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Sterling Instability and the Post-War Sterling System

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Sterling Instability and the Post-War Sterling System

Samuel I. Katz

The post-war instability of sterling, marked by external crises in 1947, 1949 and 1951-52, has in part been due to deficits of the Independent sterling countries. <sup>1/</sup> Until lately, these countries have been able to finance considerable import deficits out of their own sterling balances and to replenish their reserves without difficulty; their reserves have been augmented by the uninterrupted outflow of capital from the United Kingdom, which was largest in 1948 and 1949, and by large export earnings in late 1950 and 1951 when the prices of wool, rubber and other export crops rose sharply after the invasion of South Korea. Only recently have they been confronted with a shortage of sterling exchange.

The emergence of the sterling shortage of 1951-52 was in part the result of the reintroduction of effective monetary restraint in the United Kingdom in late 1951 and early 1952. This development focuses attention upon the strategic role to be played by monetary discipline, both in the United Kingdom and in the Independent sterling countries, if Britain is to be able to maintain a greater degree of stability for sterling than has been achieved since 1945.

Structural development of the sterling area

In the pre-1914 period, many trading nations had come to rely upon sterling for the conduct of foreign trade because of the universal acceptability of the pound. These countries tended to have close monetary and trading ties with the United Kingdom, selling much of their exports to (or through) British commercial houses or commodity markets; many were dependent upon the London money market for developmental capital financing; and virtually all of the major commercial banks engaged in financing world trade kept balances and rediscounted bills in the London market.

With the end of hostilities in 1918, the United Kingdom tried to repair the wartime deterioration of London's world position and moved quickly to reestablish the international financial position of sterling. By 1925, the United Kingdom had restored sterling to the pre-war gold parity at the price of risking internal deflation in Britain. Capital lending was also resumed on a large scale; a surplus was maintained in Britain's current accounts throughout the twenties. In fact, by 1930, the United Kingdom had been able to

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<sup>1/</sup> The important Independent sterling countries are Australia, New Zealand, Eire, Pakistan, India, Ceylon, and, for transactions not settled directly with the non-sterling world, the Union of South Africa.

rebuild total foreign assets almost to the pre-war volume, although the greater part of the post-war outflow was invested in territories within the British Empire.

Abandonment of the gold parity of the pound in September 1931, and its resulting depreciation, produced an important change in sterling area arrangements. Confronted with the immediate decision of following either sterling or gold, the British Commonwealth nations (with the exception of South Africa and Canada) decided to maintain stable rates with the pound and to forego the fixed link to gold. A number of non-British countries also joined this movement at the time or shortly thereafter.

The economic bonds holding the British countries together were strengthened with the introduction of a system of preferential tariff concessions under the Imperial Preference program agreed to at the Ottawa Conference in 1932. The overseas sterling countries (with Canada participating) granted the United Kingdom preferential treatment in their markets in exchange for tariff protection in the United Kingdom market against competitive imports from the United States, Latin America and Europe. At this time, the non-British countries were drawn into a close association with sterling by two practical facts: while prices in 1931-1932 were comparatively stable in sterling, they continued to decline in terms of gold; and the volume of Britain's imports was better maintained during the Great Depression than was that of any other major importing country. Between 1933 and 1936, the other major currencies broke their links with gold; the advantages which sterling had gained earlier then disappeared as other currencies depreciated and as some economic recovery took place in the non-sterling world. By the time war broke out in August 1939, most of the non-British countries decided to loosen their ties with a pound which had been devalued in the preceding twelve months from \$4.68 to \$4.03, and to withdraw from close monetary association with sterling.

Having determined to maintain their link with sterling, the sterling bloc countries during the thirties relied upon Britain's efforts to maintain exchange stability with the non-sterling currencies. Since sterling remained a freely convertible currency until the war, though the price of gold in the London market was no longer fixed, foreign exchange reserves held as sterling balances could be used to obtain dollar and other currencies at the holder's option. The Tripartite Agreement of 1935 between the United States, the United Kingdom and France was instituted to increase the combined effectiveness of the exchange stabilization operations which had commenced earlier in London, Paris, New York and certain other money centers and to achieve greater stability between the sterling, the dollar and the so-called gold bloc.

The World War II exchange control machinery, established first in the United Kingdom and then in the other British countries, converted the sterling area from a loose association of nations with close economic interests into a grouping with a formal structure of administrative regulations as well as a number of unwritten conventions. Under Britain's defense regulations of September 3, 1939, a comprehensive system of controls over foreign currency transactions was established for the first time in the history of the country; under the regulations, it was provided that "no person ... shall ... buy or borrow any foreign currency or any gold from, or lend or sell any foreign currency or any gold to, any person" except with permission of the Treasury. 1/ Later, in 1940, it was provided that no payment could be made "in favor of a person who is resident outside the sterling area" without Treasury permission. Moreover, for the first time, the sterling area was defined as an administrative entity, 2/ and completely free movements of funds were allowed between the United Kingdom and all parts of the British Commonwealth except Canada and Hong Kong. 3/

Systems similar to this in their broad outlines were established in the outer sterling countries with the result that capital movements to residents outside the sterling bloc were quite closely regulated everywhere within the area, while the flow of payments among the sterling area countries remained virtually uncontrolled. The exchange regulations were designed only to control capital movements and invisibles payments; regulation of the volume of imports, and of their geographic origin, was achieved by a system of import licensing; it has been common practice in the British countries to make exchange allocations virtually automatic upon receipt of an import license.

However, no central direction of trade and exchange controls was established for the area. Each participant operated its own exchange control machinery, in accordance with local laws and conditions. Consultation at the technical level was relied upon to keep the regulations along similar lines and consistent in detail. Cooperation was facilitated by the necessities of war, which imposed upon all member countries a wide area of common understanding, objective and agreement. It was clear that the hard-currency resources of the area as a whole

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1/ The Defence (Finance) Regulations Amendment Order, 1939 of September 3, 1939 which superseded the original Defence (Finance) Regulations, 1939, dated August 25, 1939.

2/ S. R. and O. 1940, No. 1254, dated July 17, 1940.

3/ S. R. and O. 1940, No. 1256, dated July 17, 1940. The sterling area was defined as the following territories, excluding Canada, Newfoundland and Hong Kong: (a) any Dominion; (b) any other part of His Majesty's dominions outside the British Islands; (c) any territory under League of Nations mandate; (d) any British protectorate; and (e) Egypt, Anglo-Egyptain Sudan and Iraq.

had to be carefully conserved and that dollar spending had to be confined to priorities determined by military necessity. To achieve economy of dollar usage, hard-currency resources were brought together for a common purpose and drawn upon in accordance with a schedule of agreed and roughly similar priorities. Thus, the dollar pool emerged out of common war requirements.

The need for Britain to finance its inevitable import surplus during the combat period of World War II, a financing problem second in magnitude and difficulty only to the need to conserve dollar exchange, accounted for another feature of the wartime sterling mechanism. The United Kingdom paid for its net import deficits by adding to the London sterling balances of the supplying countries. This form of current settlement in inconvertible sterling, rather than in a convertible currency or gold, became established practice for the sterling area. It avoided the need for the United Kingdom to go through the formality of raising loans in overseas money markets; also, although the accretions were not immediately convertible into commodities, they did represent for their recipients a foreign exchange accrual for future disposition. In this way, the acceptance and holding of sterling, once entirely a matter of self-interest when trade was in balance, became -- under an unwritten convention of the sterling area -- an obligation of member countries. In combination with the dollar pooling principle, this meant that member countries were committed to take sterling for their balance-of-payments surpluses, whether earned within or outside the sterling area.

#### Post-war instability of sterling

With major economic crises in 1947, 1949 and 1951-52, economic instability may be said to have been as characteristic of the sterling area financial relationships after 1945 as relative stability in a depressed world economy marked its course after 1931. This instability was aggravated by certain of the sterling area arrangements; furthermore, the conflicting economic interests of the various sterling nations became evident as the unity of purpose, originally imposed by overriding military necessity, disappeared with the end of hostilities.

The post-war sterling area arrangements would have had less disturbing economic consequences upon Britain had not the United Kingdom emerged from the war as a massive short-term debtor to other sterling bloc members. Because the outer sterling countries had accumulated sterling reserves during the war, they were in a position to finance import deficits; because Britain was in short-term debt to overseas "depositors", it was difficult for her to restrain their import procurement, especially since they held such high hopes of rapid economic development under their greater postwar independence. This situation, which would in any case hardly have been conducive to the attainment of current balance among the individual sterling countries, was made more difficult by the fact that the sterling

mechanism operated in a way which did not discourage or penalize external disequilibrium of its individual members.

An important feature of the sterling area arrangements in the post-war world has been the uncontrolled movement of capital funds from Britain to the member nations. For this reason, Britons have tended to look upon the sterling system as the last fragment of the pre-1914 world. But this freedom of capital movement has depended upon a second characteristic of the system: general acceptance by the United Kingdom and other members of the principle of sterling settlement for periodic surpluses or deficits. Had convertible settlement been the practice among sterling countries, capital restrictions would have been required, at least by the United Kingdom.

The dollar-pooling principle has also been considered by observers as a cause of post-war instability, for the operation of the principle has meant that the United Kingdom has been confronted with heavy demands for dollars on behalf of member countries, sometimes when its own payments position was deteriorating. In this situation, the timing of this dollar demand was as much of a disturbing influence as, or greater than, that of the dollar drain itself. At other times, when the member countries were heavy net earners of dollars, the position of sterling improved out of all proportion to the improvement in Britain's own payments position.

Dollar pooling was an outgrowth of wartime necessity, not a historic characteristic of the pre-1939 sterling system. Before the war, the member countries voluntarily chose to maintain reserves in sterling and to allow the United Kingdom to act as their banker: they were under no pressure from the British authorities to this end, until after 1939, when dollar pooling became a major feature of the wartime arrangements. Post-war dollar difficulties led the United Kingdom to seek to continue the wartime arrangements and to defend the pooling principle, even in the face of restiveness and opposition of other participants. While they have recognized that member countries could dispose of their current earnings as they saw fit, the British authorities have, in practice, encouraged mutual economy in dollar usage and resisted attempts by other members to build up independent dollar reserves, generally upon the grounds that the condition of the central reserves precluded such dispersion.

While the acceptance of dollar pooling by the sterling bloc has been responsible for some of the improvement in Britain's gold-and-dollar reserves and for increasing the sterling resources of other members, the sporadic immoderate demand for dollars at inconvenient times which Britain has experienced since 1945 has resulted from the operation of the sterling exchange standard itself, quite apart from the dollar pooling feature. So long as foreign currency reserves are

maintained in sterling, member countries can be expected to draw upon these resources at critical moments to finance current deficits outside the sterling area, whether sterling is convertible (with dollar conversion automatic) or inconvertible (with administrative action needed to effect conversion). This factor must remain a continuing threat to economic stability, whether or not dollars are pooled, so long as substantial member-nation reserves are held in London; but the extent to which dollars will be demand will depend upon the volume of sterling held by member nations and upon the degree of balance attained by the member country.

TABLE I

Overseas Sterling Area: Transactions with Dollar Area

(In millions of U. S. dollars)

<u>Area</u>	<u>1948</u>	<u>1949</u>	<u>1950</u>	<u>1951</u>	<u>1952</u>
1. U. K. Colonies:					
Imports	315	220	130	215	195
Exports, total	490	390	500	635	520
Other, net	- 11	+ 32	+ 38	+ 42	+ 51
Total above	+ 164	+ 202	+ 408	+ 462	+ 376
Gold sales to U. K.	b/	+ 27	+ 28	+ 25	+ 7
Net Balance	+ 164	+ 229	+ 436	+ 487	+ 383
2. Independent sterling countries:					
Imports a/	845	805	590	1,145	1,095
Exports, total a/	635	515	710	1,010	765
Other, net	- 264	- 268	- 111	- 62	+ 46
Total above	- 574	- 558	+ 9	- 197	- 284
Gold sales to U. K.	+ 222	+ 207	+ 253	+ 193	+ 194
Net Balance	- 252	- 351	+ 262	- 4	- 90

a/ Excludes South Africa. That part of South Africa's dollar balance settled through the U. K. is included in "other net".

b/ Included under "Independent sterling countries".

Source: -- United Kingdom Treasury, Balance of Payments White Papers, Cmd. 8505 and 8808.

More serious from the point of view of maintaining stability than the inconvenient calls upon the central reserves at critical times has been the persistency of the dollar deficits of the Independent sterling countries throughout most of the post-war period. By contrast to the United Kingdom Colonies, which have been substantial net earners of dollars in transactions with the dollar area, the Independent members have had large deficits with the dollar area in post-war years except 1950 and early 1951, as may be seen in Table I. Even when gold sales to Britain are taken into account (which come largely from South Africa rather than the other Dominions), the Independent sterling countries show large deficits. The reduced dollar drains shown for the second half of 1951 and 1952 are misleading in that the United Kingdom had to make gold payments to the European Payments Union during the latter half of 1951 and early 1952; the E. P. U. deficits attributable directly to the outer sterling countries amounted to \$238 million in the last half of 1951 and to \$39 million in the first half of 1952, according to British balance-of-payments estimates. When Britain is able to maintain balance in its own accounts, therefore, the problem of stability in the sterling area's current accounts becomes -- from the point of view of the United Kingdom as the banker for the area -- a problem of how the accounts of the larger sterling countries are to be maintained in balance.

#### Financing the post-war deficits

The recurring post-war trade deficits of the Independent sterling countries have been financed, from their point of view, out of their own foreign exchange (sterling) accumulations. Sterling balances were accumulated during World War II mainly by India (and Pakistan). Subsequently, though India's sterling balances declined, those of the other Dominions (and of the Colonies) were enlarged. Despite earlier British hopes that certain countries would prove to be "good" holders of these British liabilities, each Independent country in practice has drawn on its foreign exchange reserves from time to time to finance import deficits.

The sharpest expansion in the foreign exchange resources of the member countries occurred during the war. Before the war, the sterling balances of the entire British Empire rose only from £ 238 million in June 1932 to £ 362 million at the end of 1939, with a pre-war peak holding of £ 410 million reported for June 1937. During World War II, the holdings of the Independent sterling countries rose from £ 460 million at the end of 1941 to £ 2,007 million at the end of 1945, with 55 per cent of this total held by India (and Pakistan); during the same period, the sterling balances of the United Kingdom colonies expanded only from £ 205 million in 1941 to £ 447 million at the end of 1945. <sup>1/</sup>

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<sup>1/</sup> Reserves and Liabilities 1931 to 1945, Cmd. 8354, September 1951, pages 5 and 6.



Since the end of 1945, however, these trends have been reversed. The holdings of the Colonies have risen without interruption from £ 447 million at the end of 1945 to £ 1,065 million at the end of 1952, as may be seen in Table II below. By contrast, the United Kingdom's sterling liabilities to the Independent countries have shown a net decline from £ 2,007 million at the end of 1945 to £ 1,603 million at the end of 1952.

More significant from the point of view of the stability of the sterling area, the holdings of the Independent sterling countries have fluctuated markedly. Their balances fell substantially during 1946 and 1947, largely as a result of liquidations by India (and Pakistan); but the balances of other countries rose and those of India were partly reconstituted in the 1950 boom, rising to a peak of £ 2,192 million on June 1951 as a result of booming dollar prices of such major export materials as rubber, wool, jute and burlap. Reacting to the income inflation of the raw material boom, however, the Dominions drew heavily upon their sterling resources between July 1951 and June 1952. When the total declined by £ 661 million or about 30 per cent below the peak holding.

The way in which declines in the United Kingdom's sterling liabilities to some countries were accompanied by increases in liabilities to others is seen in the movement of individual balances, as roughly approximated on a quarterly basis from the published local banking statistics of the countries concerned, shown in Table II. <sup>1/</sup> During 1946 and 1947, some net declines were registered for India, Ceylon, and New Zealand, but roughly balanced movements were recorded for Eire, South Africa and Australia. During 1948 and 1949, however, India drew upon these balances to finance a substantial current-account deficit; however, these Indian liquidations were largely offset by accruals to Australia which, at that time, were primarily the outgrowth of a heavy -- and in large part speculative or temporary -- inflow of United Kingdom capital based upon expectations of an early appreciation of the Australian pound.

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<sup>1/</sup> For the period as a whole, the individual estimates of sterling balance changes for the Independent sterling countries seem to be reasonably consistent with the official half-yearly movements of balances of the "other sterling area countries" shown in Britain's balance-of-payments statements; but there are individual periods where the total of the changes shown in the private figures differ to a substantial extent from the changes in the official statistics. These discrepancies underline the rough nature of the individual-country estimates in the table.

TABLE II

Sterling Balances: Changes in Holdings by Sterling Area Countries  
(In millions of pounds)

	Official estimates		Rough estimates based upon local banking statistics							
	Total sterling area	Colonies only	Rest of sterling area	Australia	New Zealand	India	Pakistan	Ceylon	South Africa	Eire
<u>Total on:</u>				a/ 117	a/ 63	a/ 1,108	b/	a/ 61	a/ 33	a/ 178
June 30, 1945	2,132	391	1,741	---	---	---	---	---	---	---
Dec. 31, 1945	2,454	447	2,007	---	---	---	---	---	---	---
<u>Change during:</u>										
1946	- 37	+ 48	- 85	+ 35	+ 7	- 23	b/	- 6	-43	+ 13
1947	- 120	+ 15	- 135	- 35	-21	75	b/	-23	+43	- 18
1948	+ 68	+ 46	+ 22	+129	-16	152	c/ +100	+ 3	-25	- 4
1949	- 12	+ 26	- 38	+ 48	- 4	167	- 4	- 1	+23	+ 10
<u>1950:</u>										
I	+ 216	+ 53	+ 153	+ 73	+27	14	- 2	0	+31	- 9
II	+ 163	+ 107	+ 56	+ 45	-14	3	- 2	+17	- 6	+ 5
<u>1951:</u>										
I	+ 368	+ 156	+ 212	+116	+50	26	+ 62	+ 4	-11	- 21
II	- 311	+ 56	- 367	-204	-42	61	- 4	+ 4	-17	+ 5
<u>1952:</u>										
I	- 234	+ 60	- 294	-114	- 7	72	- 51	-14	- 1	- 3
II	+ 113	+ 41	+ 72	+ 27	- 3	13	- 47	-12	+ 5	+ 19
<u>Total on:</u>										
Dec. 31, 1952	2,668	1,065	1,603	---	---	---	---	---	---	---

Note: --- Official estimates from U.K. balance-of-payments statements. Data for individual countries: Australia, Commonwealth Bank's holdings of gold and balances abroad; New Zealand, net overseas assets of banking system; India, Reserve Bank of India's holdings of foreign securities and balances abroad; Pakistan, gold, dollar, and sterling reserves held and controlled by the State Bank of Pakistan; Ceylon, sterling assets of Government and Semi-Government funds, the Currency Board (since August 28, 1950, the Central Bank of Ceylon), and commercial banks; South Africa, Reserve Bank's foreign exchange assets; and Eire, external assets and liabilities of Irish banks plus British Government securities of the Legal Tender Fund.

TABLE II  
(continued)

Footnotes:

- a/ Foreign Commerce Weekly, U. S. Department of Commerce, February 13, 1950, page 4.  
b/ Included with India.  
c/ During 1948, upon the establishment of the State Bank of Pakistan, approximately £ 100 million was transferred from the Reserve Bank of India.

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Heavier export sales to North America and Europe during the mid-1950 Korean raw materials boom, together with the marked curtailment of dollar imports put into effect in the second half of 1949, account for the sharp rise in Dominion balances during 1950 and the first half of 1951. While Australia accounted for most of the increase as a result of swollen earnings on wool exports, there were also net surpluses of New Zealand and Pakistan. However, the income inflations of this period began to be reflected in heavy imports by mid-1951, and during the following twelve months a marked and general liquidation of balances occurred to finance import deficits with the United Kingdom and the E. P. U. and dollar areas. The Australian liquidation is the most marked, accounting for perhaps half the total decline, but the new reductions of holdings by India, Pakistan, Ceylon and New Zealand were by no means unimportant. Pakistan and Ceylon continued net spending throughout 1952.

This review of the movement of individual country balances points to the conclusion that it is the total volume of sterling in overseas hands, as much as its country distribution, which is significant for the United Kingdom in its efforts as banker to maintain the external stability of the sterling system. The earlier British hopes that certain Independent countries might be counted on to exercise restraint in using balances are inconsistent with the quite general liquidations during 1951-1952. After all, these sterling resources are foreign exchange reserves of the member countries and, when they rise above minimum levels, are likely to be drawn upon in times of need as are other foreign currency reserves. The only apparently reliable holders of sterling have been the Colonies, where Britain's controls over external transactions are peculiarly effective.

#### How the 1951-52 sterling shortage developed

The Independent sterling countries have been able to maintain larger supplies of sterling since 1945 than before the war, despite the fact that since 1947 the United Kingdom has achieved large annual surpluses on trade account with them. The uninterrupted outflow of capital from the United Kingdom has replenished their balances; but they have also acquired substantial supplies of sterling at times through sterling receipts from non-sterling countries and through depositing dollar receipts in the central reserves. Hence, the volume of sterling accruing to the Dominions has been an out-growth, not merely of Britain's direct transactions with the outer sterling countries, but of their total surpluses with all non-sterling countries.

The annual export surplus of the United Kingdom with the outer sterling countries has ranged between £ 232 million and £ 349 million in the past five years, as may be seen in Table III. The capital outflow to the sterling bloc (as roughly estimated in a residual "balancing" item in Britain's balance-of-payments statements which is believed to represent chiefly long- and short-term capital movements and variations in commercial credit 1/) has been somewhat less than the trade surplus, particularly since 1950. This capital outflow has been uncontrolled by the United Kingdom, although other member countries have local regulations governing sterling capital movements. The only restraint which the British have attempted to exercise upon the outflow of long-term investment funds has been through controlling capital issues. As early as 1932, informal restrictions were placed upon new issues in London, and control over overseas issues was established more formally in 1936 when the principal issuing houses agreed to refer large operations (which might strain the exchanges) to a Foreign Transactions Advisory Committee. 2/ After strict regulation during the war, capital issues control was put on a permanent basis when the Capital Issues Committee was formed in 1946 by legislation which placed under Treasury regulations all flotations by overseas companies or governments in the London market. 3/

Despite the absence of direct restrictions, there apparently has been some downward tendency in the outflow of capital to the sterling area, as may be seen in the table. The recent slowing down may reflect the fact that British firms have finished replenishing overseas stocks and pipelines, or have completed urgent investment projects postponed during the war. The abrupt decline during 1952, when the movement fell to half the 1951 volume, was due partly to the shrinkage of commercial credit needed to finance sterling area trade but it may also be evidence that the tighter monetary policy introduced in Britain in November 1951 and intensified in March 1952 has acted as a restraining influence on the movement of sterling capital.

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- 1/ United Kingdom Balance of Payments, 1949 to 1952, Cmd. 8808, pp. 35-36.
  - 2/ "Government Control over the Use of Capital Resources", Midland Bank Review, August 1950.
  - 3/ The Borrowing (Control and Guarantees) Act of July 1946,

TABLE III

UNITED KINGDOM: Transactions with Rest of Sterling Area

(In millions of pounds)

<u>Period</u>	Current account balance	Means of Financing			Changes in sterling balances
		Capital outflow a/	Gold and other transfers (net)	Other trans- actions	
<u>Annual:</u>					
1946	- 39	+ 50	+ 16	+ 10	- 37
1947	+ 102	- 244	+ 267	+ 4	- 129
1948	+ 232	- 229	- 71	0	+ 68
1949	+ 282	- 210	+ 4	- 64	- 12
1950	+ 260	- 168	- 467	- 4	+ 379
1951	+ 297	- 182	- 172	0	+ 57
1952	+ 349	- 93	- 135	0	- 121
<u>Half-yearly: b/</u>					
1950 - I	+ 83	- 67	- 230	- 3	+ 217
II	+ 135	- 63	- 232	- 1	+ 161
1951 - I	+ 88	- 90	- 366	0	+ 368
II	+ 182	- 63	+ 192	0	- 311
1952 - I	+ 284	- 49	0	- 1	- 234
II	+ 65	- 42	- 135	- 1	+ 113

Source: United Kingdom balance-of-payments statements.

a/ Residual balancing item which is believed to represent chiefly long- and short-term capital movements and variations in commercial credit.

b/ Being preliminary data, the half-yearly figures do not agree with the revised annual statistics.

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The stability of the post-war outflow of capital from Britain is in marked contrast with the wide changes in the trade balances of the Independent sterling countries, both with the United Kingdom and with the rest of the world. Since the member countries maintain foreign exchange reserves primarily in sterling, their balance-of-payments surpluses with countries outside the sterling bloc (whether in the dollar area or elsewhere) give rise to increases in their holdings of sterling balances, and their deficits to decreases in their holdings. In addition to dollar and sterling settlements through London credited or debited to their sterling accounts, they receive sterling against Britain's purchases of newly-mined gold from them. All these transactions of the Independent sterling countries and the Colonies with outside countries plus the gold sales are shown in column three in Table III. 1/

Up to 1950, the sterling bloc tended to be in deficit in its trade with the world as a whole. Despite this deficit and despite Britain's substantial current account surplus after 1947, however, the total sterling reserves of the other members were only slightly depleted since the capital outflow was almost as large as the commodity trade surplus. This was the period when India made substantial inroads upon its balances and when Australian reserves were augmented by a speculative capital flow from Britain,

Beginning in 1950, the capital flow to the sterling countries declined markedly. Despite this reduction, however, the sterling balances of the sterling bloc had increased to a record peak by June 1951 as may be seen in the lower section of Table III. This accrual resulted directly from the area's enormous surplus with third areas and reflected their Korean export boom, particularly with the dollar and European Payments Union areas. Part of the sterling balance accrual to the sterling area members was the counterpart of the building up of Britain's gold and dollar reserves and part came from a running down of non-sterling area holdings, but a significant volume represented European spending in the sterling countries of the credits granted by Britain to the European Payments Union.

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1/ Since the table is presented from Britain's point of view, a minus (-) sign means that the United Kingdom either has bought gold and dollar assets from the member countries or has been enabled to reduce its sterling liabilities to non-sterling area countries -- in other words, that the member countries have earned a net surplus in the transactions included in this category of payments. A plus (+) sign means that the sterling countries have obtained gold and dollars from Britain or have drawn on their sterling holdings to make payments to non-sterling countries in financing their deficits with the non-sterling world.

This accrual came to an abrupt end in mid-1951. After accumulating £ 746 million of sterling balances in the preceding 18 months, the sterling bloc ran through £ 545 million from July 1951 to June 1952. Already in the last six months of 1951, the outer sterling area had a current-account deficit with Britain that was as large as its overall deficit with the dollar and E.P.U. areas. The dollar deficit led to a drain on Britain's gold and dollar reserves; the deficit with Europe also led to the reduction of sterling liabilities. The sterling was displaced through gold and dollar payments to the E.P.U. and through the granting of credit to Britain by the E.P.U. 1/ The deficit with the United Kingdom utilized sterling, in return for goods.

During the first half of 1952, the sterling area's deficit with third areas disappeared while the deficit with Britain almost doubled. With the outflow of capital reduced, most of Britain's trade surplus led to a corresponding reduction in its overseas liabilities. Consequently, a sterling shortage developed among the Independent sterling countries for the first time in the post-war period. Several member countries found it necessary during the 1951-52 crisis to restrict sterling imports to a significant extent; this was particularly true of Australia which had undergone the most substantial reduction in its sterling assets (see Table II). The Financial Times reported that the Australian Prime Minister had proposed that "the U. K. should guarantee a form of sterling overdraft as a protection against the Australian reserves reaching a critically low point" but the proposal had not met with agreement. 2/

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1/ Throughout 1951 and early 1952 Britain's **continuing** deficit with the E.P.U. resulting in increasing percentage gold and dollar payments under E.P.U. rules; by May 1952, the United Kingdom was making full gold and dollar settlement for the sterling area's deficit, a position which continued until the deficit was eliminated in September 1952. Thus, the E.P.U. proved to be a mechanism by which Britain's sterling balances, and hence the sterling in the hands of foreign holders, was substantially reduced by means of gold and dollar payments by Britain.

2/ Financial Times (London), June 11, 1952, page 1. In Parliament, it was suggested that a long-term credit be arranged for Australia "so as to enable the speedy resumption of shipment of goods from this country to Australia" but the Chancellor of the Exchequer had replied that "the U. K. economic situation did not enable the export of British goods to be financed in this way."



The strategic role of monetary restraint

The deficits of the Independent sterling members and the fluctuations in their external positions contributed to sterling's post-war instability. These deficits were financed out of their own overseas exchange reserves and these countries were able -- until the sterling shortage of 1951-52 -- to replenish their sterling resources, largely through receipts of British capital and, at times, through export earnings from Europe and North America. The emergence of a shortage of sterling reserves in 1952 indicates that a new stage in the post-war history of the sterling area had been reached.

The 1951-52 sterling shortage of the Dominions can be attributed to four main factors: (a) the Colonies by then owned about one-third of the sterling balances; (b) the E.P.U. operated to wipe out sterling in foreign hands in exchange for gold payments by Britain and the creation of E.P.U. credit; (c) the rise in world prices and in the value of world trade had increased the minimum working reserves required by the sterling bloc; and, finally, (d) the restoration of monetary policy in Britain had been accompanied by an increase in Britain's export surplus to the area and a diminution of capital outflow from the United Kingdom.

Removal of the one-half per cent peg for Treasury bills in late 1951, which brought the era of cheap money to an end, made it more difficult to borrow in London and also more expensive; formerly money rates there had been below those in other financial centers. During the post-war period of easy money, in fact, the ease with which sterling could be acquired by foreign holders might have had even more serious external consequences had not the United Kingdom benefitted from substantial assistance from the United States and from its Colonies. The wartime balances were almost certain to lead to difficulties after 1945: they could not be expected to be entirely frozen nor their rate of current usage determined solely by financial and economic considerations. Nonetheless, the easy-money policy aggravated the disturbance growing out of this wartime inheritance and created post-war instability due to the creation of new supplies of sterling credit.

The abandonment of the easy-money policy came at about the time when the sterling bloc had passed from early post-war transitional conditions into a distinctly less difficult economic phase. The outer sterling countries had completed their initial post-hostilities investment and restocking activities, and Britain had finally been able, as a result of her investment program, American aid and the mere passage of time, to approach a greater degree of balance, both external and internal, than had yet been possible. The favorable background developments help to account for the recent improvements in Britain's economic position and in the economic prospects for the area as a whole.

Looked at more broadly, monetary restraint seems to have a particularly strategic role to play within the sterling mechanism, particularly from the point of view of the United Kingdom as the supplier of capital and the foreign-exchange banker for the area. Only by controlling the volume of sterling created by the British banking system can the United Kingdom place some limitation upon the foreign exchange receipts of the outer sterling countries. With complete freedom in capital movements, an easy-money policy in London raises the danger of excessive sterling accruals in foreign hands. In the past, because they had the sterling in hand, the member countries sought to convert it either into British merchandise or into foreign currencies at a rate beyond the capacity of Britain's resources. Because their supplies of sterling exchange were more than Britain could convert, the feeling that "dollar pooling" seriously interfered with their rate of development tended to grow; they would be able to grow more rapidly if only they were freed from the restraints of the sterling area. This reaction took the form of restiveness over dollar pooling and disagreement over dollar allocation, of sales of sterling at discount prices and of excessive importation of British merchandise. But the root cause of this discontent was less the dollar-pooling principle than the fact that the countries had sterling balances which they did not want to hold permanently as reserves. In the future, the more the United Kingdom augments the sterling supplies of the Independent countries through a light-handed regulation of credit creation by the British banks, the more likely this difficulty is to reemerge as a source of tension within the area.

To emphasize the need for some restraint upon the outflow of British capital is not to maintain that the United Kingdom is no longer in a position to provide funds to the sterling bloc. On the contrary, since 1950 the United Kingdom has been able to achieve an export surplus substantially in excess of the capital outflow to the sterling area, as may be seen in Table III. Nor is there evidence that the volume of merchandise exports from Britain has constituted an appreciable burden upon the United Kingdom economy, even at the record volume reached in the first half of 1952, although it is true that the continuing demand from the sterling bloc has served during the post-war period to discourage adjustments in the regional distribution of Britain's exports. Since the savings available in the United Kingdom are limited and must be allocated between domestic and overseas claimants, the danger exists that, without effective monetary restraint, excessive supplies of sterling created by the banking system would stimulate investment activities on a scale beyond the capacity of Britain's resources.

Limiting the volume of overseas investment to the export capacity of the British economy will lead the outer sterling countries to seek supplementary foreign capital from outside the area in order to satisfy developmental aspirations. Such a tendency is already

apparent in the growing volume of World Bank loans to sterling bloc members. Yet it is difficult to see how dollar borrowing in any way imperils the structure of the sterling system. On the other hand, the stress imposed upon the sterling mechanism by the existence of large supplies of Dominion-held sterling reserves, which was not converted into merchandise or foreign currency as rapidly as the holders desired, showed itself in 1951-52 to be a serious threat to the existence, and not merely the external economic stability, of the sterling bloc.

Britain's monetary policy has a contributory role to play in encouraging the maintenance of current-account balance by member countries in two ways. First by limiting the flow of capital and expanding U. K. exports, Britain can keep the member countries under some pressure to economize on their use of sterling. For this, they may rely on trade and exchange controls or they may adjust their domestic policies. Some restraint on the domestic policies of the Independent sterling countries can also be exerted by Britain through consultation and moral suasion. It would seem that acceptance of domestic discipline by the United Kingdom is a condition for its acceptance by other member countries. The agreement at the 1952 Commonwealth Economic Conference that "all Commonwealth Governments ... (would) persevere in their efforts to curb inflation" and that an "adequate and stable external balance must be a first objective for all Governments" <sup>1/</sup> may have been directly related to the previous measures of restraint introduced by Britain during the winter of 1951-52. These same measures also made it easier for the British Chancellor to deny to New Zealand financing facilities in the London market for the Auckland bridge as a project without a sufficiently high priority. This emphasis upon the leadership role of the United Kingdom in setting an example for the Independent sterling members recalls earlier days in the history of sterling; during the 19th and early 20th centuries, the quality of Britain's monetary management was probably one of the reasons why countries actively sought close economic association with the pound sterling. If incentives toward individual balance are not introduced into the sterling system, therefore, the United Kingdom will have to continue to rely upon suasion and example to induce the individual countries to pursue policies consistent with economic stability for the area as a whole.

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<sup>1/</sup> Commonwealth Economic Conference Communique, December 13, 1952. This emphasis upon the need for internal stability within individual Commonwealth countries was repeated in the communique of the later Economic Conference issued on June 10, 1953. (See Financial Times (London), June 10, 1953, page 1).