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The Decline of Sterling as a Reserve Currency after 1945: implications for developing economies

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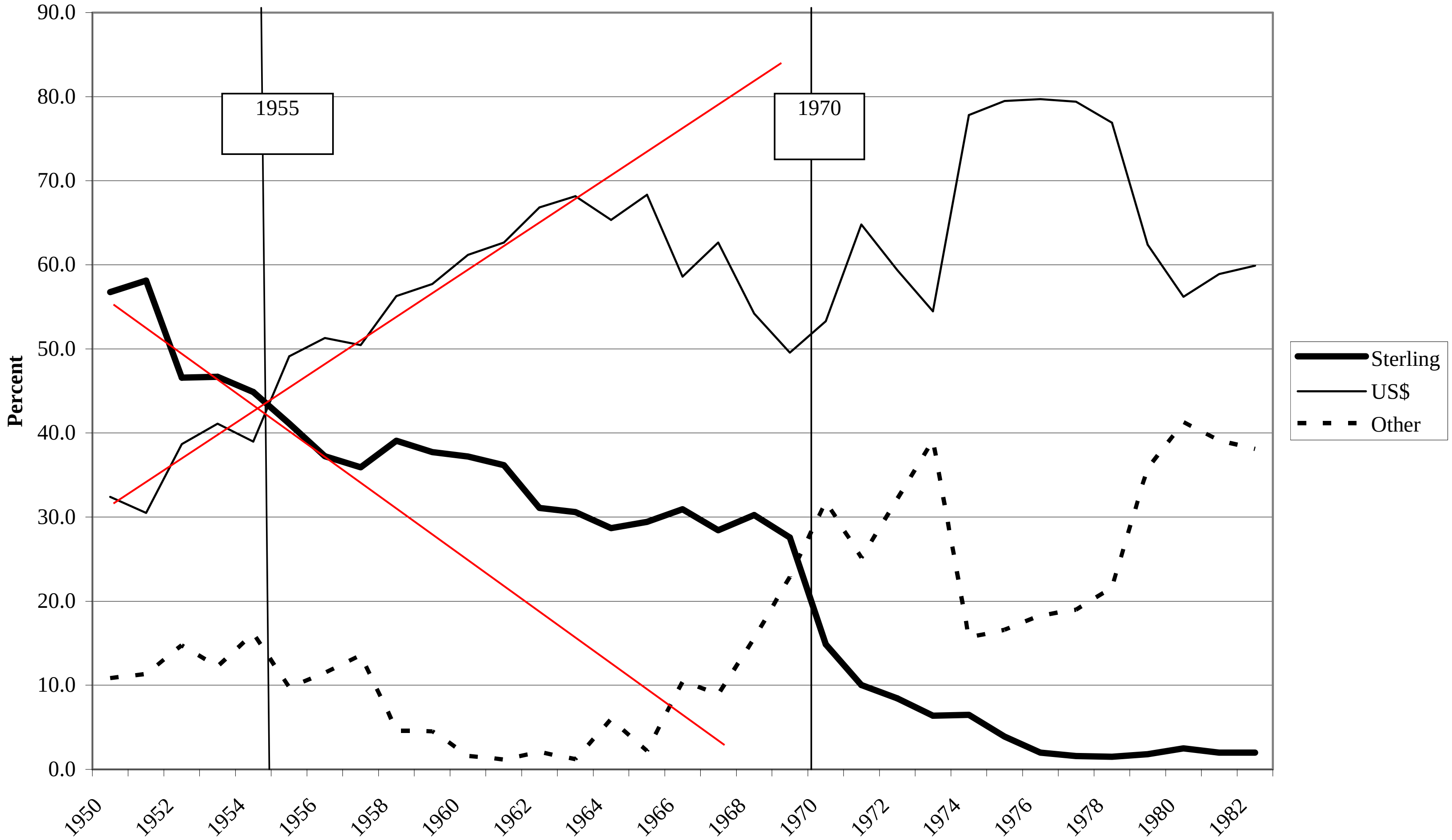
The Future of the Global Reserves System

- Global imbalance and depreciation of USD
- Stiglitz, UN, Chinese suggestions to replace the USD as a reserve currency
- Chinn and Frankel (2008): important role of inertia in demand for reserve currency
  - → Euro may overtake USD in 15-20 years
- Eichengreen and Flandreau (2008): inertia not so important (sterling-dollar-sterling switch in inter-war period)
- Inertia driven by network externalities suggests potential for landslide non-linear shift

Currency Distribution of Foreign Exchange Reserves 1950-1982
(SDR Valuation)



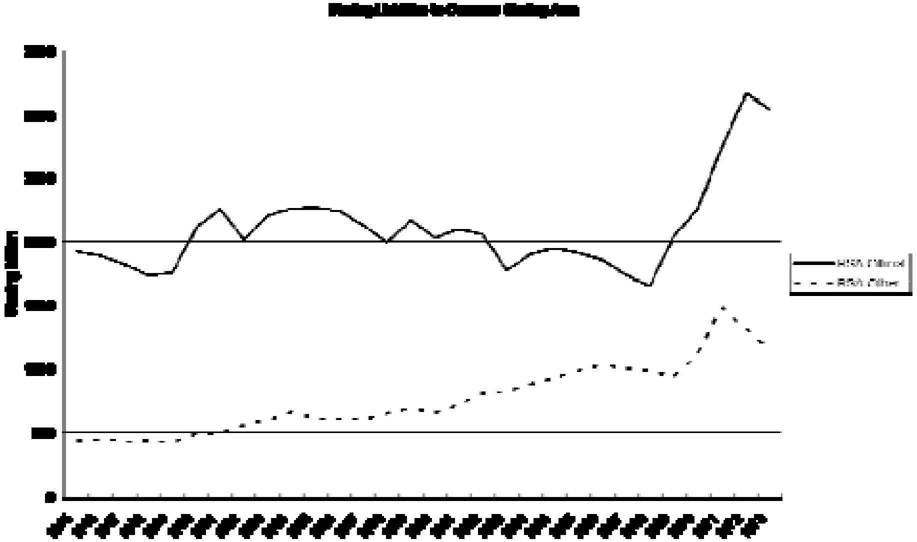
What explains ‘Inertia’ in the case of Sterling after 1945

- Chinn and Frankel (2008): ‘by 1945 the dethroning was complete’
- Krugman (1984): ‘surprising persistence’
- Shonfield, Strange, James…British government supports reserve role
  - Increases capacity to borrow, enhances prestige, supports City of London
- New archive evidence shows governments actively trying to abandon sterling’s reserve role from early 1950s
- Why didn’t they succeed?

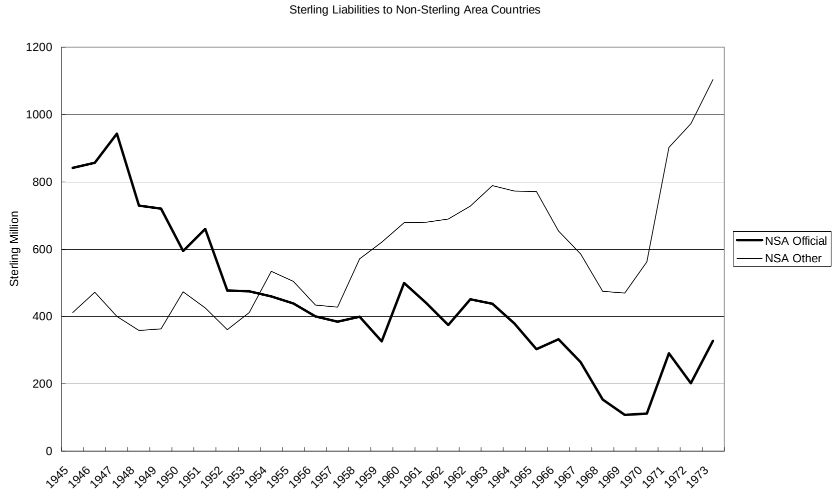
Pattern of Decline

- Sterling remains primary reserve currency for a range of (mainly developing) countries that had historic ties to the UK
- But these historic ties do not alone explain persistence through the 1950s (geographic redistribution toward Far East and Middle East)
- Denomination of trade, debt, intervention currency still matter but eroded by the 1960s (except for oil and China’s demand for sterling)
- Active discouragement of sterling’s international commercial role through exchange controls

Sterling Liabilities to Overseas Sterling Area
(other = non-official holders)



Sterling Liabilities to Non-sterling Area Countries



Sterling Reserves of State Institutions

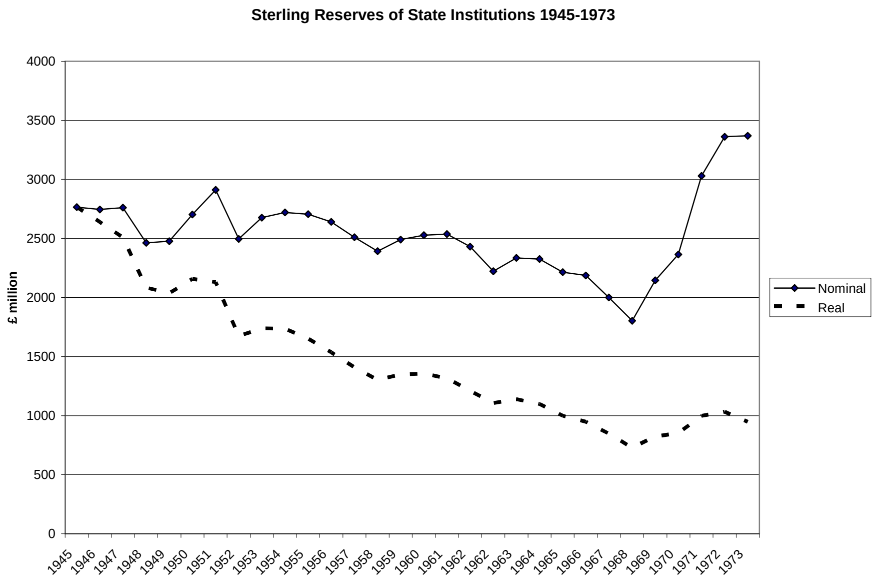
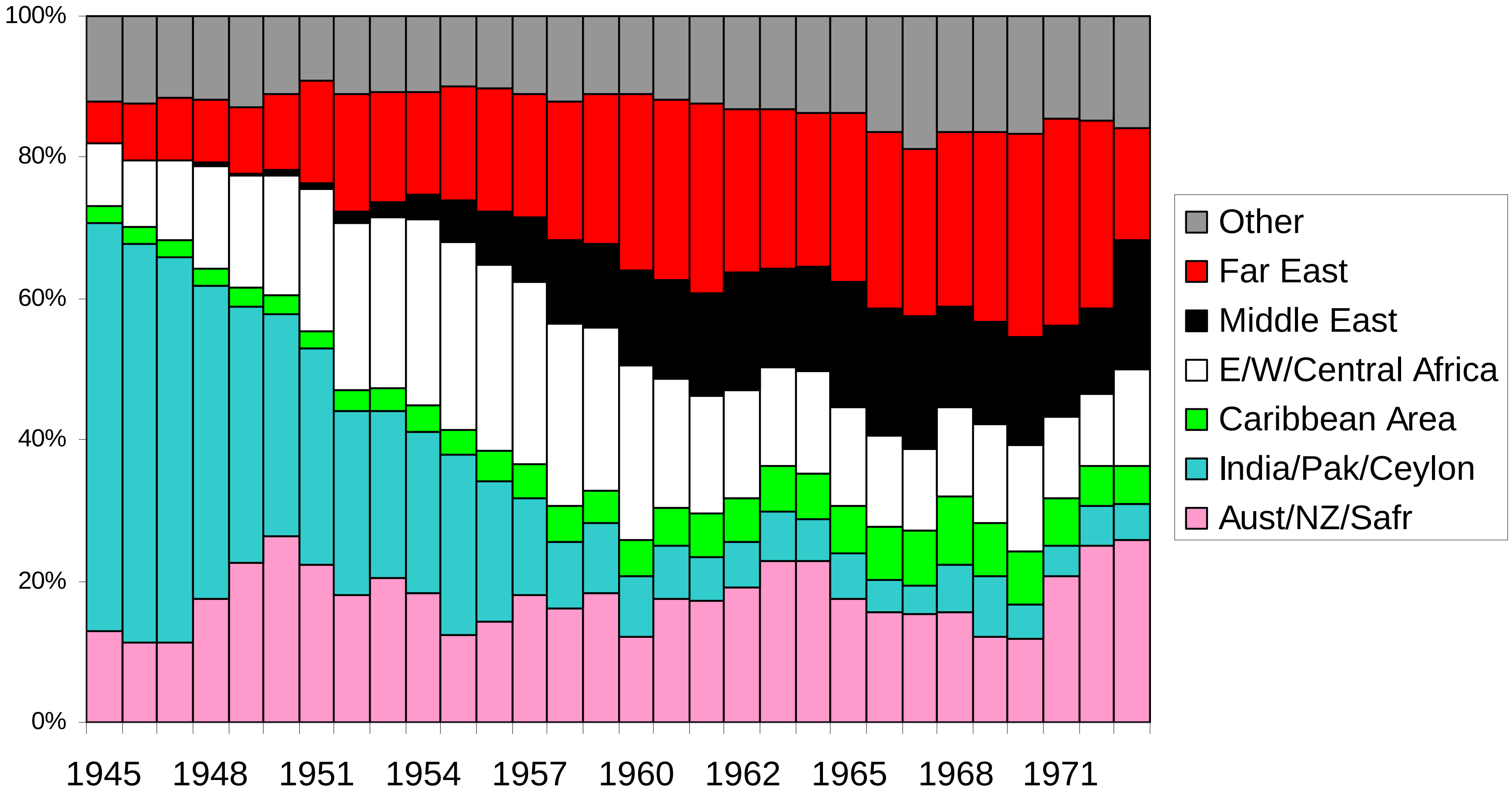


Figure 7 Distribution of OSA Sterling Balances 1945-73



Proportion of sterling in official reserves

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

Sterling remains the primary reserve asset for a range of countries up to devaluation (14.3%) in November 1967

Not explained solely by economic fundamentals: trade and debt diversify quickly away from UK in the 1960s

Hong Kong, Australia, Kuwait are largest holders of sterling by 1968
Nigeria, Kuwait and Saudi Arabia by 1973

Delaying the Tipping Point

- 1958-1967 discussions to reform the global reserves system: supplement or replace national currencies
- Discussions fail:
  - lack of consensus on problem (and therefore the appropriate solution)
  - Europeans unwilling to bail out USA
  - lack of political will by USA to replace USD
  - SDR does not replace national reserve currencies
- BUT: prospect of reform increases the willingness to prop up the existing system

Delaying the Tipping Point for Sterling

- Schemes to convert sterling reserves to longer term assets
  - not attractive to debtor: enforces repayment, shift from many creditors to one institution, negotiation could generate flight from sterling
  - Not attractive to creditor: reduced liquidity of reserve assets
- Multilateral Credit Schemes arranged among Central Banks at BIS
  - Increase UK capacity to defend exchange rate in wake of switch to USD
  - Reduce exchange risk for sterling
  - reduce first mover advantage of shifting to USD
  - Avoids delay/political issues from inter-governmental agreement

Group Arrangements to Support Sterling I

- 1961-1964 Bilateral Concerté: currency swaps for market intervention
  - $1 billion Sept 1964, $3 billion Nov 1964
    (c. $87 billion today)
- First Group Arrangement June 1966-1971
  - $1 billion in 3-mth renewable swaps (c. $18 billion today)
  - Activation specifically triggered by fall in sterling reserves
- Goals: discourage switching (no drawings), minimize impact of switching

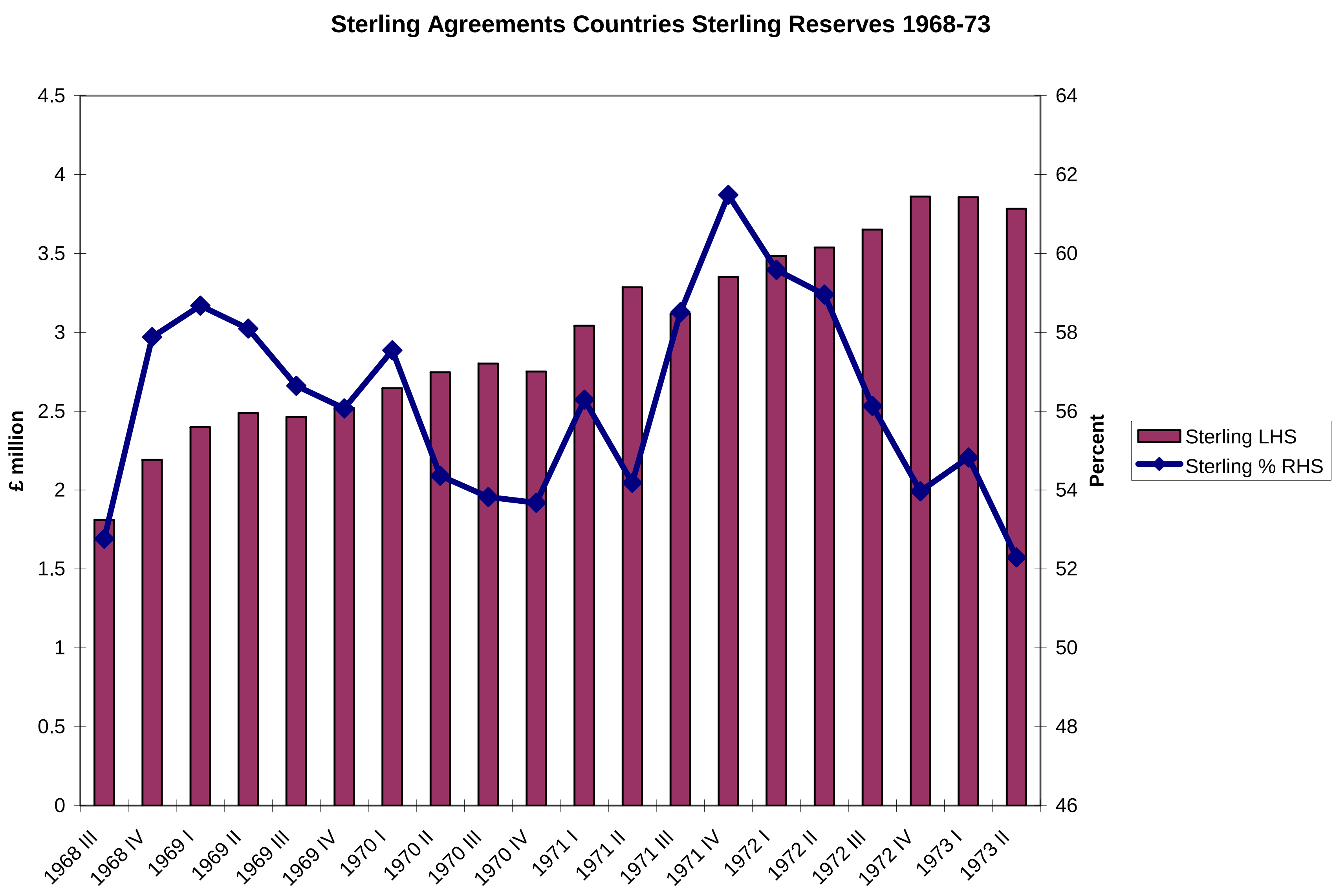
Group Arrangements to Support Sterling II

- Second Group Arrangement 1968
  - Basle Agreement $2b line of credit
  - (c. $32 billion today)
  - Sterling Agreements with 34 states 1968-1974
    - Minimum sterling proportions in reserves
    - USD value guarantee of official reserves against further devaluation of the pound

1968 Sterling Agreements: Minimum Sterling Proportions for Official 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

- * largest sterling holders
- ( ) private side agreements

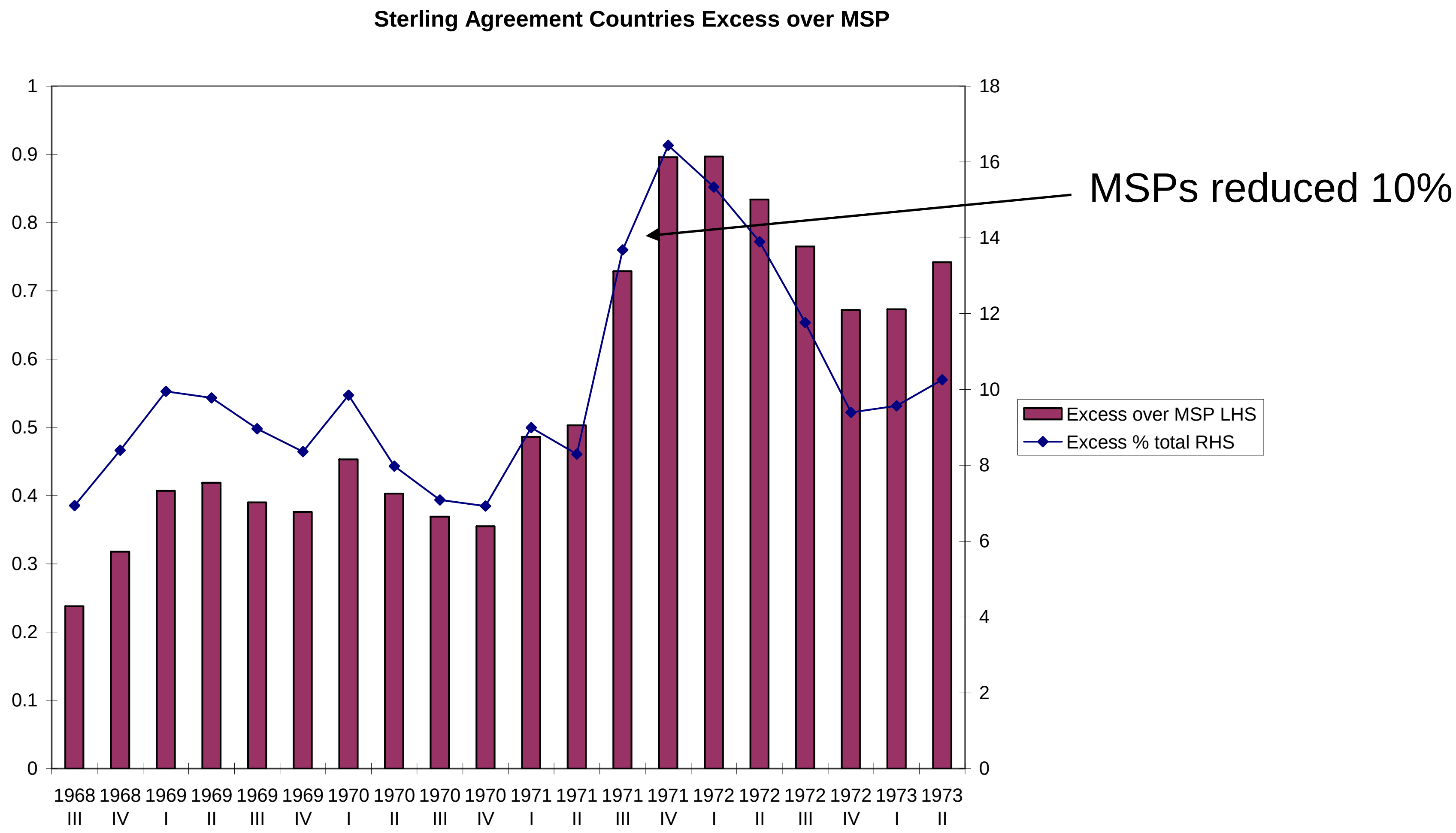

Sterling Agreements Countries Sterling Reserves 1968-73
£ million
Percent
4.5
4
3.5
3
2.5
2
1.5
1
0.5
0
64
62
60
58
56
54
52
50
48
46
1968 III
1968 IV
1969 I
1969 II
1969 III
1969 IV
1970 I
1970 II
1970 III
1970 IV
1971 I
1971 II
1971 III
1971 IV
1972 I
1972 II
1972 III
1972 IV
1973 I
1973 II
Sterling LHS
Sterling % RHS

Share of Sterling in Foreign Exchange Reserves (%)

	Sterling Agreement Countries	All Countries
1968	57.9	20
1969	56.1	17.5
1970	53.7	5.2
1971	61.6	4.5
1972	54.5	4.7

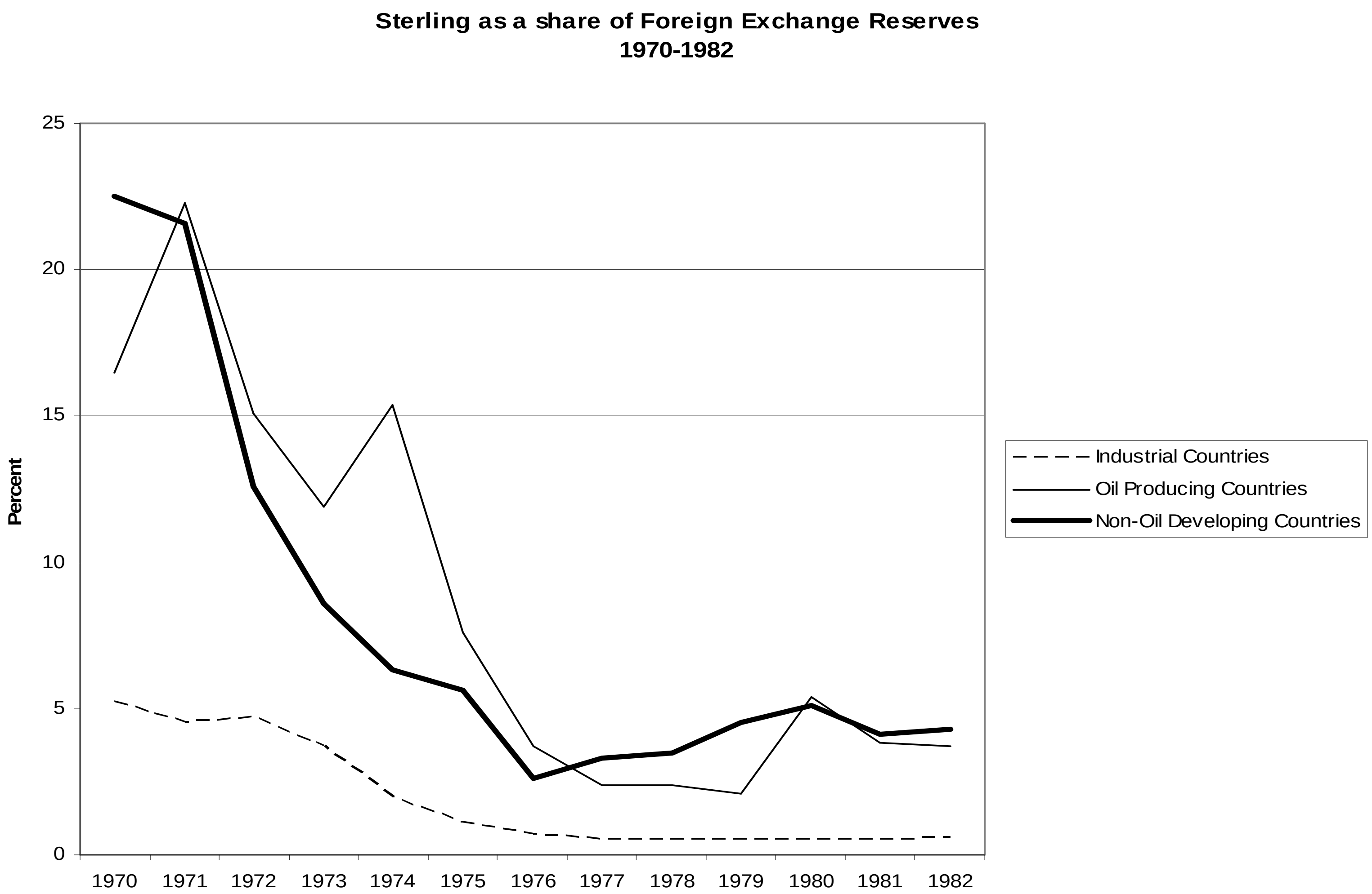
There were two rounds of compensation under the guarantee
October 1972 (costing £58 million)
October 1973 (costing £100 million)

BUT: Were the Sterling Agreements Binding?
Did they sustain sterling's share of these countries' reserves?



On average countries keep 8-10% of reserves in sterling above MSP (£400-£700m) : precautionary to avoid loosing guarantee due to cyclical movements?

Nigeria 6%, India 26%, Australia 3%



Oil Crisis transforms sterling’s reserve role

1975 Nigeria, Saudi Arabia and Kuwait hold 67% of global sterling reserves

Third Group Arrangement 1977

- $2 billion line of credit from central banks
  - activated by fall in sterling reserves ($14b today)
- UK sells $/¥/DM/SwFr denominated 5-10 year bonds in exchange for sterling reserves (total $675m or 15% of sterling reserves)
- Tied to IMF Conditionality
  - US uses safety-net as a carrot for UK to agree IMF terms on domestic credit expansion
  - Witeveen oversight on UK eligibility for credit

Conclusions

- Retreat of sterling more prolonged than usually acknowledged (still over half of the reserves of 34 Sterling Agreement countries in 1973)
- Tipping point delayed
  - In 1950s by continuation of positive market externalities esp. for Middle East and Far East
  - In 1960s by active management (‘public’ externalities)
    - Reduce first mover advantage (risk of depreciation)
    - Exchange guarantees made credible by safety-net credit for UK in case of absolute fall in sterling reserves
- Impact of tipping point reduced
  - Inflation reduces real value of liabilities
  - Oil crisis narrows range of countries holding sterling and offsets diversification elsewhere

Lessons for the USD?

- Experience of sterling should not give comfort to those concerned about avoiding a tipping point for the USD: deliberate support mechanisms, G10 consensus
- Environment conducive to successful switch of Reserve Currencies
  - adjustment through new accumulations rather than switching existing assets
  - mild inflation (reduce real value of liabilities)
  - political consensus builds support to postpone the tipping point: Cold War, G10 (credit through CBs not govts)
  - Weak alternative reserve asset
    - USD weakening, US antipathy to creating an artificial reserve asset