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THE REFORM OF STERLING

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PRINCETON UNIVERSITY
Princeton, New Jersey

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THE REFORM OF STERLING

What is the future of sterling? At present the pound is a great international currency—not so great as it used to be perhaps, but still second only to the dollar. At the level of private international transactions it functions globally as a vehicle, or trading, currency. At least a fifth of world trade is still invoiced and settled in sterling; in addition, a considerable amount of private wealth is still held in the form of sterling assets in London. The pound also functions as a reserve currency. However, at this level of international transactions its status is now largely regional rather than global. Since the Second World War the use of sterling as an official intervention and reserve medium has been confined almost entirely to the countries of the sterling area.

Should sterling be reformed—and if so, then to what extent and by what means? Should the pound continue to function as international money at both the private and official levels of international transactions, or should one or both of these roles be eliminated? Should the currency serve on a global scale or a regional scale? Should reform be unilateral or multilateral? These are the questions we shall be concerned with in the present essay. Our approach will be frankly national rather than cosmopolitan. The problem will be treated as an exercise in foreign economic policy. The desirability of any reform will be considered strictly from the point of view of the national interest of the United Kingdom itself.

From this point of view, many observers conclude that reform would in fact be desirable: for Britain, the costs of the pound's international functions are presumed to outweigh by far any benefits that may still happen to be accruing to the country. Benefits consist essentially of the sterling-related earnings of the City of London and of overseas investments. Costs include not only the payment of interest on the enormous "overhang" of sterling liabilities to foreigners; more importantly, they also include the constraint imposed by that overhang on the nature and timing of domestic full-employment policies. Accordingly, many alternative reforms have been proposed over the years by all kinds of experts. Yet for all the wealth of ideas expressed, there has been remarkably little consensus of judgment. If all the experts on sterling were laid end-to-end, they would still not reach agreement.

Proposals for the reform of sterling divide basically into two classes, according to whether or not it is thought that the currency should cease once and for all to serve as international money. One class of proposals

would terminate all of the international roles of the pound once and for all. It would be "domesticated": henceforth, it would serve only national monetary functions; it would survive only as purely domestic money. The other class of proposals would merely modify the pound's international roles. Proposals to "domesticate" sterling will be considered in the first section of this essay. Less dramatic reforms will be taken up in the following two sections. A brief final section will summarize the conclusions of the analysis.

I. THE END OF STERLING?

A Variety of Proposals

Should sterling be domesticated? Should it cease to serve altogether as international money? That is the common objective of a wide variety of reforms proposed over the years from all points of the spectrum of professional opinion. It is the objective, for instance, of schemes projected from time to time to fund the sterling balances by means of a long-term loan from, variously, the United States, the countries of the European Economic Community (EEC), the Group of Ten, the membership of the Organisation for Economic Co-operation and Development (OECD), the Commonwealth countries or sterling area, or the International Monetary Fund. Equally, it is the objective of schemes sometimes proposed which would integrate the British currency with some others, usually either with the American dollar or with the Common Market currencies. In either event, sterling holdings would be replaced by an alternative asset-reserve medium, and the pound presumably would no longer be used for any international purposes. Britain would be left with a consolidated long-term liability in place of the present mass of short-term debts.

Likewise, sterling could be domesticated in conjunction with a worldwide increase of the official price of gold. If the revaluation of gold were great enough, the United Kingdom could use its own windfall profits, plus some of the profits of others, to liquidate all outstanding sterling balances. Or it could switch to a floating rate for the pound, and in this way discourage the use of the currency for international purposes. Reform along either of these lines has frequently been proposed. Alternatively, the British might simply default on their obligations, by repudiating or confiscating the overhang of short-term liabilities. Action along these lines has not been seriously suggested. Still, it is a weapon that everyone recognizes the British could be forced to use *in extremis*. It would certainly ensure the end of sterling as an international currency.

The relative merits of these alternative reforms will be discussed at

length in the remainder of the present section. My position will be agnostic. I shall argue that none of the reforms can be seriously recommended as a genuine policy option for Britain. So far as the British are concerned, sterling *cannot* be fully domesticated. It may be quite desirable to *modify* the international roles of the pound; that we shall see in the next two sections. But it does not seem advantageous to try to *terminate* them altogether. The United Kingdom will be better off if sterling continues to serve as international money in some form.

The defect of these various reform proposals is that, basically, they are all quite unrealistic. If Britain is to wind up its international-currency business, someone must pay the cost of liquidation—either the British themselves or someone else. Schemes to fund the sterling balances, or to integrate the pound with some other currency, anticipate that the British would bear most of the burden. But given the size of outstanding balances, this, I submit, is an unrealistic expectation. Over the relevant time horizon the cost to Britain would actually be greater than the current cost of sterling as an international currency. It is not in the country's interest to press for reform along these lines.

Of course, the British would be happy to have someone else pay the cost of liquidation, if it could be arranged. This helps to explain the interest often aroused in the United Kingdom for proposals for gold revaluation, or a floating rate for the pound, or even default on the sterling balances. But these alternatives too, I submit, are unrealistic under current political and economic circumstances. The illusion that others can be made to pay is spurious; and besides, these proposals all have other critical deficiencies which seriously diminish their attractiveness as genuine policy options. In the real world, they are all nonstarters.

Funding the Sterling Balances

Proposals to fund the sterling balances began in 1945—almost as soon as the balances themselves came into existence as a result of Britain's overseas wartime expenditures. In the quarter century since, all kinds of variations on this theme have been played. One is the International Monetary Fund (IMF) variation: the balances would be taken over by the Fund in exchange for its own gold-guaranteed liabilities; and Britain would be left with a single consolidated long-term debt to be repaid gradually over a fixed period to maturity. This was the proposal, for instance, of Alan Day in his evidence submitted to the Radcliffe Committee in 1958; and in its *Report* a year later the Committee itself indicated qualified approval of the suggestion. Robert Triffin advocated IMF funding in his *Gold and the Dollar Crisis* (1960). In 1965 the idea received official support from the Italian Finance Minister at the annual

meeting of the International Monetary Fund. In 1968 it was advocated by a subcommittee of the United States Congress.

Alternatively, the sterling balances could be funded by a gold and dollar loan from other industrialized countries—from, say, the Group of Ten or the membership of the OECD. The loan could be arranged either directly or through the Bank for International Settlements. This variation was also mentioned by the Italian Finance Minister in 1965. A third variation was mentioned parenthetically by Professor Day—a long-term loan arranged on a European-Commonwealth basis. Sterling balances would be exchanged for the liabilities of a European-Commonwealth bank created expressly for this purpose. A fourth variation might be a loan arranged on a purely Commonwealth (or purely sterling-area) basis.

Proposals to integrate sterling with other currency systems are more recent in origin, beginning really just in the early 1960s, following Britain's first application to join the European Economic Community. Here, according to some observers, was an unparalleled opportunity for the United Kingdom, with help, to wind up its unilateral role in the international-currency business. Somehow the Six would be persuaded to cooperate in the liquidation of the pound. They might, for instance, help the British pay off the sterling balances by means of a long-term gold and dollar loan—a fifth variation on the funding theme. Alternatively, they might take over and manage the business themselves, promoting their own currencies as substitute asset-reserve media; or they might run the business jointly with Britain on the basis of a merged European currency—the "Europa," perhaps. As a result of any of these, the pound itself would be eliminated as international money, and Britain would be left simply with a consolidated debt to its Common Market partners.

France's repeated vetos of British attempts to join the EEC have by no means destroyed enthusiasm in the United Kingdom for Common Market membership. However, they have had the effect of turning attention to other options as well—and in particular, to the option of some kind of North Atlantic Free Trade Area (NAFTA). This would be based essentially on a trade partnership between Britain and the United States. In addition, it would almost certainly include Canada and most of the other members of the present European Free Trade Association (EFTA), and perhaps Japan, Australia, and New Zealand also. As in the Common Market alternative, so here too, in the opinion of some observers, may be an opportunity for the United Kingdom, with help, to wind up its unilateral role in the international-currency business. Somehow Britain's NAFTA partners—and most especially, the United States—might be persuaded to cooperate in the pound's liquidation. Like

the Six, they could help fund the sterling balances by means of a long-term loan, or the United States could take over the business directly, or the partners could manage the business jointly on the basis of a common NAFTA currency.

Politically, these various proposals could hardly be more diverse. Some, like the NAFTA option, would perpetuate Britain's "special relationship" with the United States; others, like the EEC alternative, would terminate it. Funding sterling balances on a Commonwealth or sterling-area basis would maintain Britain's worldwide post-colonial ties and commitments; funding on an OECD or Group-of-Ten basis would imply a "little Britain" role in world affairs. Funding through the IMF would suggest a more congenial attitude toward supranational economic management than any of the other variations.

Conversely, in their economics the proposals could hardly be more uniform. They are essentially similar in both means and effects; only their details are different. For present sterling holders, the pound would be replaced by an alternative asset-reserve medium. For Britain, the present mixed bag of short-term liabilities would be replaced by a single consolidated debt of fixed maturity, to be repaid over a long period and at an agreed annual rate.

Superficially, the attractions of this kind of approach appear great. The problem of sterling would be solved once and for all. By a quick stroke of financial surgery, the sterling balances would be consolidated and excised, and a source of uncertainty in international monetary affairs removed. The cure would be neat, clean, and final. And yet it is impossible, in my opinion, to recommend the cure to the patient, for it is not in Britain's own interest. In addition to an already massive load of outstanding fixed-term obligations (quite independent of the sterling balances), the British would be called upon to shoulder a new burden of fixed debt considerably in excess of what it currently costs to maintain the pound as an international currency. From the British point of view, this kind of comprehensive reform just does not pay.

At the end of 1968, the total of sterling liabilities outstanding to all foreigners stood at approximately £7,650 million. Of this, the total of liabilities closely related to the traditional roles of the pound—including all private holdings, plus the official holdings of overseas- sterling-area countries—stood at approximately £3,400 million. At least this latter amount would have to be consolidated if sterling were to be completely funded or integrated with another currency. This would mean a minimum long-term borrowing expressed in dollars (since the loan would inevitably carry an exchange guarantee in dollars, if not in gold) of something over $8 billion.

By any standard, this would be an immense burden of fixed debt. For Britain it would be almost too much to bear. Effectively, it would double the country's known outstanding fixed debts overseas. (These are detailed, as of the end of June 1969, in Appendix A.) In addition, in mid-1969 Britain owed substantial sums which were not officially disclosed, including drawings on central-bank swap facilities unofficially reckoned to be "on the upward side of £1,700 million" ($4 billion) (*The Times*, July 12, 1969); and also drawings on the 1969 Basle sterling facility, which may have been as high as $1.5 billion in early 1969. The United Kingdom has already been experiencing difficulty in servicing these various debts. The IMF standby arranged in June 1969, for instance, was designed not to increase the total borrowing available to Britain, but merely to enable the country to postpone for between two and five years the repayment of the final installments of Britain's 1965 credit from the Fund. The $500 million immediately drawn was used at once to pay off some of the Bank of England's swap drawings from other central banks, which were all overdue.

An additional burden of fixed debt in excess of $8 billion would thus come at a rather inopportune moment in British financial history. Appendix B provides some figures to illustrate the order of magnitude of the potential cost to Britain of a debt of these dimensions. Costs are calculated on an average annual basis, on the assumptions that (a) amortization installments would be of equal size, and (b) interest would be paid on the balance outstanding before each payment is made. A 10 per cent per annum rate of interest is the highest that Britain's creditors could reasonably be expected to charge. If the British were given only ten years to repay, this would mean annual installments averaging well over a half billion pounds a year; even if they were given 100 years, average installments would be almost £400 million annually. Of course, the cost would be correspondingly lower if the interest charge were reduced. But even at the nominal rate of just 2½ per cent per annum, and given 100 years to repay, the United Kingdom would have to meet installments averaging some £77 million a year.

This is no mean figure. Indeed, even this amount is probably in excess of what Britain would save yearly by funding the pound or integrating it with another currency. Available evidence suggests that current interest payments on the sterling balances, when adjusted for the sterling-related earnings of the City of London and of overseas investments, amount to something considerably less than any one of the figures included in Appendix B. In other words, over the period to maturity, the average annual cost to Britain of the additional debt burden of funding would actually be far in excess of what the country can save by the

proposed reform. To reduce the yearly cost below the current saving, even at the nominal interest rate of just 2½ per cent per annum, Britain's creditors would have to agree to a repayment schedule stretching out to well over a full century in length. Indeed, even if they agree to forego interest altogether, they would have to wait two to three generations to be fully repaid on their loan. Such generosity is difficult to imagine: it would be unprecedented in the history of international finance. Yet any arrangement less generous than this just would not be in the British interest. Short of a very distant time horizon, the United Kingdom stands to lose less under present currency arrangements.

The reason why should be evident. Under present arrangements the bulk of the sterling balances are really rather stable. Only a relatively small proportion of the total tends to show any significant degree of downward volatility in the short term. Moreover, in the longer term outstanding balances are more likely to rise than to fall, as expanding international transactions and global wealth steadily increase the demands of sterling users for an exchange intermediary and store of value (offset only by a tendency on the part of users to switch from the pound to other international currencies). So long as the pound continues to function as international money, therefore, most sterling balances probably never will have to be repaid at all (on a net basis). However, if the sterling balances are funded, *all* of them in effect must be repaid: liabilities, most of which are tantamount to obligations of *indefinite* maturity and payment terms, would be transformed into a consolidated debt of *fixed* maturity and payment terms. Britain would now have to finance amortization payments as well as the cost of interest—besides losing the sterling-related earnings of the City and of overseas investments. No wonder this alternative tends to be the more expensive.

Because of this, it is sometimes suggested that the debt created by any form of funding operation should be made perpetual and nonredeemable rather than of fixed maturity. This idea is most often heard in connection with the IMF variation on the funding theme. Interest would be payable by the United Kingdom to the Fund, which would in turn pay interest to the one-time sterling holders who now hold a new type of IMF obligation; but nothing at all would be required of the British in the form of amortization of the outstanding principal. In effect, Britain's presently indefinite liabilities would be transformed formally into a consolidated obligation with a fixed maturity of infinity—into a kind of foreign-exchange "consol," as it were.

Naturally, this idea ought to appeal to the British, particularly if the interest cost of the exchange "consol" were to be set below the annual saving that would accrue from sterling's total nationalization. But it is

not a very realistic idea. The IMF as currently constituted is in no position to accept liability for some £3½ billion worth of convertible balances without new backing. It would need a grant of comparable magnitude from the remainder of its full international membership. Unfortunately, it is difficult enough to imagine Britain's potential creditors *lending* an amount like this for 40-100 years or more; it is virtually impossible to conceive of them actually *giving* such a sum away.

Alternatively, the Fund might be given the authority to issue *inconvertible* obligations in place of the sterling balances. However, this too is virtually impossible to imagine. True, the IMF now has the authority to issue Special Drawing Rights which, from its point of view, are in fact, if not in name, inconvertible obligations. (That is, the Fund itself incurs no liabilities when SDRs are created.) But the important point about SDRs is that *every* country gets a share of the allocation, in proportion to its current quota in the Fund. Everyone gets a slice of the cake: there are no special beneficiaries (except, perhaps, to the extent that Fund quotas themselves are suspected of being somewhat unrepresentative of the economic weight of various countries). But if, on the other hand, the Fund were to create additional inconvertible obligations (for example, a supplementary issue of SDRs) specially for the purpose of replacing the sterling balances, there would be only *one* immediate beneficiary—the United Kingdom itself. In effect, the British would be getting a free grant to pay off all of their short-term foreign liabilities. Once again, generosity on such a scale is difficult to imagine. Among other reasons, Britain's potential creditors fear the precedent that would be established by a funding of this kind: other countries might be tempted similarly to run up massive short-term debts, and then appeal to the IMF to be bailed out. All idea of "discipline," much favored by central banks, would be vitiated.

To be sure, there would be nothing to prevent the British from using their *regular* allocation of SDRs for the purpose of replacing the sterling balances. The amendment of the IMF Articles of Agreement incorporating the SDR scheme specifically permits any participant, "in agreement with another participant," to use its SDRs "to obtain an equivalent amount of its own currency held by the other participant" (Article XXV). Accordingly, in the long run all of Britain's short-term liabilities could be paid off in this way. But it should be noticed just how long in this event the long run would actually be. The first activation of the SDR scheme provided for an allocation of $3.5 billion of SDRs in the first year, and $3 billion in each of two subsequent years—in all, $9.5 billion over a three-year period. At the same time, the British quota in the Fund (before the general and selective increases scheduled for 1970)

amounts to just a little over ten per cent of the total. The British share of the first three annual allocations, therefore, will come to less than $1 billion. At this rate it would take Britain over a quarter of a century to fund just the sterling balances closely related to the traditional roles of the pound—to say nothing of other sterling balances or of the country's additional $8 billion worth of fixed-term foreign debt. And this makes no allowance at all for adding to reserves or for financing potential payments deficits. Clearly, this approach takes us far beyond the time horizon relevant to the question at hand. The problem of sterling requires much more immediate attention than that.

Indeed, that is the difficulty with all of the proposals for funding the pound or integrating it with another currency: they all take us beyond the relevant time horizon. I have argued that, except in the unlikely event of unprecedented generosity, a consolidated long-term debt replacing the sterling balances would not be in Britain's interest: the country stands to lose less under present currency arrangements. But of course this is only over the period to maturity. Beyond that, the country stands to gain. However, 40-100 years or more is a long time to wait for benefits to begin; in most circumstances it is probably too long. Policy-makers in a representative democracy must show benefits rather more immediately—before the next election, if possible. Policy proposals, therefore, to be realistic, must usually accept the implicit constraint of a relatively short time horizon. The horizon itself may be elastic. It may be as short as next month or next year, or as long even as a decade. But only rarely can it be assumed to stretch out as far as a generation or more.

Until now I have ignored the matter of the constraint imposed by the overhang of sterling liabilities. The threat of reduction or withdrawal of liabilities adds to the independent constraint of the balance of payments on domestic economic policies: whenever a "run" on the pound develops, additional measures of deflation at home, or trade or capital restrictions, are required to protect the nation's gold and dollar reserves. This is also a cost of the international functions of the pound—a contingent cost, which may be quite considerable indeed. Taking this contingency also into account, it is possible that the burden of funding the pound or integrating it with another currency will not appear so unattractive after all. However, in the next sections we shall see that there are less expensive ways of dealing with this particular problem. The British need not assume such an immense additional burden of debt simply in order to avoid flight from the pound.

For that matter, they need not assume such an immense burden of debt in order to avoid any of the current net interest cost of sterling either. There are less expensive ways of dealing with this problem also.