The Retirement of Sterling as a Reserve Currency after 1945: Lessons for the US Dollar?

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Accumulations of large foreign exchange reserves by emerging economies such as China and Russia in the 2000s and the prospect for increased demand for precautionary reserves after the current global crisis have renewed interest in how international currencies emerge and how they can be replaced without disrupting the global economic system. The case of sterling in the post-war decades provides an opportunity to examine this process. Although a rapid global switch to the USD was widely predicted after 1945, the end of sterling's reserve role was prolonged until the late 1970s by the structure of the international monetary system and collective global interest in its continuation so that the retirement of sterling as a reserve currency was achieved through negotiated management among the developed and developing world. This paper reviews the schemes that managed the decline.

The global reserves system is coming under increased scrutiny both as a contributor to the current global crisis and as a threat to future stability. The US dollar's role as primary international reserve asset combined with the accumulation of substantial reserves in East Asia, it is argued, contributed to America's ability to accumulate large balance of payments deficits and cheapened government borrowing. Depressed US interest rates may have fuelled the consumer and mortgage debt boom. The sustained decline in the value of the USD from 2002 meanwhile, prompted a reconsideration of how long it could remain the world's primary reserve asset and if, when and how it might be overtaken by another currency such as the Euro. The prospect that more countries will accumulate precautionary reserves in the wake of the crisis, thereby renewing the cycle, has prompted questions about the costs and benefits of issuing an international currency, how international currencies emerge and how they can be replaced without disrupting the global economic system. Joseph Stiglitz put the extreme case at the United Nations in February 2009

> "The system in which the dollar is the reserve currency is a system that has long been recognized to be unsustainable in the long run. It's a system that is fraying, but as it frays it can contribute a great deal to global instability, and the movement from a dollar to a two-currency or three-currency, a dollar – euro [sic], is a movement that will make things even more unstable."[1]

The Stiglitz panel of experts reported to the UN Commission on 26 March 2009 calling for a new international reserve asset to forestall the instability arising from a transition away from the USD as the dominant reserve currency.[2] This view was endorsed by the UN Department of Economic and Social Affairs in March 2009

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[1] http://www.unmultimedia.org/tv/unifeed/detail/10803.html. Lecture by J. Stiglitz, 24 February 2009, part of the United Nations University series "Emerging Thinking on Global Issues" supported by the Office of the President of the 63rd session of the United Nations General Assembly.

[2] This recommendation echoed earlier recommendations by, e.g. J.A. Ocampo, 'The instability and inequities of the global reserves system', United Nations, Department of Economic and Social Affairs, Working Paper 59, November 2007. See also J. Stiglitz, *Making globalization work*, Norton, 2006, Ch. 9 for his proposal for 'global greenbacks'.

when it called for a system to pool reserves rather than encourage national precautionary accumulations, and for a reserve asset separate from the USD that could be issued in response to the demand for liquidity.[3] These proposals are similar to the suggestions put forward to resolve the challenges of the 1960s when the system also appeared to be unsustainable due to persistent American deficits and declining confidence in the dollar. In the 1960s these problems proved intractable and were in the end resolved for a time by the advent of floating exchange rates (for core global currencies) and financial innovation, which together reduced the need for national precautionary reserves. In the process, the secondary international reserve currency, sterling, was retired. The case of sterling in the post-war decades provides an opportunity to examine the process of a reserve currency in decline.[4]

Although the demand for reserve currencies can be modeled with a range of variables including issuing-country size, share of world trade and return on assets, these exercises have reinforced the importance of institutional rather than economic determinants. The important role of inertia is usually attributed to network externalities that prolong reserve currency status beyond the time predicted by economic fundamentals.[5] These externalities also suggest a tipping point or landslide effect should one major creditor switch reserve assets, so that the retirement of a reserve currency is likely to be non-linear. However, Eichengreen and Flandreau have cast doubt on the strength of inertia by showing that the dominant reserve currency shifted from sterling to the USD and back again during

[3] UN DESA, 'Background note on the global financial and economic crisis, its impact on development, and how the world should respond', March 2009. Interactive Thematic Dialogue of the UN General Assembly on the World Financial and Economic Crisis and Its Impact on Development, 25-27 March 2009, United Nations Headquarters.

[4] This paper is a summary of the argument in C. R. Schenk, *The Decline of Sterling; managing the retreat of an in international currency 1945-1992*, Cambridge University Press, forthcoming, 2009.

[5] M. Chinn and J. Frankel, 'Why the Euro will rival the dollar', *International Finance*, 11:1, 2008, pp. 49-73.

the inter-war period.[6] The case of sterling in the post-war period helps to explore the determinants and timing of shifts from one major reserve currency to another. Like the USD today, the demise of sterling was widely predicted but the process was more gradual than was anticipated at the time and an abrupt collapse, although widely predicted, was avoided. A major source of inertia in this case was institutional support mechanisms to delay the tipping point for the pound. This analysis also supports Eichengreen and Flandreau's contention that more than one important reserve currency can operate at the same time, although this may have been artificially managed in the 1960s through exchange controls and bilateral agreements.

At the end of the Second World War, it was clear that the US dollar would be the dominant international currency in any global economic reconfiguration, and this became the core of the Bretton Woods system. Most of the richer countries pegged their currencies to the USD, while the USD alone valued its currency directly in gold. Nevertheless, there continued to be a role for a secondary international currency to be used as a reserve asset, anchor currency and as a currency of settlement because the supply of USD assets and gold was likely to be restricted in the immediate post-war period by US balance of payments surpluses. The system thus assumed what some economists suggest is impossible: that more than one major reserve currency could operate at the same time over a prolonged period.[7] In the 1950s the sterling area (35 countries and colonies pegged to sterling and holding primarily sterling reserves) accounted for half of world trade and sterling accounted for over half of world foreign exchange reserves. In the early post-war years, this share was even higher – the IMF estimated that official sterling reserves, excluding those held by colonies, were four times the value of official USD reserves and that

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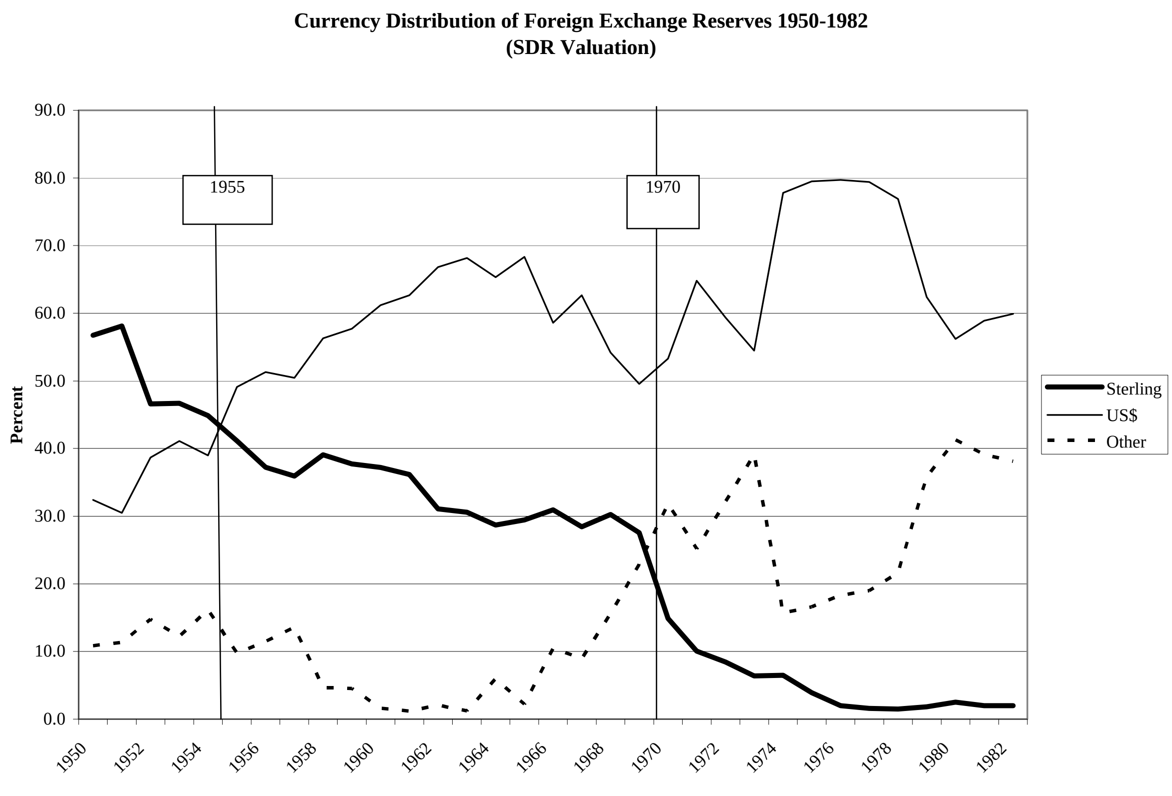
[6] B. Eichengreen and M. Flandreau, 'The rise and fall of the dollar, or when did the dollar replace sterling as the leading international currency?', NBER Working Paper 14154, 2008.
[7] See, e.g. P. Krugman, 'The international role of the dollar; theory and prospect' in JFO Bilson and RC Marston, eds, *Exchange Rate Theory and Practice*, University of Chicago Press, 1984, p. 261

by 1947 sterling accounted for about 87% of global foreign exchange reserves.[8] It took ten years after the end of the war (and a 30% devaluation of the pound) before the share of USD reserves exceeded that of sterling. This rather contradicts Chinn and Frankel's assertion that 'by 1945 the dethroning [of sterling] was complete'. Figure 1 shows the changing composition of foreign exchange reserves from 1950 to 1982.

Figure 1 Currency Distribution of Foreign Exchange Reserves



How do we explain the gradual nature of the decline of sterling, what Krugman refers to as a 'surprising persistence'?[9] Was this due to British government efforts to

[8] IMF Staff, 'International Reserves and Liquidity: a study by the staff of the International Monetary Fund, 1958' reproduced in J.K. Horsefield, *The International Monetary Fund 1965-75*, Vol. III. P. 371. At this time foreign exchange was only about 30% of global reserves, but gold holdings were highly concentrated in the USA so that foreign exchange made up about half of global reserves excluding the USA.

[9] Krugman (1984), p. 274.

prolong sterling's role because it increased the capacity to borrow, because it enhanced Britain's international prestige, or because it supported London as a centre for lucrative international finance?[10] These are the traditional explanations in the literature, but archival evidence shows that from the 1950s many British ministers and officials recognized that the burdens of sterling's role in terms of cost of borrowing and confidence in the exchange rate outweighed the benefits of issuing an international currency. Krugman asserted that 'the preeminence of sterling and its displacement by the dollar [after 1945] were largely the result of "invisible hand" processes, ratified more than guided by international agreements'.[11] Closer examination of archival evidence shows, however, that sterling's role was prolonged both by the structure of the international monetary system and by collective global interest in its continuation. As the network externalities for sterling reserves eroded, the retirement of sterling as a reserve currency was postponed through negotiated management among the developed and developing world. In contrast, the retreat of sterling as a commercial currency was achieved unilaterally through exchange controls that encouraged the use of USD and the offshore Eurodollar market, which led to the displacement of sterling as the currency of the City by the 1960s. The reserve role was less easy to shed. In 1971, UK accession to the EEC made it necessary for the UK government to be publicly explicit that sterling's reserve role would be eliminated as soon as possible. Still, this proved elusive.

During the early 1950s the UK Treasury devised various plans to discourage the use of sterling as a reserve currency by increasing exchange rate volatility or unilaterally suspending the convertibility of sterling reserves, but these plans were abandoned because they threatened Britain's political as well as economic relations with creditors, and because the retaliation and disruption to the international

[10] For the classic presentation see, S Strange, *Sterling and British Policy; a political study of an international currency in decline* (Oxford: Oxford University Press, 1971). This view is repeated in H. James, *International Monetary Cooperation since Bretton Woods* (Oxford: Oxford University Press, 1996) and P. Cain and AJ Hopkins, *British Imperialism: Crisis and Reconstruction 1914-1990* (London: Longman, 1993) among others.
[11] Krugman (1984), p. 261.

monetary system that would ensue threatened domestic priorities of full employment and price stability.[12] By the early 1960s, the future of sterling as a reserve currency became embroiled in global efforts to reform the international monetary system once it had become clear that the practice of using national currencies as international reserves in the pegged rate system was flawed. The accumulation of international reserves required persistent deficits to be run by issuing countries that ultimately undermined confidence in the value of those reserves. For sterling this was not such a threat since the value of overseas sterling reserves did not increase, although the geographical distribution shifted dramatically. Rather than managing an increase in sterling reserves, British proposals aimed at replacing existing sterling reserves with some other form of asset that would not be directly issued by the UK. This would reduce the liquidity of these UK liabilities and ultimately release the strain on the UK reserves of retiring outstanding liabilities when sterling reserves decreased, which they were expected to do. The weakness in the system was the apparently precarious ratio of outstanding sterling liabilities in the reserves of other countries relative to the slim volume of UK dollar and gold reserves (the ratio was 4:1 in the immediate postwar period). This exposed sterling to a collapse if there was a rapid switch to the USD. British governments and central bankers were successful in using the threat that the collapse of sterling as a reserve currency would lead to systemic crisis to gather extraordinary credit from the USA, IMF, BIS and the G10+1 while the world debated how to replace reserve currencies.[13]

The process of global reform was much more prolonged than expected and in the end the outcome (the SDR) was not radical enough to meet the task of retiring sterling. In the meantime, a multilateral support system was developed at the BIS that comprised three successive Group Arrangements in 1966, 1968 and 1977 whereby central banks pledged substantial lines of credit to minimize the impact of a

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[12] For a review of these plans see, C.R. Schenk, *Britain and the Sterling Area; from devaluation to convertibility in the 1950s*, Routledge, 1994.
[13] In this context the G10+1 are those defined by the IMF's General Arrangements to Borrow plus Switzerland.

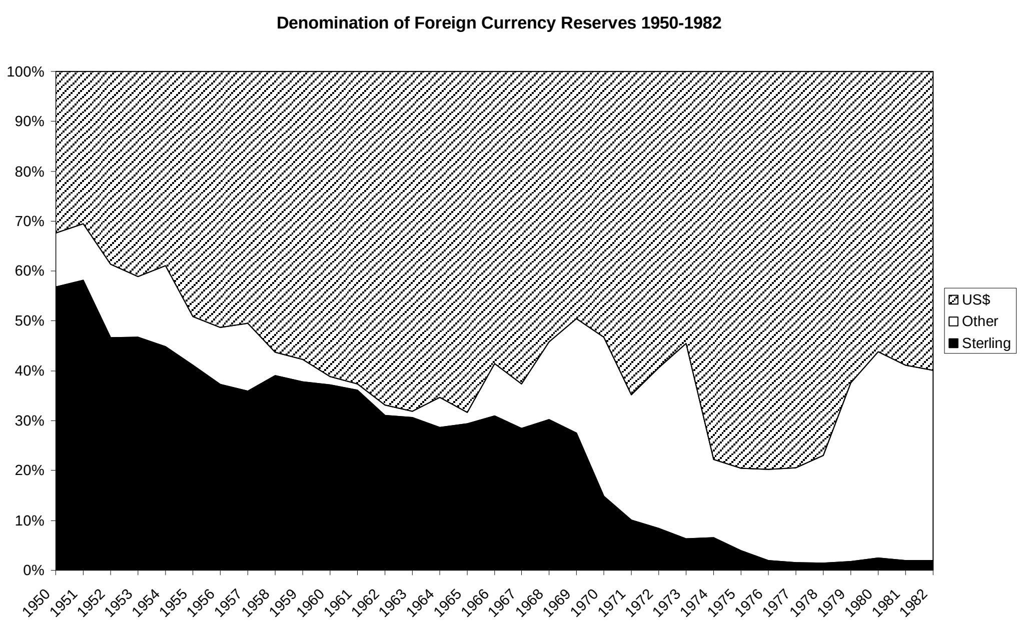
tipping point away from sterling. These safety net schemes aimed to forestall a rush away from sterling as a reserve currency by retaining market confidence and reducing the first mover advantage from a flight from sterling. In 1968 (under pressure from G10 central banks) the UK also built a system of bilateral commitments with holders of sterling to limit diversification in return for a guarantee of the USD value of 90% their reserves. These Sterling Agreements were renewed three times before finally being allowed to expire in December 1974. This forestalled some diversification, although the minimum ratios were set lower than the *status quo ante* in many cases and the thresholds were rarely binding. Although sterling's share of international reserves fell sharply in the early 1970s to below 10% of the total, accumulations by oil producers left Britain vulnerable to diversification in 1976. This provoked a final scheme to replace sterling reserves with UK-issued foreign currency bonds, again underpinned by a line of credit from G10 central banks in 1977, marking a final end to sterling's reserve role.

The shift from sterling to the USD and the elimination of sterling as a major international currency did result in periodic crises, international tensions and conflict over British domestic economic policy. It was thus not a painless transformation, but it was tempered by the waning attractions of the USD as an alternative safe haven and by the international commitment to avoid a damaging tipping point for sterling that would undermine confidence in the reserve currency system as a whole. But the persistence of sterling's reserve role was not just an artificial one. Many developing countries were willing to accumulate sterling assets during the 1960s despite the currency's vulnerability because of the denomination of their trade and debt in sterling and because many currencies remained pegged to sterling. As a result, during the final decades of sterling's reserve role there was a considerable geographical redistribution of official holdings of sterling assets. Starting in 1971 most sterling pegs were replaced by pegs to the USD or baskets, and sterling's commercial role declined rapidly relative to the USD during the oil crisis. The sharpest fall in sterling's share of reserve assets took place at a time of dramatic expansion in global reserves during a global commodity boom and inflation. These factors eased the pressure on Britain from this final transformation since the real value of existing liabilities declined. Until 1976 the reduction of sterling's share of global reserves did not require the presentation in London of sterling assets for exchange to USD, gold or other currencies on a net basis since the overall value of global sterling reserves was relatively stable. Rising international liquidity, inflation, geographical redistribution and international cooperation were the cornerstones that eased the retreat of sterling from global to national status.

Currency Distribution of Global Foreign Exchange Reserves

During the post-war decades the nature of international reserves was transformed by the accumulation of foreign exchange assets by countries other than the USA, although foreign exchange reserves only exceeded gold holdings for the first time in 1970. Figure 2 shows the fall in the relative use of sterling as a reserve asset over the course of the post-war decades.

Figure 2 Denomination of Foreign Currency Reserves



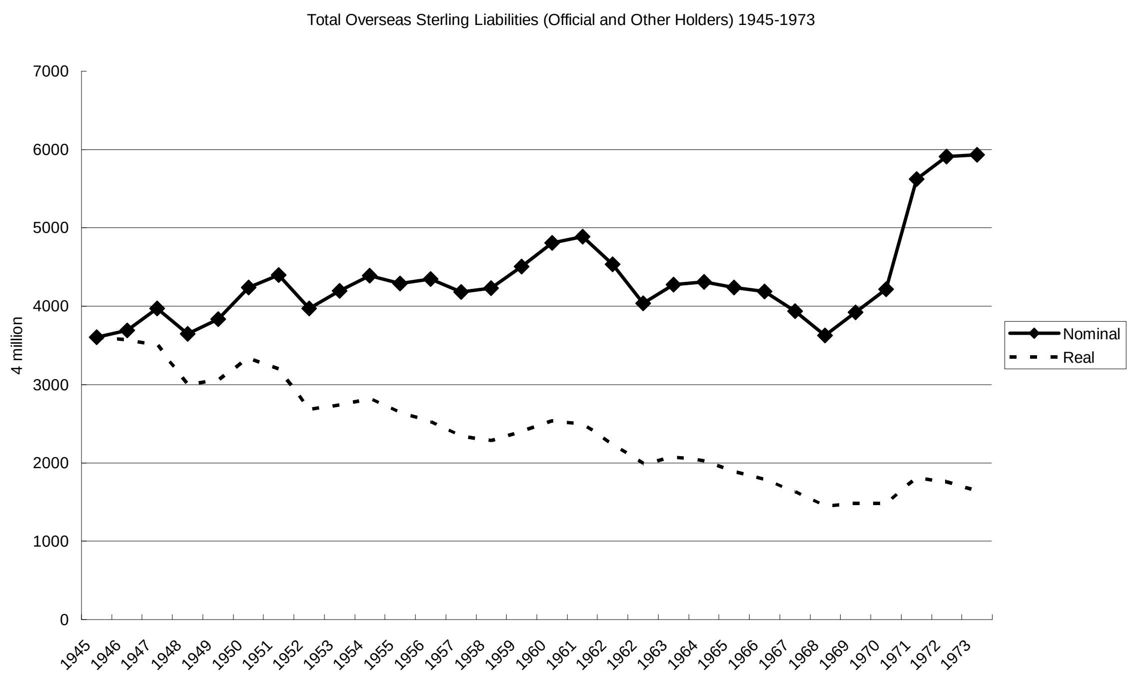
By 1950 over 55% of foreign exchange reserves were still held in sterling but this share fell quickly, partly as a result of the Korean War boom of 1951-2 as US rearmament pushed more USD overseas. Sterling then declined at a steady rate for the rest of the decade as recovering European countries accumulated USD, before recovering slightly after sterling current account convertibility in 1958. The share was then remarkably stable at close to 30% (despite a 14.3% devaluation of sterling against the USD in 1967) until a sharp fall in 1970 from 28% to 15%. In this year there was a dramatic increase in global reserves arising from a large US balance of payments deficit, which pushed the share of foreign exchange in total reserves of all countries other than the USA from 49% to 57%[14] Also in this year the UK repaid about $2b of central bank assistance, which reduced the value of sterling held by overseas central monetary institutions since much of this support had been in the form of sterling swaps. Against this transaction, CMIs of sterling area countries increased their sterling reserves by the equivalent of $400m in 1970. From June 1972, sterling floated (or sank) against the USD so valuation effects further reduced sterling's share of global reserves valued in USD.

The sharp fall in sterling's share in the early 1970s was a tipping point in terms of relative position but Figure 3 shows that the amount of sterling held by official and private institutions was remarkably steady through the 1950s, rose in the early 1960s but then declined until surging during the raw material boom of the early 1970s.[15]

[14] BIS Annual Report 1970-71, p. 14.

[15] There is a break in the series in 1962, which accounts for a one-off £97m drop. The new series excluded some special funds which did not comprise liquid liabilities of the UK, e.g. marketing boards, pensions funds, sinking funds, holdings of other commonwealth securities.

Figure 3 Total Overseas Sterling Liabilities 1945-1973 (official and non-official holdings)



Source: Sterling Balances since the War, Treasury Historical Memorandum 16, The National Archives, London [hereafter TNA] T[reasury]267/29.

The overall stability in the 1950s and 1960s masks a change in geographical distribution. Figure 4 shows that official sterling reserves of sterling area countries were fairly stable until the inflationary period at the start of the 1970s, while Figure 5 shows that other countries ran down their sterling assets almost continuously throughout the post-war decades.

Figure 4 Sterling Liabilities to Overseas Sterling Area
(other = non-official holders)

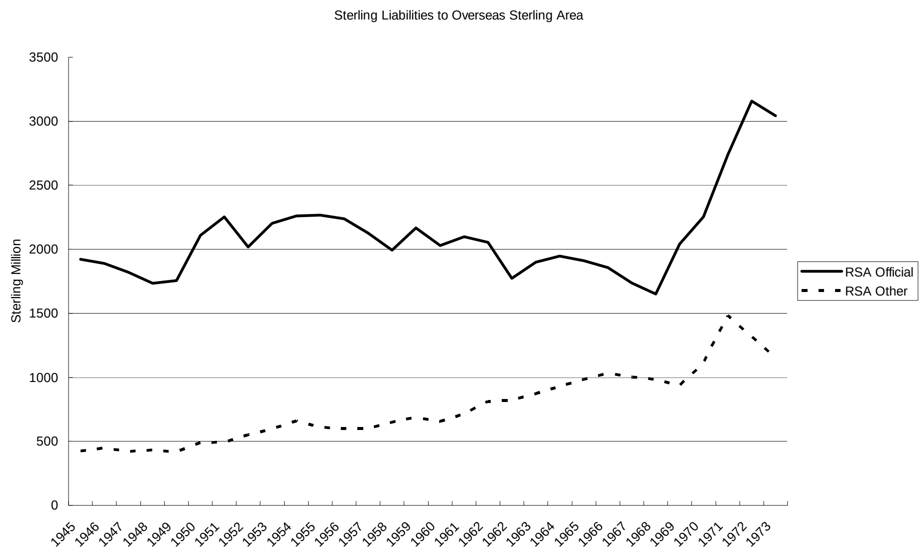
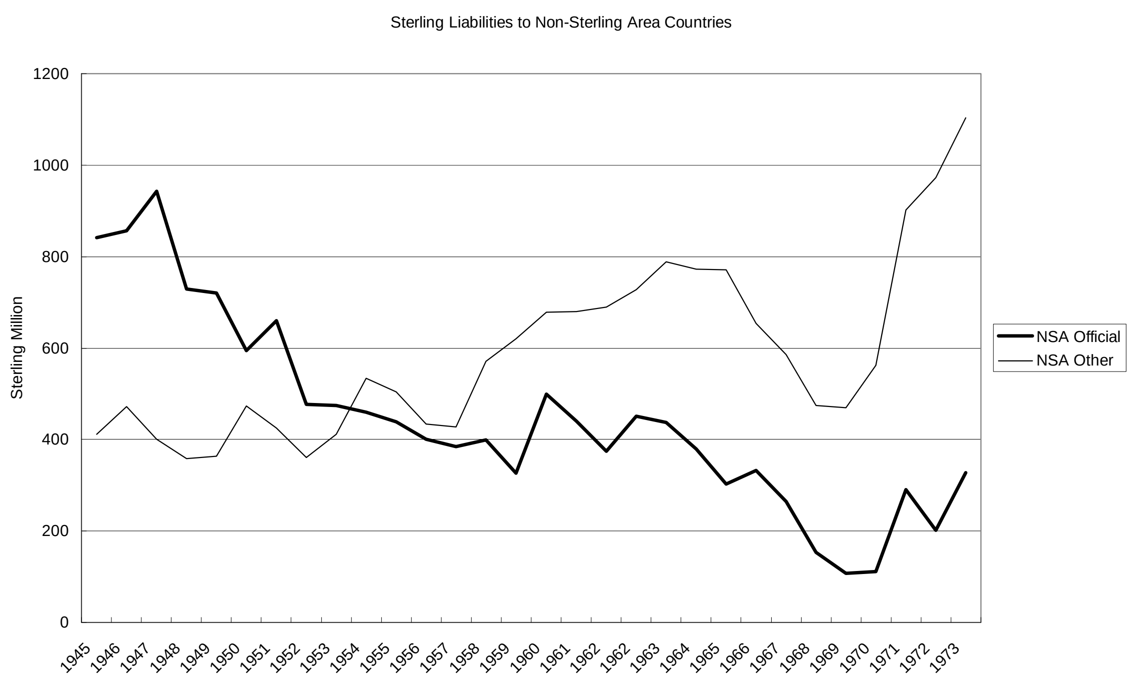
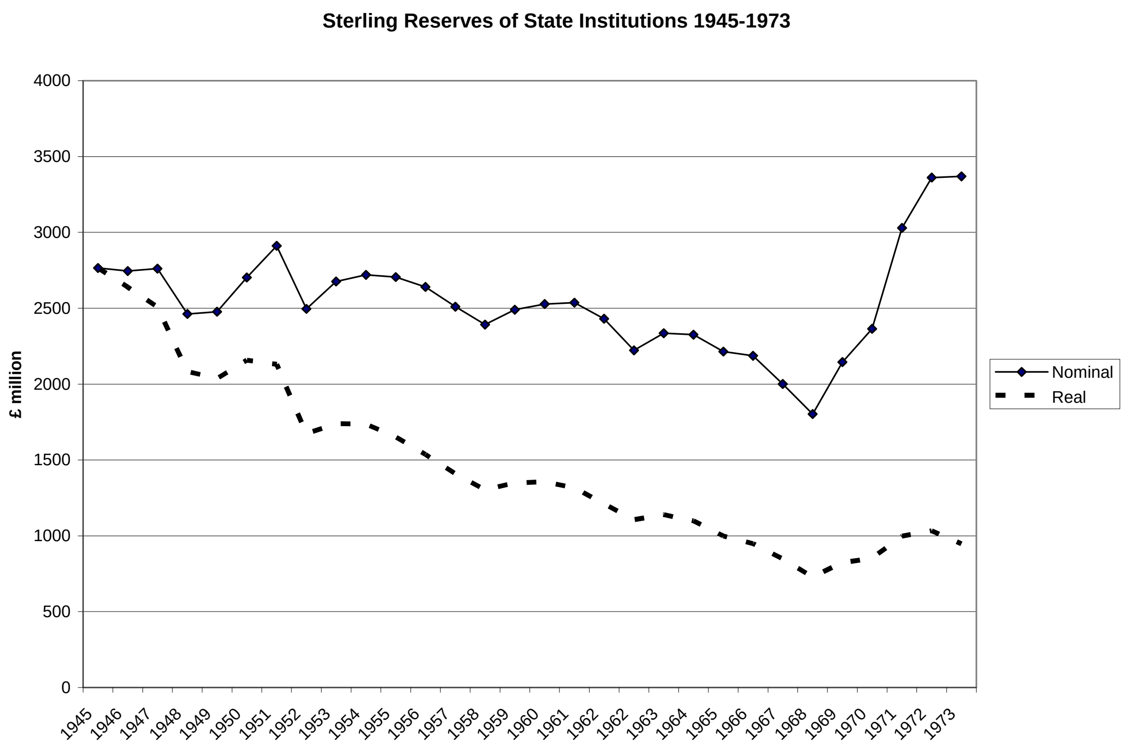


Figure 5 Sterling Liabilities to Non-sterling Area Countries



In both cases the nominal value of private holdings increased, although the impact of the devaluation of 1967 is clearly apparent for both groups. The steady decline in the real and nominal value of sterling reserves held by central banks and other state institutions (excluding the IMF) from the 1950s is shown in Figure 6.

Figure 6 Sterling Reserves of State Institutions



Privately held reserves of sterling were a fairly steady 3%-4% of world trade during the 1950s but then fell steadily to below 2% by 1969 after the confidence crises of the early 1960s.

Within the nominal stability of sterling reserves in the sterling area, Figure 7 shows that there was a dramatic geographical shift. At the end of the war, the Indian Subcontinent accounted for 58% of total sterling liabilities to the overseas sterling area. These assets were accumulated during the war in lieu of payment for war-related expenditure in the region.[16] Almost immediately, however, the dominance of these balances was challenged by accumulations in Australia/New Zealand and by colonies in the Far East and Africa so that by the end of 1952 the Indian Subcontinent accounted for only a quarter of sterling area balances. From the mid-1950s oil sales in the Middle East and economic growth in East Asia led to a further redistribution of sterling's reserve role so that by November 1968 Hong Kong was largest single official holder of sterling, followed closely by Australia and then Kuwait. These three examples show some important determinants of sterling's persistence by the end of the 1960s: empire still mattered (Hong Kong was still a colony with a colonial monetary system), inertia and size mattered (Australia was historically the largest sterling area country, although it did diversify its reserves), and denomination of commodity trade mattered (Kuwait, and later Nigeria and Saudi Arabia accumulated huge sterling royalty payments from oil companies).[17]

[16] B.R. Tomlinson, 'Indo-British relations in the post-colonial era: The sterling balances negotiations, 1947-49', *Journal of Imperial and Commonwealth History* 13(3), 1985, 142-62.
[17] For the important case of Hong Kong' sterling, see C.R. Schenk, 'The empire strikes back; Hong Kong and the decline of sterling in the 1960s', *Economic History Review*, 2001.

Figure 7 Distribution of OSA Sterling Balances 1945-73

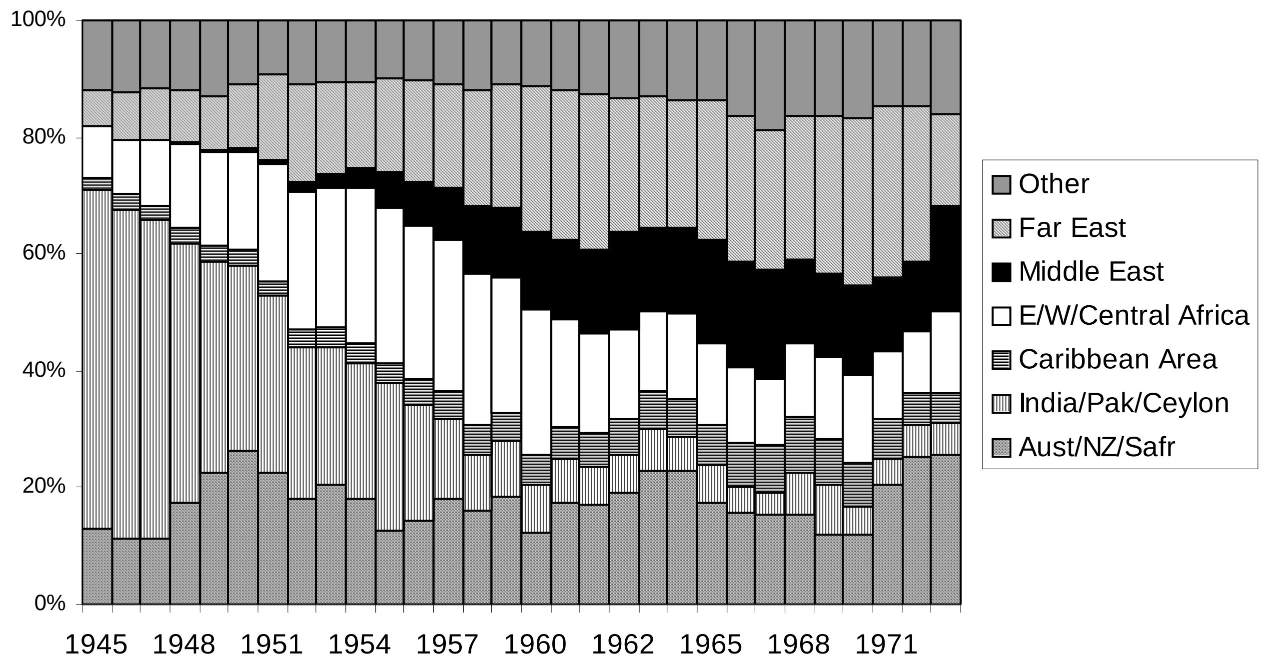


Table 1 shows that many independent members of the sterling area diversified their reserves in the 1950s, mainly through accumulation of USD assets (and gold in the case of South Africa).

Table 1 Share of Sterling in Total Reserves, percent

	1950	1951	1952	1953	1954	1955	1956	1957	1958
Iraq	95	80	81	86	91	84	80	71	66
Ceylon	89	73	78	67	73	67	56	53	47
Australia	82	66	65	70	64	49	58	65	55
Pakistan	78	79	52	57	59	62	53	50	44
India	73	69	69	97	97	98	56	44	33
New Zealand	64	61	62	73	69	61	72	63	66
South Africa	24	22	23	8	19	7	8	-	-

Source: CR Schenk, *Britain and the Sterling Area*, Routledge, 1994, p. 30.

However, this process was reversed by some sterling holders in the 1960s so that as Table 2 shows, by 1964 New Zealand held 98% of its reserve in sterling and Australia 79%.

Table 2: Proportion of sterling in official reserves

	Australia	New Zealand	Malaysia	Singapore	Hong Kong
1964	79	98	96	100	99
1965	70	97	96	98	99
1966	69	97	90	93	99
Jun-67	64	80	87	74	99
Oct-67	60	85	82	50	99
Dec-68	46	76	58	44	99

Source: Bank of England Archives [Hereafter BE] OV44/116. 1968 from TNA T312/2811, T312/2804, T312/2649, T312/2312.

As we shall see below, the share of sterling in the reserves of the sterling area countries as a whole increased further after 1968. Thus, although the share of sterling in global reserves fell, the pound remained the primary reserve currency for a range of (mainly developing) countries until the mid-1970s.

These developments all show that the distribution of sterling reserves in the 1950s was profoundly affected by the pattern of economic development on the geographical edges of Britain's former formal and informal empire. Over the next decade the decline in sterling's share of global reserves slowed as the plans for reforming the system as a whole gathered pace.

Sterling and the Reform of the Global Reserves System: Delaying the Tipping Point

A vital feature of the management of the retreat of sterling was the continuing effort to engage the rest of world's economic leaders in resolving the problems that the reserve currency role of sterling appeared to pose for domestic UK economic policy. Indeed as the 1960s progressed, waiting for a global solution to weaknesses in the international monetary system emerged as a corner-stone of British sterling strategy, allowing ministers to postpone unpalatable decisions about achieving this on their own. Their success is evident in the range of schemes designed to postpone the tipping point for sterling until a permanent solution to the problem of national currencies as reserve currencies could be agreed.

1. 1961-1964 *Bilateral Concert*é: G10+1 central banks offer support coordinated through the BIS to a range of countries (3 month bilateral swaps). UK episodes included $1 billion in September 1964 ($7 billion in current dollars), half of which came from the Fed, and $3 billion in November 1964, one third from the Fed.[18]

The arrangement of systems of multilateral support for the international monetary system was developed during the exchange crises of 1960-61 when pressure on

[18] Current dollars valued by CPI from Samuel H. Williamson, "Six Ways to Compute the Relative Value of a U.S. Dollar Amount, 1790 to Present," MeasuringWorth, 2008. URL http://www.measuringworth.com/uscompare/

sterling led to concerted efforts by European central banks to support existing exchange rates. In March and June 1961 the UK garnered bilateral support totaling $904 million from European and US central banks in what became known as Basle arrangements. As Toniolo relates, the Bank of England and the US Fed were enthusiastic about the ability of the combined forces of central banks to forestall short term speculative pressure and sought to extend or formalise the arrangements on an inter-governmental basis. Creditors in Europe were less enthusiastic about extending the system and the initiative was instead formalised through the BIS. Credits would remain bilateral but the BIS would inform each creditor of the details of the total operation, in what was termed 'bilateral concerté'.[19] In March 1963, September 1964 and November 1964 Britain negotiated a series of lines of credit under the bilateral concerté scheme to cover short-term speculative attacks on sterling.[20] The UK juggled short term credits to support sterling, drawing on them to intervene in the exchange market and also publicizing the packages to stem speculation. By moving between multilateral support from Europe, the USA and IMF facilities, the Bank of England managed to keep the speculators at bay.

While these short term facilities were successful in supporting sterling through a series of confidence crises, they did not amount to a long term solution, which Britain's creditors increasingly preferred.[21] In mid-September 1965 Bank of England Governor Cromer rejected proposals made at a BIS meeting of central bankers to 'fund' sterling reserves into a longer term and more predictable debt, effectively curtailing their liquidity and ending the reserve role. He explained that it was volatility in private sterling holdings rather than in overseas central banks' holdings that contributed to the UK's balance of payments problems. More fundamentally, the UK's creditors in the sterling area would not accept shifting their existing liquid sterling exchange reserves into less remunerative and less liquid long-term assets,

[19] G. Toniolo, *Central Bank Cooperation* at the Bank for International Settlements, 1930-1973,Cambridge University Press, 2005, pp. 381-85.
[20] MJ Thornton (BoE) to Conolly, 22 September 1964. BISA GILB9 7.18(23).
[21] For discussions during this period see Toniolo, *Central Bank,* pp. 391-94.

and the UK did not want to replace a debt that might never need to be redeemed for a certain liability.[22]

While ‘funding’ was out, the Bank of England hoped that support might be found through the BIS network to cover the eventual diversification of sterling reserves. Rather than preventing the liquidation of sterling assets, these proposals sought to protect the UK reserves from the switch to the USD based on the model of short term support already agreed under the Bilateral Concerté. In this way, the international community would ease the impact of the decline of sterling as a reserve currency on the UK. After a series of negotiations the first Group Arrangement for sterling was concluded in June 1966.

2. BIS Group Arrangement I June 1966 – January 1971: $1 billion in 3-month renewable swaps to cover 12 months ($6.6 billion in current dollars).

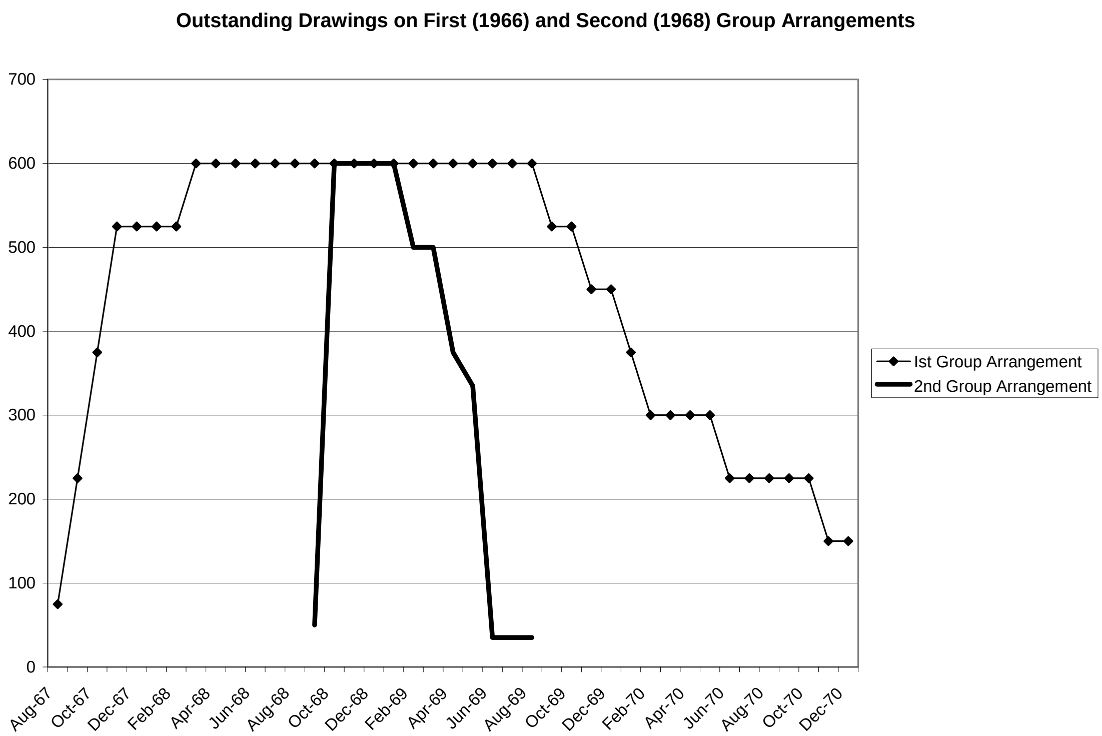
The First Group Arrangement moved on from the bilateral concerté to included a more formal relationship to the reserve role of sterling; the UK was allowed to draw on the credit up to an amount of 50% of the drop in UK reserves attributable to a decline in sterling reserves overseas.[23] The aim was to prevent a devaluation of sterling due to diversification of official reserves, but the hope was that the announcement of the agreement itself would forestall that process by enhancing market confidence in the value of sterling and by reducing the first mover advantage of shedding sterling reserves. A decline in sterling reserves was now less likely to prompt a devaluation of sterling. As it turned out, the Arrangement was not enough to forestall a sterling devaluation by 14.3% in November 1967. This crisis step was not due to diversification but to Britain’s own chronic balance of payments problem

[22] Cromer to Ferras (and copied to other Central Banks), 16 September 1965. BISA LAR2 F01 7.18(14).

[23] The support was triggered after a net reduction in overseas official holdings of sterling below a base level of £4300m due to factors other than the UK’s own balance of payments problems (the total at the time was £4500m).

and a collapse in confidence in the Labour Government's ability to restore British competitiveness. Figure 8 shows how the facility was used during this crisis.

Figure 8 Outstanding Drawings on the First (1966) and Second (1968) Group Arrangements



In March 1968, when speculative pressure against the USD prompted the end of the fixed price of gold and the entire reserves system seemed in peril, the British government sought to garner further support for sterling's international role, asking for $5 billion in longer term credit to fund any further diversification away from sterling. They were turned down, but did collect pledges from central banks ($1.175 billion) to add to existing facilities of $1.436b from bilateral and previous Basle facilities, plus $1.4b in IMF standby to make up a headline total of support of just over $4b (c. $25 billion in current dollars valued by CPI).[24] With this huge credit looming, Britain's creditors sought a longer term (and final) solution.

3. BIS Group Arrangement II (Basle Agreement) and Sterling Agreements (1968-1974): The G10 central banks agreed to provide a safety-net line of credit of $2b ($12.4 billion in current dollars) on which the Bank of England could draw if total sterling reserves fell below £3080m (the level at 11 June 1966). As a quid pro quo, they insisted that the UK negotiate bilateral Sterling Agreements to commit countries holding sterling in their reserves to keep a minimum proportion of their reserves in sterling over the term of the Basle Agreement. In return, the UK offered a guarantee of the USD value of 90% of each of these countries' official sterling reserves so long as the minimum sterling proportions were met. Countries could break the agreement and diversify, but they would lose the USD exchange guarantee. The goal was to limit the diversification away from sterling as a reserve currency through these agreements, with a guarantee underpinned by the $2b safety-net if global reserves as a whole fell sharply.

The Sterling Agreements were the most important part of this arrangement since they further reduced the exchange risk of holding sterling and thus reduced the incentive for countries to abandon sterling. The arrangements thus transformed the nature of sterling as a reserve asset from a voluntary portfolio choice to a formal contractual commitment. However, during the late 1960s and early 1970s the problem was not a decline in sterling assets held overseas but how to contain an increase in these UK liabilities. A further complication was the devaluation of the USD against gold and sterling in 1971, which undermined the value of the guarantee

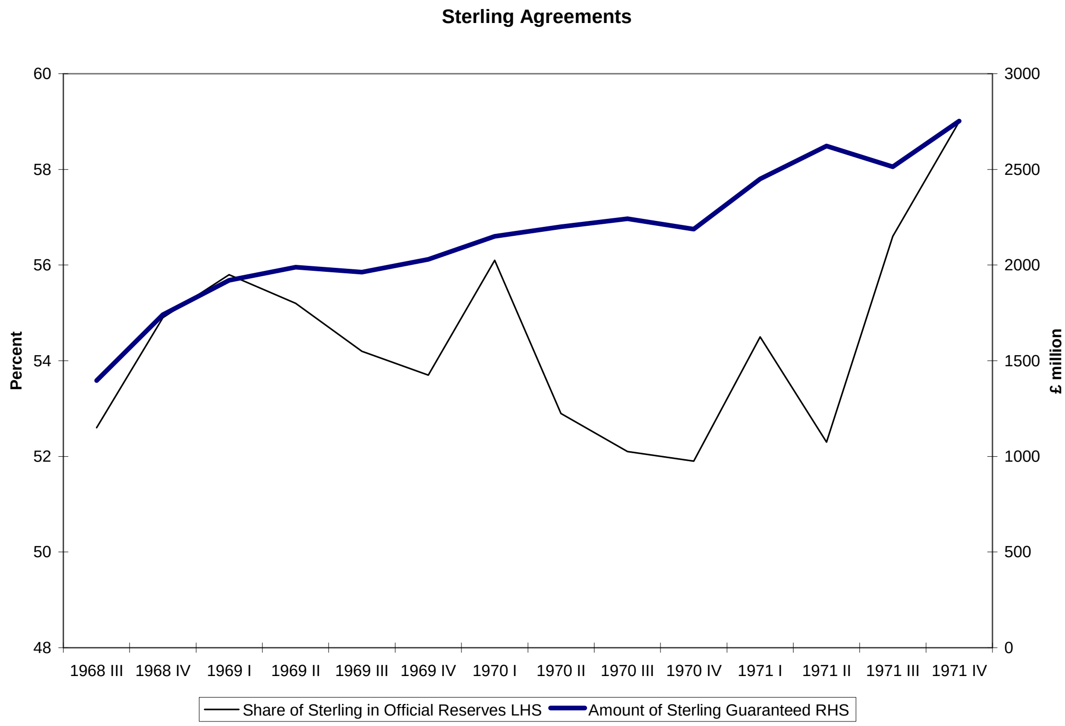
[24] Note for the Record by RJ Wiles, 19 March 1968. TNA T318/191. See also telegram Armstrong to Chancellor of the Exchequer, 17 March 1968. BE OV53/38.

since the trigger point was not changed.[25] Thirty-four agreements with sterling holders were negotiated between July and September 1968 in process that was a considerable embarrassment for the UK has negotiators were left kicking their heels waiting for agreement from a range of developing states, many former colonies. The bitterness of some countries stemmed from the 1967 devaluation, which had created a sense of betrayal and a new balance of power between Britain and these mainly Commonwealth countries. The negotiations also identified the range of issues that complicated Britain's relations with these countries, including the applications to the EEC, development aspirations, and (post)imperialism. The range of minimum sterling proportions (from 100% in East Africa to 13% in India) is presented in Appendix I.

Figure 9 shows the overall proportion of sterling in reserves of those who signed a sterling agreement. This shows the recovery of sterling in the first year of the agreements and then again from the time of the primary product boom in 1971, and the steadily rising guarantee obligation if sterling depreciated.

[25] The exchange guarantee was set to be invoked if sterling fell below $2.376, but the Smithsonian rate increased the sterling/USD exchange rate from $2.40 to $2.60 making it much less likely that the guarantee would be invoked since the exchange rate could fall 8.5% before compensation would need to be paid.

Figure 9 Sterling Share of Reserves of Sterling Agreement Countries



Source: BE EID15/7.

The Agreements were successfully renewed in 1971, 1973 and 1974 (except for Libya and Malaysia, who opted out and diversified in July 1972 after sterling floated) with reductions in the minimum sterling proportions by 10% each time.[26] Whether the agreements were binding is doubtful. Most countries retained a substantial cushion of sterling above their minimum commitment, although seasonal variations in reserves required many to keep precautionary sterling reserves to avoid falling below the minimum, as shown in Figure 11.

[26] For the case of Malaysia see, C.R. Schenk, 'Malaysia and the end of the Bretton Woods system 1965-72: Disentangling from Sterling ', *Journal of Imperial and Commonwealth History*, 36 (2), June 2008, pp. 197-220.

Figure10 Sterling Agreements Countries Sterling Reserves 1968-73

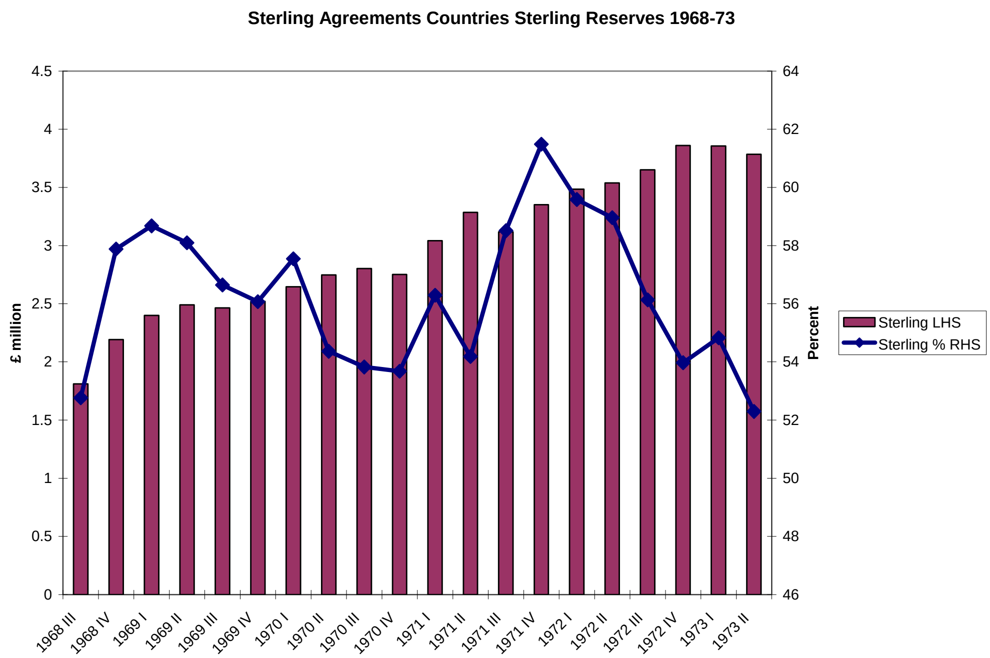


Figure 11 Excess Holdings of Sterling above Minimum Sterling Proportion

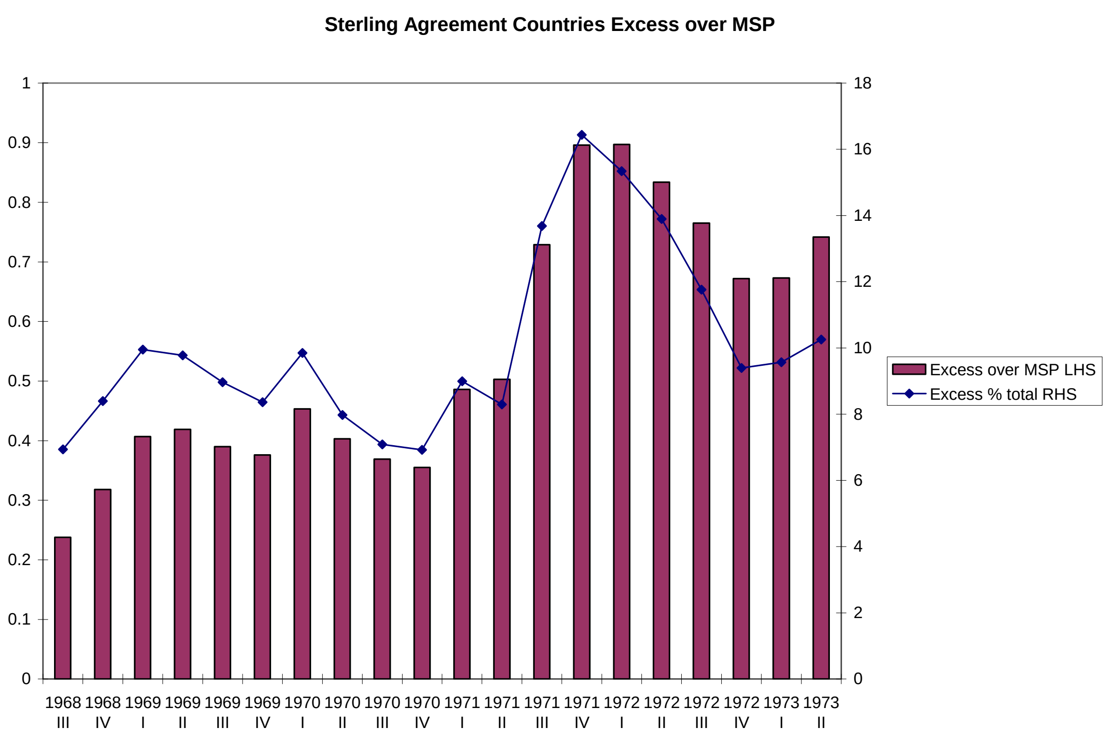


Table 3 shows that sterling countries retained their share of sterling while others diversified during the years of the Sterling Agreements.

Table 3 Share of Sterling in Foreign Exchange Reserves (%)

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

Sterling Agreement Countries from BE EID15/7, All Countries from IMF, International Financial Statistics, Supplement 1982.

In the end, there were two rounds of compensation under the guarantee – in October 1972 (costing 58m pounds) and October 1973 (costing 100m pounds).

4. BIS Group Arrangement III (1977):

$2b line of credit to fund diversification and sale of $/Yen/DM Bonds by UK to replace sterling reserves ($7.1 billion in current dollars)

The end of the pegged rate system did not deliver greater cohesion or eliminate pressures on domestic economic adjustment. The new system had to cope with a series of challenges including a commodity boom followed by two oil price shocks and the accumulation of huge sovereign debt burdens by developing countries. The oil crisis transformed the nature of sterling as a reserve currency since it generated large accumulations by oil producing countries while other countries ran down their reserves. The promise that the Sterling Agreements would remove the vulnerability that arose from the use of sterling as a reserve currency evaporated since they underestimated the rate of accumulation by Nigeria and Saudi Arabia. Still, the Agreements were abandoned only at the end of 1974. It appeared that the multilateral approach to the retirement of sterling as a reserve currency had come to an end, having lost its rationale with the end of the pegged rate system.

The 1976 sterling crisis marked the first time that sales of central monetary institutions put the primary pressure on the sterling exchange rate rather than private holdings. Although the ratio of external sterling liabilities to UK reserves had fallen since 1945 the diversification of reserves as confidence in British economic management ebbed was still sufficient to prompt a sterling crisis that could only be resolved by a humiliating recourse to the IMF with its attendant conditionality. The crisis also prompted the final multilateral effort to retire sterling as a reserve currency through the Third General Agreement of G10 central banks.

The nominal rise in sterling reserves after the Sterling Agreements had lapsed in December 1974 prompted a variety of initiatives to reduce Britain's exposure to possible instability of these liabilities. In July 1975 the Cabinet asked the Chancellor of the Exchequer to consider re-introducing guarantees for sterling balances to forestall diversification. The Treasury devised a scheme to negotiate guarantees for the largest oil-producing holders of sterling (Nigeria, Saudi Arabia and Kuwait) and then to offer a unilateral agreement to other medium sized holders such as Brunei, New Zealand, Hong Kong and Ireland.[27] On balance, however, they concluded that if anti-inflationary policies worked there would be no need for a guarantee, but if they didn't work the guarantee would be very expensive. It was noted that most speculative pressure did not in any case come from official reserves and the negotiations themselves would make sterling vulnerable to speculation if they were not successful with one or more holder. Instead of undertaking these politically as well as economically risky initiatives the Treasury advocated borrowing internationally, perhaps through the IMF, at lower interest rates to finance diversification away from sterling.

Andrew Graham, Prime Minister Harold Wilson's Economic Advisor, disagreed with the Treasury view and encouraged Wilson to solicit other opinions. He

[27] Policy Unit Paper agreed by Treasury and Chancellor of the Exchequer, 7 July 1975. TNA PREM16/371.

especially saw scope for encouraging oil producing countries to maintain their substantial balances by offering them new exchange rate guarantees.[28] In response, Wilson asked Harold Lever, Chancellor of the Duchy of Lancaster (and former Financial Secretary to the Treasury) to set up a working group on the financing of the external deficit.

Lever had been lobbying Wilson since May 1975 to pay off sterling reserves with the proceeds of borrowing in other currencies.[29] He argued that sterling borrowing was expensive because of high interest costs. Following the line of contemporary public analysis, he also blamed the disruptive 'stop-go' policies and Britain's 'reputation for being prone to these policies' on the external constraint of keeping overseas holders of sterling happy to retain them. He also reverted to the 1950s view that large sterling liabilities undermined confidence since they were mostly short term or liquid assets. While acknowledging that British interest rate policy could not be independent of international interest rates, he argued that the sterling balances constrained the flexibility of domestic policy. He therefore recommended that Britain's liabilities should be diversified away from sterling by borrowing more USD on international markets, reducing interest payable on sterling balances to encourage diversification and using the borrowed USD to replace some of the existing sterling reserves. This would turn short-term sterling liabilities into short term USD liabilities. Secondly, and even more ambitiously, he recommended a scheme to encourage UK banks to borrow USD that they would lend to the Bank of England to replace some sterling liabilities. Rather than undermining London as an international financial centre, he argued that lifting the threat of a collapse of sterling caused by 'an excessive dependence on our sterling liabilities' would enhance The City's attractions.

Partly in response to Lever's proposals, David Walker in the Treasury began to develop a plan to stabilise Nigeria's sterling balances by issuing them with an SDR

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[28] Andrew Graham minute for Prime Minister, 11 July 1975. PREM16/371.
[29] Harold Lever paper for Barber and Wilson. 4 August 1975. This was a revised version of a proposal from 18 July 1975. TNA PREM16/371.

denominated bond payable in sterling that they would likely be more willing to hold than sterling securities.[30] The Chancellor Denis Healey was initially intrigued by this idea, although the interest charge on such an instrument would have to be high enough to cover the expected depreciation of sterling. Negotiations might also prompt fears among creditors in the government's confidence in the future exchange rate.[31] Walker argued that Nigeria was the largest holder of sterling and was most likely to be responsive to the scheme, partly because 'Nigeria is newer to these investment questions, and less sophisticated than Kuwait, and Saudi Arabia, who may anyway have consciously placed a limit on UK paper of all kinds'.[32] As of May 1975 Nigeria held £1.5b ($16.7 billion) in official sterling balances out of a global total of £4.9b ($10.9 billion). Kuwait and Saudi Arabia together held £1.8b ($4 billion) so that these three countries alone accounted for two thirds of sterling reserves.[33] The reserve role of sterling had clearly been transformed as a result of the oil boom. Although the Treasury and Lever were firmly behind the plan, Healey chose to take the advice of Governor Richardson of the Bank of England that the threat to confidence outweighed the benefits of the scheme, but he asked that the proposal be developed to 'an advanced state of preparedness'.[34] It was to resurface in amended form as part of the Third General Arrangement organised through the BIS in November-December 1976.

By September 1975, Healey agreed with both Lever and with the Treasury that it was desirable to reduce sterling reserves but saw no prospect for achieving this in the near future. Sterling reserves did pose a constraint on policy but had they not been acquired, British governments and consumers would not have been able to finance their deficits to the same degree and this would have posed a different kind of constraint on policy. On Lever's specific proposals, Healey believed that Britain

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[30] Letter to DA Walker from S Payton (BE), TNA T358/219.
[31] Record of a meeting in Barber's room, HMT, 5 August 1975. TNA T358/219.
[32] ME Hedley-Millar to Sir Derek Mitchell, 18 August 1975. TNA T358/219.
[33] DA Walker, 'A Treasury SDR Bond', 15 August 1975. TNA T358/219.
[34] Note of meeting of Chancellor with Governor of Bank of England, 24 September 1975. TNA T358/219.

was already borrowing as much as it could to cover the current account deficit, and the prospect of borrowing more to retire sterling liabilities was not attractive. On the other hand both the Bank of England and the Treasury were against using British banks as a conduit for the Bank of England to borrow foreign currency from international capital markets. If it became public, it would be damaging to Britain's creditworthiness and would throw the independence and integrity of British banks into doubt.[35] Again, the threats to confidence outweighed positive initiatives to shore up sterling against an uncertain future crisis.

In mid-1976 the sterling exchange rate began to fall as a result of a loss of confidence in the government's ability to stem inflation. In June 1976 the Governor of the Bank of England arranged support from G10 (+ Switzerland) central banks over the telephone to supplement the Fed swap. The package added $2.3 billion to the bilateral swap with the Fed, bringing the total to $5.3b ($20 billion in current dollars) available in 3-month swaps renewable by mutual agreement for a further 3 months but with no maturity beyond 9 December 1976. In line with Fed Governor Burns' conditions, the UK was committed to make drawings on the IMF if necessary to repay the swaps when they came due in early December. The arrangement thus offered a six month breathing space either to allow the markets to end their pressure on sterling (if the pressure was merely speculative as the Prime Minister believed) or for the Government to get its house in order before being forced to do so by the IMF (if the pressure was due to fundamentals as the Governor of the Central Bank believed). The timing of the eventual approach to the IMF was thus set by this multilateral swap arrangement in June 1976. While the details of the IMF negotiations have attracted considerable academic interest, there has not been a full

[35] Healey's response to Lever's paper, 11 September 1975. The Chancellor's arguments were used to guide the Prime Minister in his preparation for the Cabinet discussion of the issue. Memo by John Hunt, 5 November 1975. TNA PREM16/371.

exposition of the important sterling agreements which preceded and followed the conclusion of the IMF standby in December 1976.[36]

Through the Autumn of 1976, the Treasury and the Bank of England together developed plans to gather medium term multilateral support for the impact on the UK reserves of any future fall in official sterling reserves and to restructure these external liabilities. This culminated in the Third Group Arrangement. These proposals were discussed at the same time as the IMF loan but the Americans were adamant that the IMF conditionality terms needed to be successfully concluded before any longer term support could be forthcoming. Conversely, however, it became increasingly clear that some announcement of longer term support at the same time as the short term IMF loan was a prerequisite to restoring market confidence. This led to complicated tactics on the part of the Americans, who offered their support of a longer term facility as a carrot to encourage Prime Minister Callaghan to accept the short term conditions on the IMF loan. It also complicated the planning for the Third Group Arrangement since the negotiations for the IMF loan were protracted right up to the December deadline.

In real terms the 1976 IMF rescue was not historically unprecedented, although it had a deep psychological impact on ministers and the public and was the last major operation undertaken by the IMF for a developed nation. The stand-by of $3.9b was a large nominal amount, but was equivalent to only $1.9b in 1956 dollars, a year when the UK had arranged $1.8b of support through the IMF and Exim Bank (of which $1.3m was from the IMF). In effect, the IMF loan could be viewed as merely a consolidation of the $5.3b in swaps that had been negotiated quickly over the phone in June 1976. The difference was the explicit nature of the conditionality, the prolonged and humiliating negotiations and the publicity that this generated for

[36] The most thorough treatments are K Burk and A Cairncross, *Goodbye, Great Britain: the 1976 IMF Crisis* (New Haven: Yale University Press, 1992), M.D. Harmon, *The British Labour Government and the 1976 IMF Crisis* (London: Macmillan, 1997) and K Hickson, *The IMF Crisis of 1976 and British Politics* (New York: Taurus Academic Studies, 2005). For an insider's view see D. Wass, *Decline to Fall; the making of British macro-economic policy and the 1976 IMF Crisis* (Oxford: Oxford University Press, 2008).

Britain's economic plight both among the British public and overseas.

Throughout these tortuous and often hostile negotiations, in the background lurked Callaghan's vision of a longer term solution to underpin the stabilization of confidence in sterling. If the liquidation of central banks' sterling reserves increased the vulnerability of the exchange rate, a longer term solution to prevent this kind of pressure in the future was clearly important to a sustained recovery. This diagnosis fit with a view that sterling's weakness was a symptom not primarily of confidence in the Labour governments' economic policy (which thus needed correcting) but to aberrations in the way that markets operated and extraordinary external pressures on British policy. The view that sterling was subject to special pressures because of the remnants of its reserve currency status combined with the accident of the oil crisis was shared outside Britain and helped gather a final multilateral initiative. A sterling safety net was the subject of ongoing discussion in Basle and with the US President, Treasury and Fed throughout the IMF negotiations.

The third and final BIS Group Arrangement to support sterling began to be considered in October 1976 and was finally concluded at the beginning of February 1977. The G10 (+Switzerland) central banks approved a USD3b medium term facility (75% of the value of the IMF loan) which would be available should official overseas sterling reserves fall below the £2.165b level of December 1976. The link to the IMF loan was made explicit since this Group Arrangement differed from the previous two by involving the IMF in its administration.[37] Witteveen as director of the IMF was given the task of ensuring that the British government conformed to the conditions of the stand-by and of advising the participating central banks if in his view policy had diverged away from the terms of the stand-by. In such a case, access to the safety-net facility would be suspended. The Group Arrangement thus reinforced the external surveillance and discipline of the IMF operation. As a condition of the safety-net the UK embarked on a programme of trying to reduce the

[37] Harmon, *British Labour Government,* p. 225-6.

use of sterling as a reserve asset by selling foreign currency denominated bonds in return for sterling reserves.

That Britain was still considered deserving of support to defend against the liquidation of overseas sterling liabilities despite the decline in sterling as a reserve currency and the advent of floating exchange rates is particularly striking and speaks to the priority given to stable exchange rates even in the environment of de jure floating rates. As Wass relates, the Treasury still considered that appealing to the collective interest in retiring sterling as an international currency and encouraging more orderly exchange rate dynamics were the two best prospects for engaging multilateral support for a final resolution of sterling's reserve role.[38] Certainly the position of sterling had receded considerably since the last Group Arrangement. Table 4 shows the BIS calculations of the change in the use of sterling as a reserve currency between the 1968 Basle Agreement and the crisis of 1976. By 1976 only 20 countries had sterling holdings of more than £10m and only one held close to 50% of their reserves in sterling (New Zealand). Half of the countries held less than 10% of their reserves in sterling. This compares sharply with 1968 when 23 countries (three quarters of those with at least £10m) held over half of their reserves in sterling.

[38] Wass, *Decline to Fall*, p. 242.

Table 4 Numbers of countries with sterling reserves

Proportion of sterling in reserves	December 1968	September 1976
1-10%	-	10
11-20	-	6
21-30	2	3
31-40	1	-
41-50	5	1
51-60	2	-
61-70	5	-
71-80	3	-
81-90	6	-
91-100	7	-
	31	20

The 1968 figures cover 88.5% of all official sterling and the 1976 figures 94%.
Includes only countries with holdings of £10m and above.

The Treasury moved forward with their planning for a safety-net and also with their proposal of August 1975 to issue SDR denominated debt in exchange for official sterling reserves, particularly those of oil producers. The Treasury made another push to implement the SDR scheme on 21 October 1976 either along with or prior to the arrangement of a BIS 'safety-net'.[39] By this time they argued that the extra risk to sentiment had evaporated since confidence was already so low. Moreover such an initiative would strengthen the case for the 'safety net' by showing Britain's willingness to take positive action to shore up sterling reserves.

In a broadcast of the BBC programme Panorama on 25 October Prime Minister Callaghan remarked that 'I would love to get rid of the reserve currency' perhaps by having the liabilities 'taken over in some form or other' by surplus countries like

[39] Derek Mitchell to Principal Private Secretary to Chancellor of Exchequer, 21 October 1976. TNA T358/219.

Germany, the USA and Japan.[40] By 28 October, the US magazine *Business Week* leaked discussions among central bankers, reporting that the UK was negotiating a renewal of the Basle Agreement amounting to $10b in standby arrangements.[41] A week later, on 5 November, Sam Brittan gave a detailed description in the *Financial Times* of the possibilities to be discussed in Basle, including another exchange guarantee and standby facilities. The pace was being forced at the British end through the media but American intransigence over discussing long term support until the IMF loan was concluded inhibited formal discussion among central bankers in Basle, and plans to discuss the matter in early November were postponed.[42] At this point the Treasury expected that a safety-net of about $5b would be sufficient and could be combined with an SDR bond scheme for official sterling balances (later changed to foreign currency rather than SDR). The participation and leadership of Germany, both on the Treasury and the central bank side was considered crucial, particularly if the Americans could not be convinced to take part.[43]

By the end of September, official sterling reserves were down to £2.8b having fallen £1.3b since the start of the year, of which £900m was in the second quarter of 1976 alone when sterling was under pressure. Private sterling balances, on the other hand had remained stable at about £3.2-3.4b throughout 1976. Among official holders, four oil producers Brunei, Kuwait, Nigeria, and Saudi Arabia together accounted for £1.4b, or half of total official sterling reserves. Only seven other countries had official holdings of more than £20m.

In November the Governor of the Bank of England presented proposals at the BIS to offer to holders of large official sterling reserves medium term or long term UK

[40] Dealtry note of a phone conversation with Mr McMahon, 26 October 1976. BISA DEA 4 7.18(12) Dealtry Papers. Excerpts from the interview are quoted in Wass, *Decline to Fall*, p. 247-8.
[41]Reuters report, 28 October 1976. BISA Third Group Arrangement Sterling Balances 7.18(14) LAR3.
[42]A. Lamfalussy note of a visit to Washington, 11-12 November 1976. BISA Third Group Arrangement Sterling Balances 7.18(14) LAR3.
[43] Note of meeting at Number 11 Downing Street. CoE, Wass, Derek Mitchell (HMT), Lever, Governor Richardson (BE), Kit McMahon (BE), 5 November 1976. Bank of England http://www.bankofengland.co.uk/publications/foi/disc060519.htm.

Government USD bonds issued on market terms. Creditors would thus avoid exchange risk at the cost of liquidity. In order to make the bonds attractive there would have to be some liquidity guarantee, not just marketability (since the latter would prompt a large discount if holders all began to sell on the market). The value of the bonds would be assured by a facility for the UK to have recourse to support from the G10 central banks to liquidate them. The advantages of this approach were that activation of the facility would be unambiguous (when the bonds were cashed), a market interest rate and liquidity guarantee should make the bonds attractive reserve assets so they would be unlikely to be sold, and ‘it would represent a positive and deliberate step towards a reduction in the reserve role of sterling’. But the scheme would offer no protection from running down private balances and there was no assurance that sterling holders would accept the bonds. Moreover, negotiations would be complicated and perhaps lead to a delay damaging to confidence.

The Americans proved the greatest obstacle; on the eve of the key central bank governors’ meeting in December 1976, Prime Minister Callaghan phoned Chancellor Schmidt and urged him to call Ford and get him to move the US Treasury to accept the safety-net, concluding that 'if they are not careful that bloody American Treasury is going to upset the whole of this packet'.[44] Although agreement in principal was achieved in December in time to be announced at the same time as the IMF stand-by (and thus achieved its presentational purposes) American intransigence meant that the final details were not agreed until February 1977.

Like the Second Group Arrangement, the Third Group Arrangement fulfilled the ambitions of its founders and did not need to be drawn. A total of $675 million worth of foreign currency bonds were sold to central monetary institutions in exchange for sterling. They were offered on 4 April (with a closing date of 14 April) in denominations of US$ (maturities from 5-10 years), DM, SFr and Yen (with seven year maturity). This led to a one-off reduction in old sterling reserves in April 1977,

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[44] Transcript of phone call Callaghan to Schmidt, 11 December 1976. TNA PREM16/807.

but this was offset by an increase elsewhere so that the level of sterling balances actually increased by £115m in that month. The net outcome for the period December 1976 to February 1978 was a modest fall of £102m in official sterling reserves. In 1977 as British foreign exchange reserves surged, the reduction in overseas sterling reserves finally pulled these liabilities below the level of UK nominal reserves. The 'overhang' identified in 1945 had finally disappeared after 32 years and sterling's reserve role was now formally over.

Conclusions: the decline of sterling and lessons for the Dollar

This paper has argued that the retreat of sterling as a reserve currency has been misunderstood. Sterling played a much greater role for a longer period after 1945 than is usually acknowledged and its retreat was carefully managed rather than left to market forces. Although sterling's share of global reserves did fall below 50% from the mid-1950s, it remained the dominant reserve asset for a range of countries. This was due in part to inertia related to colonial monetary systems and pre-war commonwealth links. Large accumulations of sterling after the war, lack of expertise and loyalty to the UK prolonged the transition, for example, for Malaysia. But we have seen that from the 1950s the persistence of sterling was driven by fresh accumulations among a new group of countries in the Middle East and East Asia as wartime accumulations elsewhere were run down. For these states, the economic fundamentals of the denomination of debt and trade in sterling remained important until the 1960s. At this point, the pace of the fall in sterling's share of global foreign exchange reserves slowed because of deliberate action taken by the developed and developing world. Britain was able to convince the G10 that prolonging the tipping point for sterling was in their common interest and to gather substantial international support to guard against a collapse in the pound that would arise from a rapid switch to the dollar. This allowed the UK to offer a credible exchange guarantee for existing sterling reserves, in return for an undertaking that these states would retain a minimum proportion of their reserves in sterling. By the time the Agreements expired at the end of 1974 sterling's reserve role was swamped by the effects of the oil crisis, which concentrated sterling reserves among a few countries, reduced the global share of reserves held in sterling and increased the nominal value of these liabilities. When pressure on sterling finally arose from sales of official reserves in 1976, the value of these liabilities had fallen in real terms, relative to UK GDP and relative to UK reserves. The 1977 scheme to replace sterling reserves with UK liabilities denominated in other currencies merely marked the formal end of sterling's reserve role.

It is clear that the case of sterling does not provide a blueprint for retiring the USD, but it does provide some perspective. For sterling, there was an obvious rival currency in the dollar. Despite debates over recent years, the strains on the Eurozone arising from the global financial crisis mean the Euro is not an attractive alternative in the current climate. It could be argued that by the 1960s the USD was not a strong rival to the pound, but rather the lesser of two evils, and that this was compounded by the depreciation of the USD from 1971. Certainly, those sterling countries that shifted their peg to the USD in the early 1970s found themselves in a serious dilemma as they underwent unwanted depreciation in an inflationary climate and some switched back to a de facto sterling peg. Nevertheless, the dollar was a viable alternative reserve asset in a way that the Euro is not today. On the other hand, the experience of sterling does support Eichengreen and Flandreau's conclusion that the transition between major reserve currencies need not result in a dramatic tipping point, and that two reserve currencies can operate simultaneously. In the sterling case, countries with economies linked to the British economy continued to use sterling as their primary reserve currency even while the USD soared in relative share of global reserves.

The prospect that America would offer a floor value for the USD in return for major holders retaining their reserves in dollars seems remote. In the UK case the exchange risk was underpinned by a substantial multilateral line of credit. Britain carefully avoided the interference in domestic economic policy that such large amounts of credit usually attract by negotiating with central banks (who deplored taking political stances) rather then inter-governmental or IMF routes. However, in the end even central bankers ran out of patience and IMF conditionality was transferred to the Third BIS Group Arrangement in 1977. We also need to note that multilateral support for retiring sterling as a reserve currency was contingent on a range of specific factors including on-going negotiations to replace national currencies as reserve assets and more general reform of the system. American support was prompted by self-interest to preclude pressure spreading from the pound to the USD.

However, some more general lessons might be learned. Firstly, retiring a reserve currency is likely to be easier in a time of moderate inflation (which decreases the real value of outstanding liabilities) and growth in international liquidity so that the shift is achieved through acquisition of new reserves rather than exchanging or replacing existing assets. Secondly, the global political environment is also important. The stability of the international monetary system was closely linked to Cold War interests in the 1960s. Generally, it was believed that a collapse in the global reserve system would destabilise capitalism. More specifically, both Britain and the USA recognised that a run on sterling could only be stemmed by Britain's retreat from the international economy and an acceleration of the retreat of its global military presence. Thus, during the Vietnam War US support for sterling was often linked to British strategic commitments in Southeast Asia. When the war ended, the American administration became much less cooperative and pushed Britain more firmly toward the harsher terms of the IMF rather than the cosy arrangements in Basle. Existing predictions of the timing for the change from the USD to the Euro as the dominant reserve currency usually set the change well into the future, mainly due to the impact of inertia. The experience of sterling suggests that extending the tipping point and avoiding a landslide effect may require more deliberate management than the gradual trends predicted by changing economic fundamentals suggest.

APPENDIX I

1968 Sterling Agreements
Minimum Sterling Proportions for Official Reserves (percent)

East Caribbean Currency Authority	100
Gambia	100
Hong Kong*	99
Barbados	97
Mauritius	95
British Honduras	90
Bahamas	80
Bermuda	80
Ceylon	80
Ghana	80
Guyana	80
Malawi	80
Trinidad	80
Malta	75
Bahrain	70
New Zealand*	70
Sierra Leone	70
Zambia	65
Nigeria	60
Jamaica	57
Ireland	55
Uganda	51
Cyprus	50
Dubai	50
Iceland	45
Australia*	40 (47)
Malaysia*	40 (45)
Pakistan	40
Singapore*	40
Jordan	25
Tanzania	25
Kuwait*	25 (54)
Libya	18 (50)
India	13

- * largest sterling holders
- ( ) private side agreements