ESSAYS IN INTERNATIONAL FINANCE

No. 17, September 1953

PROBLEMS OF THE STERLING AREA

WITH SPECIAL REFERENCE TO AUSTRALIA

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INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS AND SOCIAL INSTITUTIONS

PRINCETON UNIVERSITY

Princeton, New Jersey

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I. INTRODUCTION

IN the latter stages of the 1939-45 war, when policies were being evolved for a united world operating through a new and grand conception of a United Nations and its agencies, plans for cooperative action on the economic front, in international finance and trade, were discussed with much fervour and hope. The world economy was to make a fresh start, comradeship in the many and varied arts of peace were to supplant comradeship in war, and even the vanquished were to find a place eventually in the new dispensation. Many of us were engaged in international discussions designed to produce a blue-print for the new order. We were aware of the obstacles, or at least of some of the more important—such as the disparity between the dollar and non-dollar countries, the development of the new nations that were to emerge from the conflict, the shortages of capital and the alteration in the main sources of supply, the difficulties of abandoning the autarchic practices inevitable in war, the vast problem of relief and rehabilitation. On this last problem, and on it alone, the fine fervour of cooperation in war was carried over into the peace, but even this was abandoned in 1946 as the conflict between the communist and non-communist worlds began to dominate the international situation. With the death of UNRRA, the high hopes of a world economy, taking shape on the lines of the wartime plans, had finally to be abandoned, and the economic divisions in the western world began to emerge.

Some day perhaps these massive forces will be seen in their correct perspective. One may express the opinion that the early termination of UNRRA was the first decisive move in a series of developments that were to divide rather than unite the world economy; indeed, it may be said that it was at this stage, the end of 1946, that the pattern of the post-war economy with its new groupings began to emerge, and that the onus was on individual nations to make their decisions, in so far as they were able, as to the group to which they would belong.

II. A DEFENSIVE MECHANISM

It was in this atmosphere that the sterling area began to emerge as one of the major features of the post-war economy. Fifty years earlier, the idea of a "sterling area" would have been regarded as a *reductio ad absurdum.* Sterling was the world currency, London the main source of capital supply for the whole world, and the Bank of England the most influential single institution in the world economy. Two wars, a depression, the emergence of the welfare state, the increasing devotion to control for positive ends and to restriction as a short term solution of long term problems, and finally the rise of the United States as by far the most powerful economic unit in the western world, quickly altered the position of sterling, of London as a source of capital, and of the controlling mechanism that could be operated through the Bank of England and the London money market. The sterling area was the response of the United Kingdom to the series of changes in the world economic situation that commenced with World War I and are still in progress. Just as nature abhors a vacuum, so in the course of economic evolution there are few, if any, complete breaks with the past. It is easy to trace the development of the sterling area from the end of the 1914-18 war, at first slowly and perhaps without conscious purpose, but later under the impetus of a definite plan to retain as wide an advantage for sterling as the circumstances permitted. We see it, for example, in the privileged position of trustee stocks in the London money market in the twenties, in the association of emigration and capital movements, in the hesitant expression of Imperial Preference in 1923, in the steady pressure of most Dominions for favoured treatment in finance and trade in the United Kingdom and the growth of a school of thought there favouring this course, in the circumstances attending Britain's abandonment of the gold standard in 1931, and finally, and most clearly at this stage, in the protective measures taken at the Ottawa Conference in 1932. With the malaise of the thirties these tendencies were strengthened, and with the burden of World War II it was but a short step to the control of capital movements, the blocking of currencies, restrictions on dollar purchases and limitations on international transfers of currencies.

Thus the sterling area emerged largely as a defensive mechanism, and its history since the end of the war suggests that by and large it has been driven from one defensive position to another. It is well to bear this evolution of the sterling area in mind in reflecting on how membership in it affects an overseas country like Australia with a largely dependent economy, and in setting out the considerations that led Australia to adhere willingly to the sterling area and its practices.

It may be argued that Australia had in fact no choice. That would be true only if we assume that its economic policy in the post-war period was a given and fixed force that the country was powerless to alter, and that this, combined with a devotion to the maintenance of the closest association with the United Kingdom, set the course. In these circumstances, an independent line of action leading to a freely convertible currency, to the abandonment of trade restrictions, to free movement of capital (and especially to an adequate supply from abroad) was not a practicable objective. I think it would be more correct to say that it was never seriously considered as a possible course, that officially, and to a large extent in non-official circles, the dollar gap, the need for trade restrictions, the desire to avoid overseas capital commitments and the fear of an unstable dollar area were the over-riding considerations. The alternative course was not seriously pondered, nor was there a penetrating analysis of the logical consequences of taking the course that actually was followed. It was not perhaps realized that it was the line of least resistance, in part making virtue of necessity whilst sticking to the traditional path and obtaining the greatest relief in the shortest period.

Whether this would be true of the other members of the sterling area I am in no position to say, and I have no doubt that the views I have expressed on the Australian position will be controverted. It would be wrong, however, for the critics to assume that, in putting the problem as I have, I am unmindful of the advantages that accrued to Australia from membership in the sterling area. That Australia believed there were substantial advantages is not open to question, and I shall deal with this aspect of the problem later. It need only be said at this stage that membership offered to Australia the opportunity of proceeding on a somewhat progressive and advanced economic policy, without undue embarrassment from the impact of world economic forces, whilst at the same time sustaining quite a high level of economic expansion. Thus in the short run, and as an answer to the special problems of changing over from a war to a peace economy, of implementing a somewhat ambitious social policy, and of embarking on a heavy investment programme both public and private, membership in the sterling area offered great attractions. Not all of these considerations would apply to other members, of whom some no doubt were influenced by their holdings of sterling, and some by long standing association in trade and finance with the United Kingdom.

The sterling area today consists of the members of the Commonwealth (other than Canada) together with Ireland, Iceland, Burma, Iraq, Jordan and Libya, and of course all the British colonies which would be included in the generic term Commonwealth. Canada alone among the members of the Commonwealth chose to take an independent course, and to go the hard way of working towards freedom from restrictions and free convertibility of her currency. These decisions were taken in 1946 at a time when the striking developments in new resources and in investment, that were to follow, could not have been foreseen, and it remains an open question how far Canada would have been along the road to her goal had fortune not been so kind. But it was a deliberate choice, and no one doubts that the goal would have been reached sooner or later. It involved for Canada the blending of internal social and economic policy with the maintenance of a cost structure competitive with the world outside. The substantial measures taken by Canada in the post-war period to promote social justice and provide social services were fitted into a policy designed to restore the largest possible measure of economic freedom and the highest degree of productivity. This is a point that must not be overlooked. A British Prime Minister was responsible for enunciating the now well established principle that self government is to be preferred to good government, and many countries may argue that the pursuit of social justice is to be preferred to economic freedom and high productivity. At least those who chose the sheltered path offered in the sterling area would plead this in extenuation, and perhaps in the short run they might be able to make a case. It may be doubted whether it would be true of the long run and, after all, the pursuit of high productivity and economic freedom is not inconsistent with the promotion of social justice, and may well lead to a higher level of social justice because of the higher standard of living.

III. THE SUPPLY OF CAPITAL

If we pause to look at the developments that have already taken place within the sterling area, we may find justification for this point of view. In the first place, the sterling area can no longer provide the capital it needs for development. The United Kingdom is not able, as it was in the halcyon days, to provide capital in full and sufficient quantity at low rates of interest. As far as Australia was concerned, this was not regarded as a serious matter in the immediate post-war period. From 1931 to the end of the war Australia had been paying off external debt, the total amount so redeemed being nearly £A200 million.* Australia was anxious to avoid a renewal of heavy commitments for external debt and interest payments, the experience of 1930-33 being still too fresh in mind. By 1950 external interest payments,

* Throughout this essay £ refers to pounds sterling and £A to Australian pounds. The present official rates of exchange are £1=$2.80 and £A1=$2.24.

as a percentage of Australian exports, had fallen to nearly 5% compared with over 20% at the close of the twenties, and a much higher figure during the period of actual difficulty in the depression of the early thirties. Moreover, at the end of the war and for a period of some five years thereafter, there was an active movement of capital from the United Kingdom to Australia, some £500 million in all going into investment opportunities or being transferred temporarily in the belief that the Australian pound was bound to appreciate, perhaps to the extent of being brought back to parity with sterling. This large inflow of capital gave the money market great buoyancy, eased the balance of payments and enabled Australia to proceed with a rapid rate of development without, as in the old days, having to make a conscious effort to borrow overseas. But it was a temporary phase, and the inflow of capital was to be reversed in 1951, when it was seen that the Australian pound would not be appreciated, and when the heavy rate of importing caused a rapid drain on London funds despite the record price of wool. From June 1951 to June 1952 London funds fell from nearly £A850 million to a little more than £A350 million, by far the largest yearly drain on Australia's overseas reserves ever experienced.

Meanwhile, it had become clear to the government, and to unofficial circles concerned with high financial policy, that the rate of development contemplated by Australia could not be sustained without some regular inflow of capital for investment. Australia, in common with Canada and other countries, had ambitious post-war development plans involving heavy immigration. Indeed, the Australian immigration plans, relative to the size of the existing population, are by far the most ambitious of any undertaken by the newer countries with scope for migration. From 1947 to 1952 Australia experienced a total annual growth of population of 250,000, or 3%. This is a high rate of growth on any standards but, with the capital equipment required for industry, agriculture, transport, power and social amenities, under modern conditions of high technical and living standards, it involves a rate of investment of about 30% of gross national product. Obviously, this cannot be obtained from local savings, not even if heavy taxation is levied to provide a considerable ingredient of public investment from government revenue.

In practice the Commonwealth Government has in recent years financed, from revenue, capital works to the extent of approximately £A100 million per year. Additional capital from abroad was thus essential if the high rates of development and immigration were to be sustained. This became apparent in the middle of 1950 when the first approach was made to the International Bank for Reconstruction and

Development, and an amount of $50 million obtained for each of the next two years. It was clear that, as a regular source of capital for development on the scale required, the resources of the sterling area were not sufficient. This is the experience of other countries in the sterling area which have problems of development demanding capital resources. It is highly likely that the deficiencies of the sterling area as a source of capital will become more pronounced because higher living standards, and devotion within the area to the welfare state, will slow down the rate of saving, while the demands of the members of the sterling area for capital for development are likely to expand. So, on this vital front, it would appear that the sterling area is fighting a losing battle, and that some at least of its members must contemplate a financial association outside the area by which their capital needs may be satisfied. It is not necessary to dwell on the significance of this for the future of the area. Either the rate of development must be slowed down, or special arrangements made to obtain supplies of capital outside the sterling area—that is, from the dollar area.

I discussed this problem in 1950 and suggested then that the Commonwealth countries as a whole should agree upon their capital needs for the maximum rate of development required, decide how much collectively and individually could be provided from the sterling area itself, and how much would be needed from the dollar area.* Since the last mentioned funds would be required for development and long term investment, the transaction could be regarded as a sound financial transaction, providing a suitable opportunity of resuming the pre-war or nineteenth century practice of export of capital, without which it is not possible for the world economy to work efficiently. There were some obvious obstacles in the way of such a proposal. There was naturally some official reticence to proceed boldly on the assumption that London could no longer supply sufficient capital and that some regular arrangement with the dollar area would be necessary. The members of the Commonwealth were themselves hardly agreed individually, still less collectively, on the need for it, while neither the money market in the United States nor Congress was altogether prepared for what was then an unusual transaction. Since then, however, the climate has changed and it is admitted that both short and long term capital from outside the area is essential if sterling is to be strengthened and if the rate of economic development is to be sustained. In these circumstances the slogan "Trade, not Aid" was hardly the most tactful way of expressing the difficulties facing the Commonwealth and the sterling area, or of pointing the way out.

* *Foreign Affairs*, July, 1950. This has been reprinted in my essays *Expansion and Inflation* (Melbourne: Cheshire, 1951).

IV. CHANGES IN THE TRADE PATTERN

This problem of capital supply is perhaps the most significant factor affecting the structure of the sterling area and the enduring contribution it can make to the fortunes of its members and to the working of the world economy as a whole. But we have also to consider the relationship to the world economy of the economy of the area as a whole, and of those of its individual members. In this respect one of the most significant developments is the change in the proportion of trade enjoyed by the members of the area within the markets of the area itself. In the comparison that follows I take the pre-war period and 1950, because 1950 was clear of the great impact of higher prices for commodities of international commerce and was unaffected by the restrictions that had to be imposed early in 1952. On this basis, it is found that exports from the United Kingdom to overseas members of the sterling area have risen from about 48% of total United Kingdom exports to 55%. The market for British exports, presumably manufactured and engineering products, was more favourable in the sterling area than in the outer world. This would be quite natural for a number of reasons—some of the members of the sterling area had accumulated sterling for the purchase of United Kingdom goods; all members preferred purchasing within the sterling area to incurring dollar obligations; the general restriction on dollar imports was strengthened in 1949 to deal with the crisis in the sterling balances of that year; and in many sterling area countries preferences and trade practices favoured British goods as against foreign goods. For all these reasons the markets in the sterling area were weighted in favour of the United Kingdom. To this must be added the fact that the markets of the overseas members of the sterling area were buoyant, partly because of the rising prices of the foodstuffs and raw materials produced by the countries concerned, and partly because their rate of development was high. On the whole, Britain lost little by close trade ties with the members of the sterling area; it is likely that on balance there was a gain, and this may well have become more pronounced as the ex-enemy countries, Germany and Japan, came into the market, and the general condition of shortages gave way to a more easy state of supply.

What was the situation with regard to the exports of the overseas members to the United Kingdom market? As a whole, the proportion of their exports going to the United Kingdom declined considerably. Table I below illustrates the point.

Canada is a special case, as she is not a member of the sterling area. A decline in her exports to the United Kingdom was to be expected under conditions in which dollars were hard to acquire. But for all

TABLE I

EXPORTS OF OVERSEAS MEMBERS TO UNITED KINGDOM

(As percentage of total value of exports)

	1937	*1950*
Australia	50	39
New Zealand	76	66
India	33	22
Pakistan		17
Ceylon	46	24
South Africa	38	26
Canada	40	15

the other Commonwealth countries, themselves members of the sterling area, the movement is too significant to be ignored. If this condition is maintained, it is clear that the relative importance of the United Kingdom market has declined since the war. But this is precisely what one would expect to happen, and it is a trend that may well continue in the years ahead. For one thing, in the post-war world there has been a more wide-spread, as well as a greater, demand for defence supplies probably than at any other time in peace. This could not but affect the trade of the overseas members of the sterling area who produce a wide range of the basic materials used in defence supplies. Then there is the general tendency, especially in the United States, for the demand for raw materials to outstrip supplies on present capacity to produce. The output of the American economy is expanding at the rate of some 2½% per annum, and at this rate the gross product of the economy will double in less than 30 years. Such a contingency would involve a very heavy increase in the American demand for raw materials—in some cases a more than proportionate increase. Indeed, the prospect of the American economy becoming increasingly dependent on overseas supplies of materials is one of the most significant features of the post-war economy, as well as one of the most encouraging. The Paley Report has brought the main facts into prominence, but it may be doubted whether public opinion and official policy have yet caught up with the inevitable trend of events. Equally true is it that the spectre of the dollar problem, that for too long after the war dominated thought and action in some sterling area countries, including Australia, tended to obscure this more significant and hopeful factor. It is, as it were, a double edged weapon in that it requires the United States not only to lay out more dollars for essential supplies, but also to sustain development loans or to supply finance in some form, so that the output of these essential supplies will keep pace with the demand. It is not merely that the United States will demand more and more of certain materials of which she is in short supply. The countries that will have to step up their production, and the overseas members of the sterling area play an important part here, will also be demanding increased quantities of capital equipment during the gestation period in which they are expanding their output of basic materials. So, on this basis, there is some hope of an expanding world economy; the underlying economic forces are working mostly in the right direction, though they often have to contend with strongly entrenched lobbies that will endeavour to set back the normal course of events. To assume, as too many do in the face of what we must admit is pretty strong evidence, that the lobbies will win, is to accept defeat before the event. For the overseas members of the sterling area, this whole development of a stronger market outside the area for basic materials is a matter of great moment, and must affect, almost as much as does the problem of capital supply, the structure and development of the sterling area. The overseas members of the area will continue to expand their production of manufactured goods and to build up their transport systems and power supplies, but their principal source of development and wealth in the next two decades will be in exporting certain basic materials and foodstuffs which we have seen are likely to be demanded in increasing quantities. The members of the sterling area can supply largely increased amounts of such goods as rubber, tin, burlap and jute, wool, diamonds, hides and skins, cocoa, tea, spices, uranium, tobacco and perhaps oil. But this in turn depends upon satisfactory plans for expanding production; so the problem of capital supply and the problem of trade converge on the same point, namely a closer association than was contemplated in the years immediately following the war between the members of the sterling area, collectively or individually, and the dollar area.

V. RESTRICTIONS AND SOCIAL POLICY

So far, I have concentrated rather on long term problems of the sterling area, and the prospects it offers its overseas members with respect to capital supply, development and trade. A close liaison between the area as a whole and the dollar area, with the clearly defined object of working towards convertibility of sterling into dollars, would have enabled the members of the sterling area to obtain the short term benefits offered by the area to their attenuated post-war economies, whilst avoiding policies that might interfere with the rate of development and the expansion of trade.

The short term benefits of membership of the sterling area were