britain*, p. 62-64.

target in 1950. The initiative for coordinated trade policy reflected the British view of the sterling area as a complementary system where producers of primary products (food and raw materials) would supply the British population and industry in return for manufactured goods from the factories of Britain. Unfortunately for this vision, the overseas sterling area countries had ambitions for industrial development themselves and sought more competitive manufactures both in terms of price and quality from European, American and Japanese producers.[16]

In the wake of severe balance of payments difficulties and the dislocation of the international economy, the controls of 1949 were continued through to 1951, but thereafter the closed and coordinated stage of the sterling area system began to unwind. When the rearmament associated with the Korean War of 1950-52 sparked a boom in demand for commodities, the fortunes of primary producers in the sterling area was transformed. Australian wool, Indian cotton, Malayan tin and rubber and Pakistan's jute exports all soared. Substantial surpluses in Africa, Australasia and Southeast Asia bolstered the central reserves and financed greater imports into the UK in 1950-51, but the asymmetry between deficits in the UK and surpluses elsewhere in the sterling area became even more apparent. Rather than constraining their demand for dollar imports and pooling their reserves for use in London, these countries all increased their imports substantially. British efforts to coerce the sterling area to conserve dollars by anticipating a looming crisis fell on increasingly deaf ears.[17] In January 1952 sterling area finance ministers reluctantly accepted fresh targets for dollar imports, but this was the last time that coordinated trade

[16] See, for example, P. Robertson and J. Singleton, *Economic Relations between Britain and Australasia 1945-1970*, Cambridge, 2002.
[17] Schenk, *Britain*, p. 69.

agreements formed part of the sterling area system. The December 1952 Commonwealth Finance Ministers meeting concentrated instead on liberalisation of payments.

By this time Australia, as Britain's largest trading partner in the sterling area, began to lead a campaign to increase the convertibility of sterling and reduce the closed nature of the sterling area system. The Australian Treasury ended trade discrimination in favour of the UK from March 1952, when it imposed restrictions on imports from all countries. Other countries followed, including South Africa from 1954 and Pakistan from 1955. Partly as a result of the erosion of trade discrimination in favour of the UK, Britain's share of sterling area trade declined steadily. Table 1 shows the weakening of the trade ties binding members of the sterling area to the UK market through the 1950s. In 1953 62% of manufacturing imports into the overseas sterling area came from the UK but by 1959 this had fallen to 48%. For most countries, British manufactures were replaced by German, Japanese and US products.

Table 1: Share of Imported Manufactures from the UK (per cent)

	1953	1959
Overseas Sterling Area	62.4	48.2
Australia	70.7	52
New Zealand	84.5	72.2
India	49.8	44.3
Pakistan	43.2	35.9
South Africa	50.5	42.0
Iraq	52.6	42.8
Malaya	60.3	40.3

Source: C. Schenk, *Britain and the Sterling Area; from devaluation to convertibility in the 1950s*, Routledge (1994) p. 81.

The unwillingness of Australia and other partners to persist with a closed system that constrained their economic diversification formed part of the motivation for a series of initiatives to increase the convertibility of sterling over this period including the famous ROBOT plan for convertibility with a floating exchange rate and the abortive Collective Approach to convertibility in 1952, that would have seen a common European move to convertibility funded by credits from the USA.[18] After the failure of these initiatives, the Bank of England turned to a lower key technical approach that culminated in the achievement of de facto convertibility on current account at a supported official rate in February 1955. From this time sterling could be traded in New York at the official exchange rate supported by the Bank of England. Over the next three years, West European partners discussed the timing for a coordinated progression to formal current account convertibility, with the final 'Operation Unicorn' completed at the end of 1958 when all major European currencies were made convertible. Finally, it seemed the prerequisites were in place for the multilateral payments system designed at Bretton Woods to operate.

It is perhaps surprising that the sterling area set of controls persisted through the advent of current account convertibility, but the terms of this much heralded stage of development were actually quite restricted. Sterling was convertible only for holders outside the UK and

[18] P. Burnham, *Remaking the postwar world economy; ROBOT and British Policy in the 1950s*, Macmillan, 2003. See also Cairncross, *Years of Recovery*, pp. 234-71 and Schenk, *Britain*, pp. 119-124. S.J. Procter, 'Floating convertibility; the emergence of the ROBOT plan 1951-52', *Contemporary British History*, Vol. 7, no 1, 1993, pp. 24-43.,.B.W. Muirhead, 'Britain, Canada, and the Collective Approach to Freer Trade and Payments 1952-57', *Journal of Imperial and Commonwealth History*, vo. 20, no. 1, 1992, pp. 108-126. S Kelly, 'Ministers matter: Gaitskell and Butler at odds over convertibility 1950-52', *Contemporary British History*, vol. 14, no. 4, 2000, pp. 27-52.

sterling area, while the central banks of the sterling area continued to exercise exchange controls on the transactions of their residents. Tight controls remained on capital transactions, including international borrowing and investment; indeed capital controls were intensified through the 1950s and 1960s to support the balance of payments. This dichotomy reflected the Bretton Woods ethos that trade was an engine of growth, but international capital flows were a perfidious and dangerous distraction that could destabilise real economic activity. The emphasis was therefore on liberalisation of trade and commerce, but continued restriction of international capital flows.[19]

By this time, most central banks outside the sterling area had divested themselves of their sterling reserves and accumulated US dollars instead. Conversely, members of the sterling area continued to peg their exchange rates to sterling and to hold most of their reserves in sterling. The terms of the UK Exchange Control Act provided these scheduled territories with freer access to the London capital market for borrowing than for other countries, which was an important incentive to remain within the system in the context of tight capital markets in Europe and the USA. The sterling area thus delivered mutual benefit since it bolstered foreign exchange reserves and reduced the risk of a run on the pound for the UK while maximising access to the London capital market for other members at a time of generalised capital controls that restricted access to other lenders. Underpinning this bilateral trade-off was a mutual interest in protecting the value of sterling and reducing exchange risk for the vast majority of economic transactions between the partners that was denominated in sterling during the 1950s. Through the 1960s, however, these mutual interests began to erode and the system entered a new stage.

[19] E. Helleiner, *States and the Reemergence of global finance: from Bretton Woods to the 1990s*, Cornell University Press, 1994. G. Burn, *The Re-emergence of Global Finance*, Palgrave, 2006. M. Obstfeld and A.M. Taylor, *Global Capital Markets: integration, crisis and growth*, Cambridge, 2005.

II Sterling Area in the 1960s

Despite the exchange control network operated by members of the sterling area, the global convertibility of sterling was greatly enhanced by the formal liberalisation of European payments from the end of 1958. Very soon thereafter, the foundation of the pegged exchange rate began to erode with a loss of confidence in the gold value of the US dollar. Since most other currencies were pegged either to the dollar or indirectly to the dollar through sterling, the basis of the Bretton Woods system was under threat. This danger drew the major central banks into a formal coordinated support mechanism to support the gold price in the London market from 1961, the so-called Gold Pool.[20] During the 1960s the Bretton Woods system was further undermined by innovations in international banking and capital markets, first with the expansion of the Eurodollar market and then its translation into the Eurobond market. These markets operated outside the capital controls and prudential supervisory systems of national central banks and allowed greater convertibility to stretch the post-war solution to the Mundell-Fleming policy trilemma, which relied on closed capital markets to facilitate pegged exchange rates while preserving national monetary policy sovereignty.[21]

The 1960s also became the decade of decolonisation and was identified as the United Nations (UN) Development Decade. In this changing geopolitical context many countries in the sterling area sought opportunities to diversify the sectoral distribution of their

[20] G. Toniolo, *Central bank cooperation at the Bank for International Settlements: 1930-1973*, Cambridge, 2005. Pp 375-81. F. Gavin, *Gold, Dollars and Power: the politics of international monetary relations 1958-1971*, University of North Carolina Press, 2004.

[21] M.D. Bordo and B. Eichengreen eds., *A retrospective on the Bretton Woods system: lessons for international monetary reform*, Chicago, 1993. M. Obstfeld and A.M. Taylor, *Global capital markets; integration, crisis and growth*, Cambridge, 2004. C.R. Schenk, 'The Origins of the Eurodollar Market in London, 1955-1963', *Explorations in Economic History*, 35, pp. 221-238, April 1998.

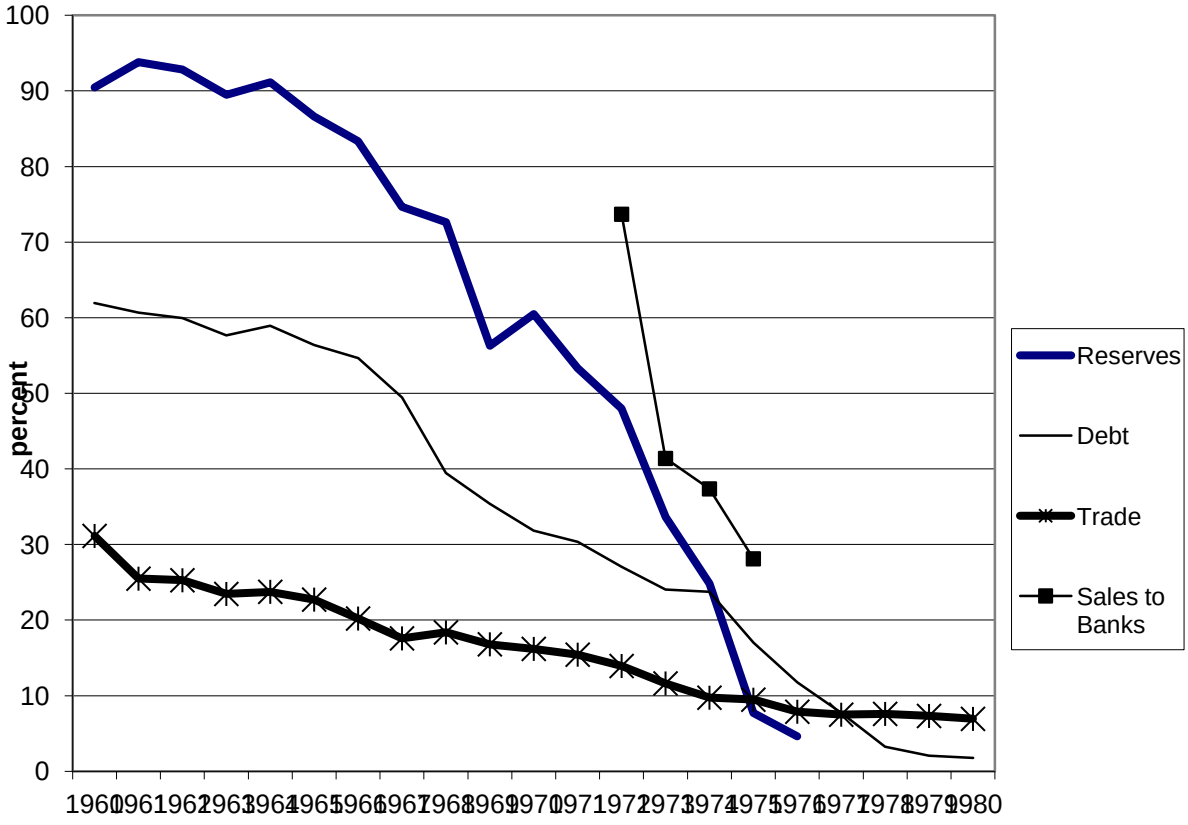
economies and also their international economic relationships.[22] At the same time, new customers created by the internationalisation of US business created demand for financial innovation and led to a revival of international banking in Europe, especially in the City of London.[23] Controls on sterling persisted even while there was greater opportunity to function in London using the US dollar. In the wake of a balance of payments crisis in 1966 the British Treasury imposed new controls to restrain reinvestment of profits in the British dominions, specifically targeted at Australia, New Zealand and South Africa. The benefits of preferred access to the London capital market for members of the sterling area were thus being eroded by a tightening in London and by greater opportunity in European and American markets. New central banks were established in former colonies such as Ghana, Nigeria and Malaysia who were substantial holders of sterling reserves. Although they kept their currencies pegged to sterling through the decade and retained the bulk of their reserves in sterling, the institutional foundations for a more independent policy were established.[24]

As an example of this process, Figure 2 shows the changes in the role of sterling in the international economic relations of Australia, the largest economy in the overseas sterling area. At the beginning of the 1960s over 90% of reserves were denominated in sterling, but this was rapidly reduced, mainly through retained earnings of US dollars through the decade. On a similar but less dramatic scale the denomination of overseas debt obligations shifted away from sterling and toward the dollar (and DM, SwFr). At the same time, Australia's trade was already in a process of diversifying away from the UK and toward

[22] For the foundations of weakening economic links within the empire see, A. Hinds, *Britain's Sterling colonial Policy and Decolonization, 1939-1958*, Greenwood Press, 2001.
[23] G. Burn, *The Re-emergence of global finance*, Palgrave, 2006.
[24] C.R. Schenk, 'Monetary Institutions in Newly Independent Countries: the experience of Malaya, Ghana and Nigeria in the 1950s', *Financial History Review*, (4) 1997, pp. 181-198.

Japan and the USA at the start of the 1960s, and this process continued over the following decade. On 2 July 1968, the Board of the Reserve Bank of Australia (the central bank) 'noted the longer-term trends in the directions of Australian trade and in the location of public indebtedness, and felt that on these grounds the disposition of our reserve remained too heavily weighted towards sterling'.[25] This example shows the erosion of underlying economic and financial integration between Australia and the UK that took place during the pivotal decade of the 1960s, a pattern that was repeated elsewhere.

Figure 2: Australia's Commitment to Sterling (%)



[25] Minute of 2 July of the Board with Coombs as Chair and Phillips as Deputy, Reserve Bank of Australia Archives.

On the British side, the benefits of the sterling area were also receding as the focus of international economic relations turned toward Europe with the first application to join the EEC in 1961.[26] Despite the rejection of this initiative in 1963 and then again in 1967, joining the EEC remained the target of successive British governments in the 1960s, culminating in the accession to the Community in 1973. The role of sterling as an international currency and the persistence of the sterling area network's preferred access to the London market was a particular obstacle to accession, as was made clear in de Gaulle's emphatic 'non' in November 1967 when he declared that 'a Common Market [is] incompatible (…) with the state of the pound sterling'.[27] For Britain, as for the overseas sterling area, the recovery and growth of markets in Europe and the USA meant that the freer trade and payments among the sterling area members was a less compelling priority for economic relations than in the immediate post-war period.

Nevertheless, as the Bretton Woods framework based on the dollar showed evidence of weakness, sterling continued to have a role to play in the smooth operation of the international monetary system. From a global perspective, abandoning sterling's international role would reduce international liquidity. The US government was particularly sensitive to threats to sterling in international markets which might spread to a loss of confidence in the dollar. As a result, the UK was able to attract substantial bilateral support from the US and multilateral support from the G10 central banks through the Bank for International Settlements (BIS) during the 1960s.[28] Meanwhile members of the IMF, OECD

[26] C. Schenk, 'Sterling, international monetary reform and Britain's applications to the EEC in the 1960s', *Contemporary European History*, 11(3) 2002, pp. 345-69.
[27] For the text of de Gaulle's rejection of the second British application to join the EEC, see Text of the press conference given by General de Gaulle at the Élysée, 27 November 1967, available online at http://www.cvce.eu/content/publication/1999/1/1/fe79955c-ef62-4b76-9677-dce44151be53/publishable_en.pdf, accessed 17 October 2012.
[28] Toniolo, *Central Bank*, pp. 388-99. Schenk, *Decline*.

and G10 were embroiled in prolonged discussions over how to replace national currencies as reserve assets, culminating in the innovation of the Special Drawing Right (SDR) in 1968.[29] In the end, however, the SDR never replaced the role of the dollar in global reserves and the system continued to rely on national currencies as reserve assets.

Table 2 shows the share of sterling in the foreign exchange reserves of four major independent sterling area members and the colony of Hong Kong in the run-up to the devaluation of sterling in November 1967. Clearly the pace and extent of diversification varied across members so that by October 1967 Australia and Singapore had diversified their reserves substantially, although over half was still denominated in sterling. In contrast, New Zealand (where trade and commercial ties were still much more focussed on the UK) and Malaysia (where central bankers negotiated diversification with the UK) held much larger proportions of their reserves in sterling. The Hong Kong government operated a sterling-based currency board and experienced dramatic growth of the economy and money supply in the 1960s, which swelled their sterling reserves.[30]

Table 2: Share of Sterling in Foreign Exchange Reserves

	Australia	New Zealand	Malaysia	Singapore	Hong Kong
1964	79	98	96	100	99
1965	70	97	96	98	99

[29] James, *International*. For details of the negotiations at the IMF see, M.G. de Vries, *The International Monetary Fund 1966-71; the system under stress*, Washington, 1976.
[30] C.R. Schenk, 'The evolution of the Hong Kong currency board during global exchange rate instability, 1967-1973', *Financial History Review*, 16 (2), 2009.

1966	69	97	90	93	99
Jun-67	64	80	87	74	99
Oct-67	60	85	82	50	99
Dec-68	46	76	58	44	99

Source: C. Schenk, *The decline of sterling; managing the retreat of an international currency 1945-1992*, Cambridge, 2010, p. 296.

The devaluation of sterling in 1967 marked a sharp departure for the sterling area and also for the international monetary system more generally. After a repeated series of annual summertime crises in confidence in sterling, the pound was finally depreciated by 14.3% in November 1967.[31] Since national currencies of the sterling area did not generally follow sterling, this depreciated the purchasing power of their foreign exchange reserves. Nevertheless every country re-pegged to sterling and the sterling area formally continued. In the aftermath, the British Treasury and government reassessed the role of sterling in the international monetary system and made contingency plans to suspend convertibility and/or float the pound.[32]

The survival of the sterling area through this crossroads testifies to how loose its relations had become. There was no collective discussion in advance or coordinated response among the sterling area members. The reaction ranged from a quiet but resentful acceptance that

[31] S Newton, 'The sterling devaluation of 1967, the international economy and post-war social democracy', *English Historical Review*, CXXV (515), 2010, pp. 912-45. M.D. Bordo, R. Macdonald and M.J. Oliver, 'Sterling in crisis 1964-67', *European Review of Economic History*, 13, 2009, pp. 437-59.
[32] M.J. Oliver and A. Hamilton, 'Downhill from devaluation: the battle for sterling 1968-72', *Economic History Review*, 60(3), 2007, pp. 486-512.

the British government had taken the only option left to it (in the case of Australia) to outrage at the lack of consultation (Hong Kong) to a strong sense of betrayal (Malaysia and Singapore).[33] Many sterling area countries had already begun to diversify their reserves as part of the realignment of their international economic relations and to spread risk, but there were challenges to finding a reliable alternative anchor. At this point the dollar had also lost many of its attractions after the US Treasury imposed taxes on overseas lending from 1963 and the dollar's gold value and the exchange rate against the DM and the Yen became more fragile. While Australia and New Zealand, for example, would have liked to expand their holdings of DM, Yen and Swiss Francs, the issuing central banks imposed restrictions on the use of these currencies as national reserves in order to insulate their domestic economies from fluctuations in the international monetary system.[34] The ensuing run on the dollar through the first quarter of 1968 seemed to vindicate those who resisted the international use of their currency, as well as justifying the support that sterling had attracted as part of the bulwark to defend the Bretton Woods system. After the end of the fixed dollar price of gold in March 1968, the survival of the system appeared to rely even more on propping up its two (uneven) pillars – the pound and the dollar - until alternatives could be found. The SDR was supposed to be the long term solution to reduce the role of the dollar, but this ambition required several years of transition. The outcome for sterling was the Basel Agreement of September 1968, which marked the next stage in the disintegration of the sterling area.

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[33] C.R. Schenk, 'Malaysia and the end of the Bretton Woods system 1965-72: Disentangling from Sterling', *Journal of Imperial and Commonwealth History*, 36 (2), June 2008, pp. 197-220. C.R. Schenk, 'The empire strikes back; Hong Kong and the decline of sterling in the 1960s', *Economic History Review*, LVII(3), 2004, pp. 551-80.

[34] C. R. Schenk and J. Singleton, 'Basket pegs and exchange rate regime change: Australia and New Zealand in the mid-1970s' *Australian Economic History Review*, 51(2), 2011, pp. 120-149.

During the 1960s, therefore, the links that drew sterling area countries together continued to erode. Political ties were weakened by decolonisation, and the diversification of trade and payments led to a natural diminution of economic integration. Thus the trade relations of members shifted to Europe, Asia and the USA while the capital market in London was tightened and opportunities arose in Europe to borrow both dollars and European currencies. British interests became much more clearly directed at the EEC at the expense of trade relations with traditional trading partners in the Commonwealth. There remained a shared interest in supporting the exchange rate of sterling, since the bulk of each member's reserves was in sterling, but this was undermined by the unilateral devaluation of November 1967.

III Negotiating the end of the Sterling Area

The aftermath of the 1967 devaluation established the institutional process for the end of the sterling area. By this time the economic disintegration had already progressed for most members and the continuation of the sterling area might be viewed as a relic of the immediate post-war period that was difficult to dispense with. From 1968 the strategy for Britain as well as for overseas members of the sterling area was clearly to manage disengagement while avoiding a tipping point that would push sterling into collapse. Despite the new avenues for international borrowing that emerged from the mid-1960s London continued to be the main capital market for sterling area governments. Preferred access for sterling area countries was expected to be abandoned when Britain joined the EEC, but sterling area governments were not willing to anticipate this unwelcome eventuality by unilaterally removing themselves from the sterling area.

As noted above, throughout the 1960s the G10 central banks (through the BIS) supported sterling through a series of lines of credit and currency swaps. After the devaluation of November 1967, a new arrangement was negotiated, known formally as the Second Group Arrangement (informally as the Basel Agreement). Under the First Group Arrangement of June 1966, the G10 central banks had offered a $1 billion line of credit to reimburse the Bank of England for diversification of reserves by the sterling area.[35] The goal was to reduce the first mover advantage of any member of the sterling area; with the strength of the G10 central banks behind Britain's central reserves there would be less incentive to be the first to dump sterling assets in anticipation of devaluation. As it turned out, it was not the official reserves held in central banks of the sterling area that proved to be the most volatile source of speculative pressure on the pound in 1967, but private holdings outside the sterling area.

The Second Group Arrangement in September 1968 also aimed to forestall diversification by increasing the credibility of Britain's defence of the (new) exchange rate. Under the Basel Agreement, the Bank of England was offered a $2 billion line of credit to reimburse the reserves in case of diversification. This time, given the recent devaluation of the pound, the risk of first mover advantage leading to a tipping point was much greater. Any residual 'loyalty' of the sterling area to sterling had been effectively destroyed. The G10 central banks therefore insisted that in return for the line of credit, the British government had to negotiate with each of the 34 sterling area territories to establish a minimum sterling proportion for their national reserves. This drastically reduced the likelihood that the line of credit would be drawn. To get the sterling area to agree to abandon sovereignty over their reserves composition in this way, Britain offered to guarantee the dollar value of 90% of

[35] Toniolo, *Central Bank*, p. 395-97. Schenk, *Decline*, p. 281-3.

their official reserves. The Sterling Agreements, signed as an adjunct to the Basel Agreement, marked a drastic change in the organisation of the sterling area.

An important further element of the Sterling Agreements provides evidence of how members of the sterling area viewed their participation in the network. The Australian government led the way in insisting that, not only did they require a guarantee of the dollar value of their reserves, but they would not sign up to the Minimum Sterling Proportion (MSP) unless there was a guarantee of continued access to the London capital market. The British government finally agreed to a formal side letter to the sterling agreement that stipulated that if Britain imposed new capital controls on investment in Australia the Sterling Agreements would be renegotiated. Furthermore, if Australia was unable at any time to refinance maturing debt in London, the sterling amount would be added to the notional amount of sterling reserves in the calculation of the MSP. Thus, Australia could diversify their reserves more if they were unable to raise refinancing through London. Moreover, any foreign currency borrowing that affected the reserves would not be included in the calculation of the MSP for the first three months, so the sterling agreement would not restrict access to other capital markets. After being negotiated by Australia, this side letter agreement was then extended to other sterling area countries. Table 3 shows the range of countries with which the British government was able to secure bilateral contracts and the level of the minimum sterling proportion. In most cases this reflected the status quo ante and so prevented further diversification after the debacle of the devaluation of 1967.

Table 3: Sterling Agreements of 1968-71 Minimum Sterling Proportions in Reserves

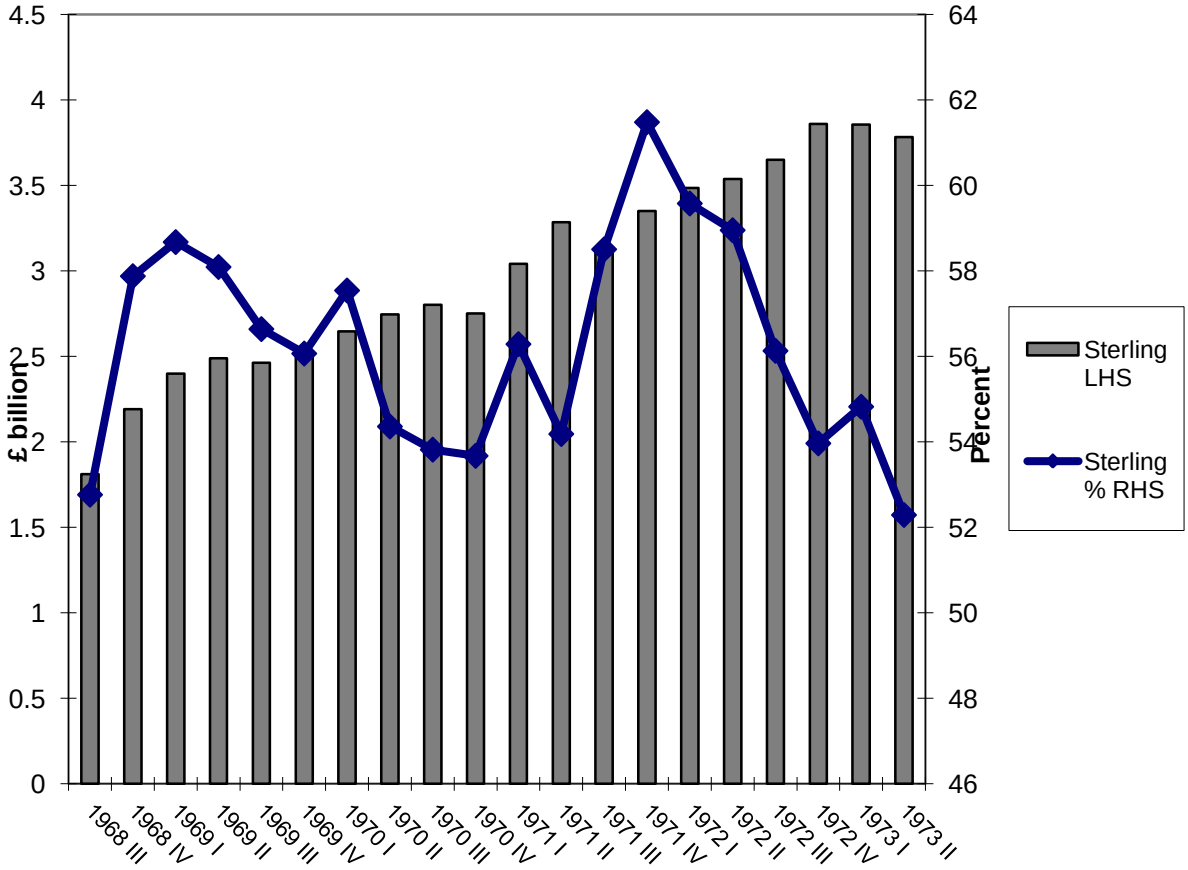
Territory	**MSP (%)**	**Territory**	**MSP (%)**
East Caribbean Currency Authority	100	Zambia	65
Gambia	100	Nigeria	60
Hong Kong	99	Jamaica	57
Barbados	97	Ireland	55
Mauritius	95	Uganda	51
British Honduras	90	Cyprus	50
Bahamas	80	Dubai	50
Bermuda	80	Iceland	45
Ceylon	80	Australia	40 (47)
Ghana	80	Malaysia	40 (45)
Guyana	80	Pakistan	40
Malawi	80	Singapore	40
Trinidad	80	Jordan	25
Malta	75	Tanzania	25
Bahrain	70	Kuwait	25 (54)
New Zealand	70	Libya	18 (50)
Sierra Leone	70	India	13

Source: Schenk, *Decline*, p. 295.

Figure 3 shows that the amount of sterling held in reserves of participating countries increased by £2 billion from 1968 to the peak in the fourth quarter of 1972. The share of sterling in reserves rose sharply in the two quarters after the first sterling agreements were

signed but then declined gradually until 1971 when overall reserves were run down due to balance of payments difficulties. From early 1972 there was a sharp and sustained decline in the sterling share of reserves as these countries rebuilt their foreign exchange reserves.

Figure 3: Sterling Agreements Countries Sterling Reserves 1968-73



After the negotiation of the Sterling Agreements in 1968, the character of the sterling area was transformed from a voluntary association of states that had traditional economic and commercial ties to the UK to a formalised network of bilateral contracts between the UK and various members. The Exchange Control Act still identified the 'Scheduled Territories' that pegged their exchange rates to sterling and held the bulk of their reserves in sterling and the preferred access to the London capital market was still a protected feature under

UK exchange control. However, the benefits that drew the partners together had eroded to such an extent that the system had to be stabilised through contractual arrangements.

The focus of sterling area government strategy was on the ability to borrow and retaining exchange rate stability. As the global system based on the dollar floundered from the collapse of the Gold Pool in March 1968 and US inflation increased, shifting their pegged exchange rates from sterling to the dollar did not seem an attractive option. In August 1971, President Nixon suspended gold convertibility and threatened trade sanctions unless Japan, West Germany and other currencies were revalued against the dollar. The US Administration thus forced a general realignment of exchange rates to increase the competitiveness of US production and combat the deficit. President Nixon's ultimatum, accompanied by the removal of support for the US exchange rate, marked the culmination of two years of US deliberation over how to reform their role in the international monetary system.[36] When the pegged exchange rate system was restored in December 1971, the margins between sterling and the dollar were widened, which left sterling area members with a potentially larger band against the US dollar. Australia and New Zealand chose at this time to shift their exchange rate peg to the dollar in order to minimise the volatility against this currency. Table 4 shows that several other members of the sterling area followed. Malaysia and Singapore retained the peg to the pound since they were in the midst of a complicated disentanglement of their own monetary union.[37] The Middle Eastern states also retained sterling as their anchor currency given the operations of UK oil companies and the substantial share of oil royalties still paid in sterling.

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[36] Gavin, *Gold, dollars and power*. Schenk, *Decline*, pp. 317-29. A. H. Meltzer, *A History of the Federal Reserve, Volume II, Book Two, 1970-1986*, Chicago, 2009, pp. 684-758.

[37] C. Schenk, 'The dissolution of a monetary union: the case of Malaysia and Singapore 1963-74', *Journal of Imperial and Commonwealth History*, 2013.

Table 4: Dates when the Anchor currency moved from the Pound to the Dollar

India	August 1971
Pakistan	September 1971
Kenya	October 1971
Nigeria	November 1971
Ghana	November 1971
Malaysia	June 1972
Singapore	June 1972
Kuwait	June 1972
South Africa	October 1972

Source: International Monetary Fund, *Annual Report on Exchange Restrictions*, various issues.

The Sterling Agreements of 1968-71 were renewed for a further three years in September 1971, just after the Nixon Shock threw the architecture of the international monetary system into disarray. By the time the dust had settled with the Smithsonian Agreement of December 1971, the new Sterling Agreement already seemed out of date. The British refused to adjust the trigger point to invoke the dollar value guarantee despite the depreciation of the dollar against the pound. For the second agreement, therefore, sterling could depreciate 8.5 per cent before compensation was payable. But sterling did not survive in the Smithsonian Agreement for long.

In the summer of 1972, sterling's new exchange rate came under increasing threat and a run quickly accumulated. In June alone £1.14 billion flowed out of the Bank of England in foreign exchange. The main drawers in the sterling area included Malaysia, Singapore and

Kuwait who all had scope within their sterling agreements to diversify their holdings.[38] Instead of yet another step-change devaluation the British government chose to embark on a 'temporary' float of the pound. At the same time, the decision was taken quietly to introduce exchange control on the Scheduled Territories so the sterling area was contracted to the Republic of Ireland and the Channel Islands. By the end of 1972, therefore, the main former sterling area countries had re-pegged their exchange rates to the dollar after 25 years the sterling area system was at an end. Nevertheless, only Malaysia chose this moment to abrogate their Sterling Agreement by unilaterally diversifying their reserves beyond the agreed limits under the Sterling Agreement and so lost access to the guarantee. The usefulness of the sterling agreements outlived the sterling area they were meant to solidify.

The continuation of the Sterling Agreements through to 1974 suggest that they overtook the Exchange Control Act provisions as a means of ensuring continued access to the London market in exchange for signatories retaining a substantial amount of their reserves in sterling. The increased volatility of the exchange markets during the collapse of the Bretton Woods system made the exchange rate guarantee more valuable. By October, the sterling float drew the sterling exchange rate below the trigger point for compensation and the first payments under the guarantee cost the British £58 million. The second set of Sterling Agreements expired in September 1973, but the British government encouraged a renewal for six months at a lower MSP and most countries agreed. The new terms capped the amount of guaranteed sterling reserves (rather than merely a percentage) to discourage new accumulations and limit British exposure. The trigger point was also adjusted to take

[38] Schenk, *Decline*, pp. 329-41. Oliver and Hamilton, 'Downhill from Devaluation'.

into account the devalued dollar. Compensation amounting to £100 million was eventually paid in compensation under this set of Agreements.

During the second and third round of sterling agreements the global pegged exchange rate system collapsed, Britain joined the EEC and the balance of global economic power lurched toward the Middle East with the Organisation of the Petroleum Exporting Countries (OPEC) oil price shock of October 1973. Nevertheless, the sterling agreements system persisted. The sterling exchange rate was more flexible, but there were still worries about the resilience of the UK foreign exchange reserves. With a general election looming, in March 1974 the British government renewed the Sterling Agreements one final time for a further nine months to the end of that year. The terms reflected the new environment: MSPs were reduced further and the trigger was shifted to the value of the effective exchange rate rather than the bilateral dollar exchange rate.

IV Conclusions

Monetary integration has complex and profound political facets, as has been exposed most starkly in the Eurozone crises of 2010. While monetary union among sovereign states is therefore historically unusual, greater integration of economies has been sought through pegged exchange rate regimes which confer the benefits of policy credibility (if the anchor economy is stable) combined with a plausible exit strategy should circumstances change. Of course, the periodic readjustments that characterised the postwar decades showed that the discretionary element of pegged rates tended to undermine the credibility of the peg and promoted speculation once international capital flows were liberalised. While the sterling area was not an example of monetary integration, it did provide a sustained framework for international monetary relations among a diverse group of large and small, high and low

income per capita economies for thirty years. Based on pegged exchange rates, freer capital flows and some elements of policy coordination (in the early years), the sterling area was an important element in the post-war international monetary system. It emerged from the collection of countries that had pegged to sterling in the storm of the interwar depression and from the controls introduced as part of Britain's economic war effort. In the immediate post-war years the operation and rationale for the sterling area was closely identified with the accumulation of substantial British war debts, but from the mid-1950s the character of the system began to change into one of mutual benefit.

That the sterling area persisted for so long through such a transformation of the international monetary system is remarkable. The advantages that the sterling area generated for overseas members, for Britain and for other stakeholders in the global system (including USA and the G10) were instrumental in determining the institutional supports that allowed it to persist. From 1952 it was not a closed system of tightly integrated members. Nor was it the forum for significant coordination of policy. Instead, it offered a source of stability in uncertain times, both for the exchange rate regime and for access to international borrowing. As the economic focus of the members of this network turned to Europe, Japan and the USA, the ties that bound the system together weakened and it relied increasingly on the support from third parties. Unlike 1931 or 1949, members of the sterling area did not follow the devaluation of sterling against the dollar in 1967 and from 1968 the sterling area was redefined by formalised agreements to retain a proportion of reserves in sterling. The main enduring element of the original sterling area was the continued importance of access to the London capital market, but even this eroded as capital markets in Europe and the USA became more competitive. Eliminating the sterling area in 1972 was in the end a mere footnote to the more profound shift in British policy

toward exchange rate flexibility and a commitment to economic integration with Western Europe through membership of the EEC. Without much ado, the main vestige of the economics of empire was quietly abandoned.