Zombie International Currency: The Pound Sterling 1945-1971

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In the 20th century, international money markets witnessed a major shift: the decline of sterling as the international currency and the rise of the dollar. This paper provides a new view on the decline of sterling after WWII. Earlier contributions such as Eichengreen et al. (2018) and Schenk (2010) argued that after 1945, the pound sterling gradually lost its international status but remained an important reserve currency, especially in the sterling area. The sterling area was a monetary zone built in 1939, covering most of Commonwealth, British Empire, and newly independent colonies who pegged their currency to sterling. Interpretations diverge as to whether sterling area countries, when choosing sterling as their key reserve currency, followed their best interest, or were constrained by exchange controls and moral suasion from the British authorities. In this paper, I demonstrate that from WWII onward, sterling was no serious competitor of the dollar and that the sterling area functioned as a captive market for sterling.

I constructed a new dataset of foreign exchange reserves at country level for both Western Europe central banks and the sterling area from various archival sources. My dataset reveals that Western European countries stopped considering the sterling as a reserve currency shortly after WWII while sterling area countries kept most of their reserves in sterling. I argue that the existence of commercial and exchange controls imposed on the sterling area created high switching-out costs which affected the composition of their reserves. I show that these constraints rendered the composition of the reserves the sterling area members less elastic than European countries' reserves to variations in underlying macroeconomic fundamentals.

I provide a new narrative on the decline of sterling: from 1945, sterling was a zombie international currency as in the aftermath of WWII, the Bank of England was virtually insolvent but sterling was maintained by blocking sterling liabilities. Sterling area members could not freely diversify their foreign exchange reserves as British authorities systematically threatened to apply commercial sanctions and freeze of assets those who would risk doing it without their approval. British authorities used international blackmailing, propaganda and economic sanctions to limit the decline of sterling. The persistence of the international reserve role of sterling within the sterling area benefited mostly Britain and the City of London but represented a significant cost for sterling area countries subjected to the British policy of sedation of sterling holders, through inflation, and devaluations.

1. Data and methods

In this paper, I focus on the reserve role of sterling, studying the decision of central banks to hold their reserves in the form of sterling. This approach is standard in the historical literature on international currencies.[2] I am the first to use it with a panel dataset at annual country-level for the Bretton Woods era. Previous studies of this period relied on aggregated data provided on overall levels of reserves held in sterling in the world or conducted case studies on one or two sterling holders only.

I reconstruct the foreign exchange reserves of nine western European countries[3] using their central banks' archives for the period 1950-1971. Using documentation from the BIS archives, the Bank of England Archives and Her Majesty's Treasury Archives, I also reconstruct the composition of the official reserves of the main sterling holders of the sterling area.

I investigate the motives for the holdings of sterling as international reserve currency using both econometric analysis and historical narratives built from archival research from British, Irish, IMF and BIS archives as well as secondary literature.

2. The use of sterling as reserve currency

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[2] See Eichengreen and Flandreau, 2009
[3] Austria, Belgium, France, Germany, Italy, Norway, Portugal, Switzerland, Spain.

Using the sources described above, I compare the share of sterling within official reserves of the sterling area countries and European countries, as displayed in figure 1.

Figure 1*: Shares of sterling in central banks' reserves (gold + foreign exchange)*

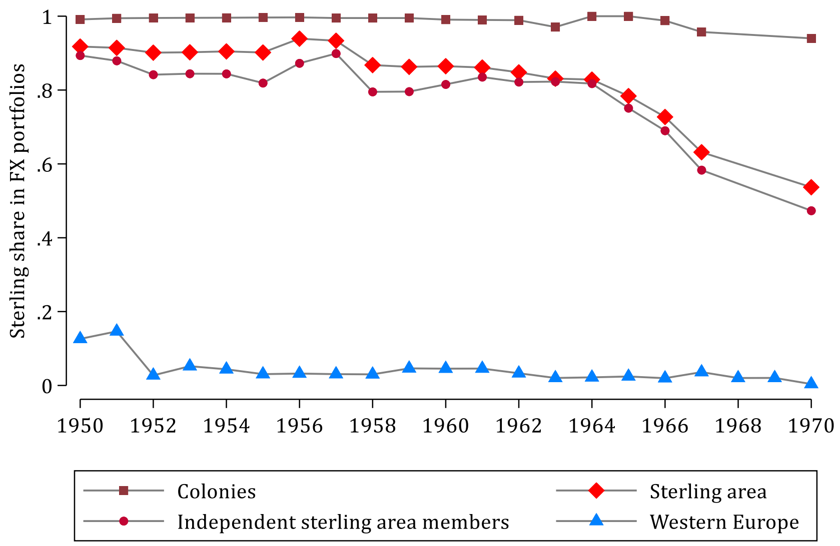

Figure 1 shows that sterling accounted for less than 10% of the reserves of Western European countries as early as 1952, while it accounted for more than 60% of sterling area reserves until 1967. This contrasts with the trend at world level of an ongoing decline in its relative position in the fifties and sixties. In Europe, the shift away from sterling was already completed by the early fifties.

Though less spectacular, the decline also occurred within the sterling area. Whereas sterling represented 90% of reserves at the beginning of my sample, its share decreased by nearly 30 percentage points in just 20 years. Breaking down sterling area reserves between independent members of the sterling area and colonies reveals that the diversification away from sterling occurred only in independent members' portfolios. This suggests that colonies would have divested from sterling too, had they been free to choose. This new data confirms the interpretation of a regional role of sterling as reserve currency in the postwar period.

3. A Zombie International currency

Previous studies on reserve currencies emphasized that the issuers of reserve currency should have strong macroeconomic performances to guarantee the credibility of the issuer country in defending the convertibility of its currency, notably a surplus on the current account of its balance of payments and developed financial markets.

However, the course of the two wars turned Britain from the world's largest creditor into the world's largest debtor. The failure of the successive British governments to maintain a surplus on the current account, notably due to high peacetime levels of defense expenditure, fed multiple sterling crises. The UK ran a persistent trade deficit and its share in World trade went from more than 10% in 1950 to 6.2% in 1970. The London capital market was losing ground compared with US and European financial centers. These indicators point toward low advantages and high risks of holding sterling as a reserve currency. Sterling did not display the fundamental characteristics of an international reserve currency. The low share of sterling observed in European countries' reserves may therefore have reflected UK difficulties.

I investigate the impact bilateral relationships on sterling holdings. I test how sterling membership affects the share of sterling in foreign exchange portfolios. I also test whether the impact of the trade relations on the share of sterling was similar between European countries and sterling area countries. I match my data on foreign exchange holdings with the Historical Bilateral Trade and Gravity Dataset from which I construct a trade intensity index between country *i* and the UK and relative GDP.

$$\begin{aligned}(\pounds share_{i,t}) &= b_1 sterling\ area\ membership_{i,t} + b_2(\ Trade_{i,t}) + \\ & b_3\left(sterling\ area\ membership_{i,t} * (\ Trade_{i,t})\right) + b_4(GDP_{i,t}) + \\ & + b_5\left(sterling\ area\ membership_{i,t} * (GDP_{i,t})\right) + controls_{i,t} + e_i + \epsilon \end{aligned} \quad (1)$$

Table 1 displays the results of such analysis for a panel of 31 countries, 9 European countries and 22 sterling area countries over the period 1954-1971 as sterling was not transferable before 1954. Column 1 reports the baseline panel. Column 2 displays the results for the post-European Payment Union period of 1958-1971, when all European currencies including sterling were convertible. Column 3 shows the estimates for a panel excluding the colonies.

Table 1: Panel regressions on the drivers for sterling holdings.

	(1) With Sterling Area	(2) Post 1957	(3) Independent countries only
trade intensity w/UK	0.05***	0.05***	0.05***
	0.00	0.00	0.01
trade * Sterling area membership	-0.04**	-0.04**	-0.04*
	0.05	0.04	0.07
GDP ratio	0.00	0.01	0.01
	0.94	0.67	0.84
GDP ratio * Sterling area membership	-0.71***	-0.86***	-0.71***
	0.00	0.00	0.00
Sterling area membership	0.76***	0.73***	0.76***
	0.00	0.00	0.00
Controls			
Weighted Distance	Yes	Yes	Yes
Year Fixed effects	Yes	Yes	Yes
Colony	Yes	Yes	No
Adjusted R^2	0.900	0.889	0.878
Observations	379	302	317

*Note: the dependent variable is the share of sterling in reserves of monetary authorities of sterling area countries. A constant is always included but not shown here. All errors are clustered at the country level. The variable controlling for distance measures the population-weighted-great-circle distance, in km. * p<0.1, ** p<0.05, *** p<0.01.*

While the theory of international reserve currency defines trade as a key determinant of reserves holding, sterling holdings in the sterling area members compared to Western Europe countries were less reactive to variations in the intensity of bilateral trade and more to economic development of the holding country. Economic growth was negatively correlated with sterling shares of reserves showing that a growing size of a sterling area country was correlated with a diversification of their reserves. Being a sterling area member had an important impact on the share of sterling, independently of the size of the economy or trade link with the UK, notably due to institutional constraints imposed on the portfolio of sterling area countries. Indeed, the sterling area was not a free market in which one could enter and leave voluntarily but a captive market protected by exchange controls.

4. The sterling area as a captive market

In British policymakers' words, the system worked similarly to Bentham's panopticon, a central authority controlling well-kept ones who would surrender their earnings:

> *At the end of the war therefore, the sterling area consisted of a named list of countries, with a strong exchange control fence around them, who surrendered their currency earnings, pooled their reserves in sterling, had complete freedom for all payments within*

the area and limited convertibility outside; the whole system subject to control at the center.[4]

Members of the area must pool their gold and foreign exchange earnings in London and were not allowed to build up independent reserves in foreign currencies and gold without explicit consent from London. They enjoyed free access to the London market and members of the Commonwealth were granted preferential treatment by the UK.[5] However, investments in the Commonwealth were conditioned to projects that would 'contribute to the improvement of the sterling area's balance of payments with the rest of the world'.[6]

Leaving the Sterling Area implied that capital and exchange control would be imposed on the leaving country. From 1947 to 1972, strong exchange controls between the sterling area and the rest of the world were enforced to conserve UK's gold and foreign currency assets and to protect the UK balance of payments.

British authorities used the institutional framework of the sterling area to systematically threaten countries who showed signs of willingness to reduce their sterling balances and punishing who refused to keep sterling as their main reserve currency.

The three most important cases of departure/exclusion from the sterling area, Egypt (1947), Iraq (1959), and Burma (1966) illustrate the treatment that the British authorities reserved to Leavers. Egypt, who was the second holder of sterling after India, asked for the buildup of a gold reserve amounting to 25% of its currency or a partial release of its blocked sterling balances in 1947. Such demands were qualified as 'completely unacceptable'[7] by the British authorities who then decided that exclusion of Egypt from the sterling area was necessary in order to keep the hand on the rhythm of the liquidation of the Egyptian sterling balances.[8] Egyptians assets in London were thus frozen, which pushed the country in a long foreign exchange crisis.

Iraq chose to leave the sterling area in 1959 because British authorities were refusing any gold or convertibility guarantee to its sterling holdings and were against the constitution of an independent gold and foreign exchange reserves in Iraq. The British Treasury chose not to block the Iraqi balances as confidence in the strength of sterling has been already affected by the Suez crisis. Upon departure, Iraq lost preferential treatment for its imports to the UK and was given to the most favorable treatment accorded to countries outside the sterling area and was imposed exchange controls.

Burma's exit from the sterling area occurred in 1966 but the country had already run down it reserves of sterling during the 1964-65 sterling's crisis. From 1966 onward, they started to ask for gold clauses on international contract to hedge against potential sterling devaluation. British authorities warned that such offending attitude would cause expulsion from the sterling area but the Burmese publicly announced their withdrawal from the sterling area in October 1966 to be able to build independent dollar and gold reserves.

The UK also threatened to exclude India and South-Africa in order to limit the liquidation of sterling holdings but negotiations always succeeded to keep them in the area. From the late 1950s, newly independent countries such as Ghana also considered leaving the area. Treasury officials developed propaganda rhetoric to discourage them, pointing that they would face new exchange control barrier, would lose free flows of private capital, access the London market and would cause a disturbance of confidence for investors and creditors.[9] Large independent countries of the area such as Australia, Ireland and New Zealand found themselves in a sterling trap in the sixties. They understood that it would be rationale to decrease their exposure to sterling but the priority was to guarantee a continued access to the London markets, which implied following closely the sterling area rules and pooling their dollar and gold in London.

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[4] 'The Sterling Area', S.W.P. note, 29 July 1966, BoE Archives, OV44/33.

[5] Bank for International Settlements. 'The Sterling Area', January 1953. Box 671672200, Archives of the Federal Reserve Bank of New York.

[6] 'Commonwealth development; and United Kingdom assistance to the Commonwealth and elsewhere', p.2-7, T.2665-54. BoE Archives, OV44/53.

[7] Secret minute sheet, 20 January 1947. TNA T236/761

[8] Top secret Treasury, OF.36/10/9 'Egypt and the sterling area' T 898-47, TNA T236/767

[9] Letter to D. Rickett "Leaving the Sterling Area" from A.W.Taylor, 27th September 1957. TNA T236/5362

5. Gains and losses of the long life of the Zombie

In 1966, British policymakers were aiming at 'slow[ing] down the erosion [of sterling share of reserves of the sterling area countries] to a manageable pace' i.e. 'the sedation of holders of sterling'[10] to limit sterling crises due to the low level of UK reserves compared to sterling balances. In 1967, sterling devaluated by 14.3% which caused heavy losses on the reserves of sterling area countries. These losses represented on average 1.5% of annual GDP for larger members of the area. After the 1967 devaluation, the UK faced a run on sterling from the sterling area holders. The G10 countries pushed British authorities to offer a guarantee of the US dollar value sterling reserves as long as some minimum sterling proportions bilaterally defined were met. Such agreements called Minimum Sterling Proportion (MSP) were signed in 1968 with all sterling area countries and they succeeded in stopping the run. The MSP agreements worked as a way of 'acceptable freeze' on sterling balances to allow for a continuation of the sterling balances in the sterling area.

Had the sterling balances been liquidated earlier or more rapidly, the Bank of England would not have been able to cope with the inflow of sterling and would have been forced to devaluate the pound sterling. Throughout the Bretton Wood era, The Bank of England was struggling to maintain its reserves. It resorted to window dressing in the sixties[11] and relied heavily on the international assistance provided by the G10. In the words of UK officials, capital and exchange controls aimed at supporting the international use of sterling to 'give [the UK] command of resources' and help them 'remain a first-class power'.[12]

Conclusion

This paper presents a new narrative on the decline of sterling under the Bretton Woods era. The UK did not have the economic fundamentals of an issuer of international currency. Countries who could access alternative foreign exchange reserves, such as Western Europe, held only very limited amounts of sterling. On the contrary, sterling area countries constituted a captive market for sterling, artificially maintained through capital controls and threats of commercial and economic sanctions. The regional role of sterling after WWII was an artificial construction of the British authorities supported by the G10, the unique key international reserve currency of the Bretton Woods era was the US dollar.

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[10] Letter to the chief of overseas, « The Sterling Area. "S.W.P. note of 29 July 1966). 3rd of August 1966, BoE Archives, OV44/33.

[11] See Naef (2020)

[12] Letter to the Deputy Governor, 8 February 1955. BoE Archives, OV44_53.