1 Introduction

The role of sterling and the management (or mismanagement) of its retreat from an international to a national currency has been a central issue in the post-war history of the United Kingdom. Politically as well as economically, sterling's international role has helped to define Britain's place in the world. From the earliest days of post-war western European integration, sterling's place in the global international monetary system distinguished Britain from other European countries. In terms of the 'special relationship' with the United States, the international status of sterling alongside the US dollar created a forum for Anglo-American cooperation and an opportunity for the United Kingdom to exercise strategic influence. In Commonwealth relations, the problems of sterling were an important shared concern that defined the economic dimension of the new Commonwealth and the British Empire after the war. Given Britain's greatly reduced position in the international economy after 1945 and its relatively poor economic performance in the following decades, however, supporting an international currency seemed to many critics to pose an unacceptable burden. In this context, why was sterling's international role as a reserve currency and a commercial currency prolonged for so long? The literature notes that there is considerable inertia in the use of international currencies, but this is not easily explained.[1] Network externalities may delay switching from a currency used by a wide group of traders and states, and this would suggest that a tipping point will arise at some point that will lead to a rapid transformation, but what will prompt this event? The historical process of how states and markets adapt to the erosion of global economic leadership and how the use of international currencies is determined in this context is not clearly

[1] Chinn, M., and J Frankel, *Will the Euro Eventually Surpass the Dollar as Leading International Reserve Currency?*, Working Paper no. 11510 (Cambridge, MA: National Bureau of Economic Research [NBER], 2005) contains a review of the literature. See also Kindleberger, C., *International Money* (London: Allen & Unwin, 1981), and Eichengreen, B., *Sterling's Past, Dollar's Future: Historical Perspectives on Reserve Currency Competition*, Working Paper no. 11336 (Cambridge, MA: NBER, 2005).

Table 1.1 *International currency roles*

Role	Governments	Private	Determinants
Unit of account	Defining exchange rate parity	Denomination of merchandise trade	Stable value, size of issuing country in international trade and payments
Means of payment	Intervention currency in foreign exchange market	Vehicle currency: foreign exchange market	Depth and efficiency of the issuing country's financial markets
Store of value	Denomination of reserves	Denomination of deposits, loans, bonds	Stable value, depth and efficiency of country's financial markets

understood. To understand this phenomenon better we need to move beyond the British economy to examine how sterling's status fitted with the structure of the international monetary system and the commitment of almost all post-war governments to stable exchange rates.

The international role of sterling comprised its use as a reserve asset for other countries and its use commercially both as a unit of account and a settlement currency for international trade and investment.[2] It thus relates to the portfolio choices of both state and private market actors, as shown in table 1.1. This leads to a set of determinants for international currency status, including: the size of the issuing country; its relative importance in global trade and investment; the location of an international financial centre; and confidence in the stability of the currency's value.

The combination of a rapidly growing international economy with the pegged exchange rate system of the post-war decades required central banks to hold significant working reserves of foreign exchange as well as precautionary reserves to defend exchange rate parities. Although gold formed the foundation of the Bretton Woods arrangements and the US dollar's value was defined in terms of a fixed value of gold, as the system developed foreign exchange made up an increasing share of world reserves. In this context, many countries accumulated US dollar assets, but substantial reserves of sterling were also held by central monetary authorities, and many currencies were pegged to sterling rather than to the US dollar until the early 1970s. The denomination of commercial transactions in sterling was related not only to Britain's own trade but to

[2] This typology follows Kenen, P. B., *The Role of the Dollar as an International Currency*, Occasional Paper no. 13 (New York: Group of Thirty, 1983).

the institutions of the City of London, which re-emerged as the centre for many commercial and financial transactions unrelated to Britain's own commerce. Thus the insurance, shipping, commodity trading, banking and investment business located in London encouraged the use of sterling as the unit of account and the currency of settlement in a wide range of global commercial activities. These two functions of reserve and transactions currency are, of course, related through the efficiencies of retaining working reserves in the currency in which most transactions take place, but they are not mutually dependent, and we shall see that the importance of sterling to the activities of the City declined before sterling was able to be retired from its reserve currency status.

Despite profound changes in the way that the international monetary system functioned and a dramatic shift in the United Kingdom's global economic and political position during the decades after the war, there is a striking continuity in the historiographical tradition to the effect that successive governments promoted sterling as an international currency at the expense of national economic interests because of delusions of imperial grandeur right through to the 1970s. In 1954 Day warned that 'to lay emphasis on re-establishing sterling as an international currency … can involve Britain in taking up an excessively large part of the burden of world payments disequilibrium', given Britain's relative economic weakness compared to the United States and the shallowness of international liquidity. For these reasons, he argued that 'serious doubt should be thrown on the desirability of re-establishing the position of sterling as an international currency' in the 1950s.[3] The Suez Crisis of 1956 forced a reassessment of the United Kingdom's strategic power, after which the status of sterling became closely linked with the perception that British governments had overreached the limits of their global influence, with disastrous results. In 1958 Shonfield wrote a vigorous and influential criticism of British economic policy, asserting that 'there is no doubt that the Government has allowed its domestic policy since 1955 to be determined largely by the movement in international confidence in the pound sterling', which he judged 'tragic and absurd'.[4] The promotion of sterling's international role was 'an extraordinarily hazardous venture' that made the economy vulnerable to speculative exchange crises, necessitating damaging 'crisis measures of restriction' on the domestic economy.[5] Additionally, the sterling area system on which the international role of sterling depended caused a drain of scarce capital

[3] Day, A. C. L., *The Future of Sterling* (Oxford: Clarendon Press, 1954), pp. 8–10.
[4] Shonfield, A., *British Economic Policy since the War* (London: Penguin, 1958), p. 218.
[5] Ibid., p. 151.

from home industry. For Shonfield, sterling policy, along with excessive overseas military spending, was evidence of a costly failure on the part of the Conservative government between 1951 and 1957 to grasp Britain's true (reduced) international position.

In 1971 Strange reiterated many of Shonfield's arguments in her critique of the Labour government's sterling policy in the 1960s. Like Shonfield, she related the promotion of sterling as an international currency to misguided efforts to prolong the United Kingdom's great power status from the late nineteenth century, stressing that 'it has been the misfortune of British policy since the Second World War to have inherited from this distant imperial hey-day, associated ideas which no longer apply to Britain's changed situation, but have nevertheless proved remarkably hard to shed or modify'.[6] In an article published the same year as her seminal book she blamed the decline of Britain's economic power on successive governments 'clinging to traditional roles outside Europe, as world policeman and as universal financial uncle, and for putting before other considerations and objectives the prestige of sterling and the solidarity of the sterling area as the main prop of the commonwealth system'.[7] The inducements necessary to encourage countries to hold sterling had become a burden on the British economy through defence spending, high interest rates and excessive outward flows of investment. This interpretation of UK sterling policy has become entrenched in the post-war economic history of Britain.[8] For example, James repeats Strange's view of sterling policy as 'a British attempt to reassert the nineteenth-century role of world banker that it could in reality no longer afford'.[9] Cain and Hopkins describe the British authorities as 'intent upon restoring sterling to its rightful position in the world' and say that 'international economic policy [in the 1950s] was largely decided by gentlemen who clearly believed that re-establishing sterling internationally was more important' than export competitiveness or the fate of the empire.[10] Sir Alec Cairncross, a senior Treasury official during the 1960s and 1970s, is one of the few historians to emphasise the external constraints on British

[6] Strange, S., *Sterling and British Policy: A Political Study of an International Currency in Decline* (Oxford: Oxford University Press, 1971), p. 47.

[7] Strange, S., 'Sterling and British policy: a political view', *International Affairs*, 47(2), 1971, pp. 302–15, p. 304.

[8] Alford, B., *Britain in the World Economy since 1880* (London: Longman, 1996); Burk, K., 'Introduction', in K. Burk (ed.), *The British Isles since 1945* (Oxford: Oxford University Press, 2003), pp. 1–17, p. 6.

[9] James, H., *International Monetary Cooperation since Bretton Woods* (Oxford: Oxford University Press, 1996), p. 100.

[10] Cain, P., and A. J. Hopkins, *British Imperialism: Crisis and Reconstruction 1914–1990* (London: Longman, 1993), p. 274.

policy options, observing (without elaboration) that 'sterling remained a reserve currency largely because Britain was in no position to liquidate the balances in which other countries' reserves were held'.[11]

Whether or not sterling policy drained the domestic economy of vigour is not the main focus of this book. I have argued elsewhere that this case is overstated for the 1950s; investment in the sterling area was more a trickle than a flood, short-term sterling liabilities were not very liquid and the sterling area was not a safe market that postponed innovation in uncompetitive British industry.[12] Total net long-term capital flows never exceeded an amount equivalent to 1.6 per cent of gross domestic product (GDP) in the 1950s, and the problem for the British economy was not the amount of investment but the fact that the impact of investment on growth was much weaker than most of the United Kingdom's competitors.[13] Secondly, capital flows to the sterling area were restricted. Until 1952 all overseas investment was subject to the condition that it must promise to assist the UK balance of payments, and until 1954 sterling area governments could float loans only for specific development projects. Access to the London market, however, depended on the appetite for such loans in London (which declined) and the cost of borrowing (which increased). About one-quarter of private UK investment in the sterling area was for oil exploitation, and a significant additional portion was for mining, which promised to deliver scarce raw materials to the British economy.[14] It would be hard to make a case that restricting this category of investment would have benefited British industry. Reddaway has shown that direct investment in the sterling area generated substantial exports (on average £47 for every £100 invested for five years).[15]

Certainly, the pegged exchange rate system of the 1950s and 1960s constrained domestic economic sovereignty; this is the essence of a fixed exchange rate system. That this inflexible system struggled to adapt to the adjustments that were necessary after the end of the Second World War and the transition of global economic power to the United States and then western Europe is also uncontroversial. Rather than looking at the impact of sterling's international role, however, this book focuses on

[11] Cairncross, A., *The British Economy since 1945: Economic Policy and Performance, 1945–1995*, 2nd edn. (Oxford: Blackwell, 1995), p. 320.
[12] Schenk, C. R., *Britain and the Sterling Area: From Devaluation to Convertibility in the 1950s* (London: Routledge, 1994).
[13] Ibid., pp. 98–101.
[14] Ibid., pp. 96–7.
[15] Reddaway, W. B., *Effects of UK Direct Investment Overseas; Final Report* (Cambridge: Cambridge University Press, 1968).

the reasons why sterling persisted as an international currency, outliving the repeated predictions of its imminent demise so that, even in the late 1970s, its use as a reserve currency was still considered a multilateral responsibility that attracted financial support from the United States and western Europe. We need surely to look beyond lingering delusions of imperial grandeur for an explanation, and to view sterling in a wider context than just British policy.

Within the international monetary system, sterling was embedded in broader global and regional economic and political relations, with the result that the options available to UK governments were more complex than is usually acknowledged. Existing studies have noted this wider context, but none has fully integrated these global aspects using archival sources. The evidence suggests the need for a re-examination of the constraints on British policy and a reassessment of the common characterisation of it as an incompetent failure. An earlier devaluation and/or the elimination of sterling as a reserve or transactions currency were not easy solutions to the problem as it had emerged by the 1950s. The advent of a floating exchange rate in the 1970s and 1980s did not deliver the freedom from balance of payments constraints promised by critics of the pegged rate, nor did it rid the exchange rate of its political and economic importance. With simple unilateral fixes beyond the reach of successive governments they undertook a multilateral negotiated approach to sterling's international role.

Rather than cooperation, British governments could have opted unilaterally for a 'Little Britain' solution, defaulting on debt and retreating to national autarky, but there are few who would have proposed this as a realistic alternative.[16] British prosperity depends on international trade, and, in the era of the 'long boom' from 1955 to 1973, opting out of the international economic system would have been costly indeed. Instead, governments sought to internationalise the resolution of the vulnerabilities posed by sterling's use overseas by shifting some of the burden to other countries. They identified the international use of sterling as part of the wider global monetary system in which all major trading states had a vested interest. This strategy did involve a sacrifice in terms of national policy sovereignty, particularly to the International Monetary Fund (IMF) but also in other forums such as the European Economic Community (EEC), but it was clearly a better alternative than the other extreme. To understand the management of sterling's retreat, therefore, it is important to view it in the context of the evolution of the international monetary system in which it operated.

[16] This approach was supported by Tony Benn, for example.

Evolution of the international monetary system

The history of the international economy in the twentieth century can be interpreted in a stylised way through the framework of the Holy Grail of international economics; to achieve the impossible trinity of stable exchange rates, free capital flows and monetary independence.[17] The premise of the trilemma is as follows

(a) To keep exchange rates pegged with free international capital flows, governments must coordinate their economic policies with those of other countries or risk persistent and unsupportable imbalances in the balance of payments.
(b) If pegged exchange rates are abandoned, then countries can pursue independent national policies in an open economy.

In essence, only two out of the three options are sustainable: fixed exchange rates, policy sovereignty, free capital flows.

For the forty years before the First World War the international economy operated under the gold standard, which delivered stable exchange rates and rising volumes of world trade and investment. This is often characterised as the first era of globalisation, although the breadth of international transactions was narrower than during the second era a century later.[18] After the end of the nineteenth century

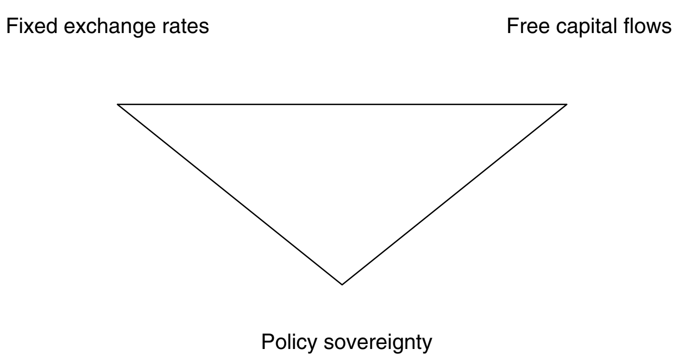

Figure 1.1 Policy trilemma

[17] Obstfeld, M., and A. Taylor, *Global Capital Markets: Integration, Crisis and Growth* (Cambridge: Cambridge University Press, 2004); Obstfeld, M., and K. Rogoff, 'The mirage of fixed exchange rates', *Journal of Economic Perspectives*, 9(4), 1995, pp. 73–96.

[18] Bordo, M., B. Eichengreen and D. Irwin, *Is Globalization Today Really Different than Globalization a Hundred Years Ago?*, Working Paper no. 7159 (Cambridge, MA: NBER, 1999).

and the horrors of the First World War, popular expectations of the government's responsibility for domestic economic affairs increased, and domestic monetary policy sovereignty gained priority. This left the choice between stable exchange rates and free capital flows. The perils of making the wrong choice about international monetary policy were made clear in the attempt to re-establish a fixed exchange rate system through the interwar gold exchange standard. There were a variety of problems with this system that drove it apart, including inappropriate exchange rates that necessitated pro-cyclical contractionary policies in the United Kingdom. War debt and reparations weakened the international financial system, and damaging international short-term capital flows culminated in the international financial crisis of 1931 that heralded the end of the gold standard, widely fluctuating nominal exchange rates and competitive devaluations. The downward spiral of international trade and payments as countries resorted to economic nationalism in an attempt to insulate their domestic economies from this unprecedented international crisis was symptomatic of the Great Depression of the 1930s.

During the Second World War the United States and the United Kingdom together designed a system to avoid a repeat of the failures of the 1919 Versailles peace settlement and the ensuing economic disasters of the interwar period. To this end, they sought to ensure multilateral trade and pegged exchange rates, combined with controls on capital flows to deliver national policy sovereignty. This reflected the contemporary view that the problems of the 1930s were caused by open capital markets that left countries vulnerable to contagion due to fickle and irrational investors with short-term horizons. As well as increasing risk in international trade and payments (thereby inhibiting growth), the consensus was that floating exchange rates undermined international political and economic cohesion by contributing to excessive nationalism. The response of states to the crisis in the 1930s had been to close borders to trade as well as capital, which prolonged and spread the Great Depression. The focus of policy-makers after the war, therefore, was on the multilateral liberalisation of international trade combined with a framework of stable exchange rates policed by the new International Monetary Fund. To this end, the IMF also provided short-term support for temporary disequilibria to give governments the confidence to free up trade and make their currencies convertible for current account transactions at a pegged exchange rate. This solution emphasised the right of states to pursue national policies of expansion to ensure the prosperity of their beleaguered populations. Freedom to invest overseas, particularly in the short term, was considered a small price to pay for the achievement of these cornerstones of growth and international harmony after decades of depression and war.

In the 1950s, therefore, free capital flows were sacrificed in order to gain exchange rate stability and policy sovereignty. The Bretton Woods institutions advocated current account currency convertibility to facilitate multilateral trade, but given the imbalance in the global economy after the war even this could not be achieved until the end of 1958. With the help of US aid, a restocking boom associated with the Korean War, and regional payments systems, national economies eventually recovered and world trade increased in volume. Regional payments solutions replaced the global multilateralism that the Bretton Woods system had been supposed to create. Britain coordinated the sterling area group of countries, which pegged their exchange rates to sterling, held sterling as their main foreign exchange reserve, imposed common exchange control against the rest of the world and enjoyed relatively unfettered capital flows from London.[19] Western European states (including the United Kingdom) devised the European Payments Union (EPU) in 1950, with US support, to allow the multilateral settlement of trade and payments among themselves before full current account convertibility.[20] International economic diplomacy became focused on visible trade, and this yielded spectacular results in the reduction of quantitative restrictions and tariffs, particularly in western Europe with the development of the European Coal and Steel Community (ECSC), and then the EEC in 1957, and also through successive rounds of the General Agreement on Tariffs and Trade (GATT).[21]

Current account convertibility was finally introduced at the end of the 1950s, while capital flows continued to be controlled. As the 1960s progressed, flows of long-term capital were liberalised in recognition of the fact that foreign direct investment (FDI) is conducive to growth and that investment for development is beneficial for the international economy as a whole.[22] This was an era that saw the dramatic expansion of multinational companies (particularly from the United States), prompting concerns in France and some less developed countries (LDCs) about

[19] Schenk, *Britain and the Sterling Area*.

[20] Kaplan, J. J., and G. Schleiminger, *The European Payments Union* (Oxford: Oxford University Press, 1989); Eichengreen, B., *Reconstructing Europe's Trade and Payments: the European Payments Union* (Manchester: Manchester University Press, 1993).

[21] Asbeek Brusse, W., *Tariffs, Trade and European Integration, 1947–1957* (London: Macmillan, 1997); Milward, A. S., *The European Rescue of the Nation State* (London: Routledge, 2000).

[22] The 1960s were designated the first United Nations Development Decade, and the United Nations Conference on Trade and Development (UNCTAD) was founded in 1964.

cultural as well as economic imperialism, but American companies were generally welcomed in their largest target, the United Kingdom.[23] The combination of trade liberalisation and the expansion of long term investment delivered the 'long boom' for industrialised countries. Organisation for Economic Co-operation and Development (OECD) economies grew at an annual average rate of 5.4 per cent from 1958 to 1971. Almost as soon as the fixed exchange rate system devised at Bretton Woods started to work as planned (i.e. with current account convertibility and relatively free trade), however, it began to fall apart. From 1960 the United States and the United Kingdom both began to run persistent current account deficits while West Germany (the Federal Republic) ran surpluses, bringing pegged exchange rates into doubt and drawing currency speculators into a one-sided sure bet.

Meanwhile, financial innovation allowed short-term capital flows to evade the control of regulators, undermining the post-war solution to the trilemma. Although Obstfeld and Taylor use empirical tests on interest rates to conclude that capital controls in the Bretton Woods era were effective in isolating national capital markets, the rise of offshore markets infringed on national policy sovereignty as the decade progressed.[24] The offshore US dollar market (the Eurodollar market) grew rapidly in response to the increasing fragility of the pegged exchange rate system and the chronic imbalance between deficit and surplus countries. Freer capital flows left governments with the remaining choice in the trilemma: between monetary independence or fixed exchange rates. Under the pegged exchange rate system only the United States, as the anchor, could pursue an independent monetary policy, and other countries became increasingly dissatisfied with the sacrifices they had to make to retain their dollar exchange rate. The growing unease with the status quo was intensified by the United States' expensive involvement in the unpopular Vietnam War, which, combined with domestic expansion, contributed to the chronic balance of payments deficit and exported inflationary pressure. Unable to contract the domestic economy for political reasons and unable to control overseas expenditure for strategic reasons, the Americans restricted outflows of long- and short-term capital, relying on the offshore dollar market to meet the capital needs of US multinational corporations (MNCs) abroad. The tension between surplus and deficit countries eventually provoked a crisis, in which stable exchange rates between the United States and western Europe were sacrificed so

[23] The annual flow rose from \$3 billion in 1960 to \$7.6 billion in 1970.
[24] Obstfeld and Taylor, *Global Capital Markets*, ch. 5.