STERLING AREA — ITS PRESENT AND FUTURE

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Background

In the period before the World War First the world was an economic unity to a far greater extent than was ever achieved during the interwar period. U. K. was world's largest trader, and her highly efficient international banking system financed a very large part of world's trade, London became the financial centre of the world. That certainly did not come by deliberate planning. It was involuntary and unconscious; most of all the process of Pooling, of the foreign exchange earnings of Commonwealth. Pooling grew because the Commonwealth Countries sold their produce for Sterling, not only when they sold it to Britain, but also when sold to other countries. Moreover the existence of international commodity market in Britain where business could be done for spot and forward delivery led to the pooling of reserves. The gold Standard was in a sense Sterling Standard, and it operated successfully. Since the pound was fully convertible in gold or in foreign exchange, it could be used throughout the world, and there was no Sterling Area as it is known to-day. But we can identify a Sterling Area of another type which has specially close relations for a variety of reasons. Pound Sterling was legal tender in several colonies and keeping of bank reserves by them gave nucleus to the Sterling Area later on formed.

The World War I put complications in the intricately balanced working of trade and payments which had existed previously. The world wide depression of thirties put further strain on the world financial system; the link between gold and sterling was broken and sterling block appeared as a separate monetary area.

For some countries the choice was virtually automatic, and others decided to link their currencies with sterling rather than gold. The motives can be classified as.

(*a*) Political bonds.

(*b*) Economic reasons.

(*c*) Suspicion about gold.

The break down of gold standard as an international monetary system, therefore, led to the formation of a group within which the trade could flow more freely. The basis of formation can thus be enumerated as follows:

1. Some of the countries were intimately connected with sterling since their reserves were invested in London.

2. They had close commercial and financial relations with U. K. and bulk of their foreign trade was with that country.

3. Political factors played their part especially with the colonies and British Commonwealth.

4. Apprehension was felt about gold and prestige of sterling might have been an important factor.

5. Advantage of maintaining stable exchange rate with the principal trading partners and strong interest in safeguarding their export;"

6. A reasonable stability in the economic condition of U. K. was another factor. Decline in the business activity in Britain in the great crash of thirties was less severe than in other industrial nations. Moreover the new technique developed by U. K. for holding the paper pound at a fairly stable level at a time when there was so much unstability and uncertainty attracted the members.

The closest links were maintained by Australia, India, South Rhodesia, New Zealand, the Straits Settlements and Portugal. In this way countries obtained relief from additional deflation that would otherwise have been required. Sterling prices were kept stable while gold prices continued to fall. It showed that the abandonment of gold standard does not involve the adoption of freely fluctuating exchange rate; and that under a paper currency standard it is possible to maintain reasonable exchange stability and organize a system of multilateral trade over a wide area.

The existence of the Imperial Preferences system, and special, agreements with Baltic and Scandinavian countries led not only to the co-herence of the system but also its strengthening by Argentina, Portugal, Latvia etc. In addition there were several countries like Japan, which for years kept the official exchange rate with sterling but were not generally recognized members of the sterling area.

Thus before 1939 sterling area was based on a trading relationship. Financing of the trade between the member countries had eased. In a world in which exchange controls were multiplying, the countries of the fosterling group were able to trade with one another, unfettered by exchange restrictions. This tended to increase the volume of international trade. Except in the case of dependent countries, the S. A. was a voluntary organization. Most of the members were free to leave, whenever they found, the continuance of the membership disadvantageous; and what is more important they could peg their currencies to the sterling at a rate chosen by them unilaterally. There was no condition of membership, no specific obligation, except that of the obligation of U. K. in respect of sterling balances held in London.

The change thus brought about was very great. The pound was freely convertible Exchange control was only for a few months and the fluctuation in exchange rate was limited by the Exchange Equalization Accounts. We can in a way put what the membership of the sterling Area implied before the war.

1. A member country found it convenient to peg its exchange, rate against the pound, and to alter exchange rate comparatively rarely.

2. To maintain this pegged rate, that country's central bank, kept a reserve of sterling assets, consisting partly of balances with London banks, and partly of sterling bills, securities, and other recognized banking investments.

3. It conducted the bulk of its foreign exchange business through London, buying and selling pound against its currency.

War changed the whole situation of the Sterling Area. We have to see its nature during the war, because the present day mechanism is the result of policy pursued in those years.

World War II

With the outbreak of war S. A. was employed in the field for which it was never intended Numerous causes seemed to endanger the over all balance of the S. A. Exchange control mechanism was therefore introduced which had the purpose of monopolizing the hard currency earnings and saleable assets of S. A. countries so that these might be used to the best advantage in purchasing, goods, raw material and military equipment for Britain. Throughout the S. A. gold and foreign exchange dealings were monopolized by respective treasuries. U.K. purchased gold holdings of specified foreign exchange compulsorily. Payments to the residents outside the S.A. was banned, and all marketable securities were to be registered and acquired as needed by Government. Early in 1940, foreign held securities were blocked in London as a further safeguard against capital flight. Pooling of gold and dollar reserves came to be re-enforced by more strategic arguments But the most important development was that the habit of treating London as the banker and holder of external reserves endured even when the payments passing out were no longer of a commercial character. It allowed war-time expenditure, which really ought to have gone into; a special account to be financed — and all that means paid for — by the issue of I.O.U.'s, and it developed what are now called the sterling balances.

To regulate the working of these controls it was felt necessary to define the limits of the S. A. This was a marked change in the evolution, because the fluid position of earlier years when countries, joined or left the area, according to will, as they kept their balances in London was gone. Some countries were declared out side the area because of the closeness of their ties with hard currencies and with some, special agreements were made, that any sterling outstanding should be repaid in gold. As the war spread further east many countries outside the Commonwealth joined the S. A.

After War Period

After the war S. A. became what it had never been before. The difficulties and problems created by the war had as yet not been solved. A number of factors were responsible for the lack of balance between what the S. A. countries wanted from dollar Areas, and its capacity to pay for them. It became a conscious group with a powerful weapon for discrimination in its commercial and financial relations with other countries. And since the war these are being used in order to keep down the purchases made by the whole Sterling Area from U.S.A. and other dollar area Countries. These restrictions were accepted with the best of grace so long as it could be assumed that the banker's difficulties were only temporary, but now a time has come when this justification might not receive such unquestioned acceptance from inside and outside the group.

Sterling Area thus represents a wide group of countries, within which exchange dealings are free of government Control. But difficulty arises as regards hard currencies. If a Pakistani merchant sells Jute to U.S.A. he hands, over the earned Dollars to the Pakistan Government, who turns these dollars into sterling. Dollars in this way find their way into the Sterling Area dollar pool, while the Pakistani merchant gets the rupees and the Government Sterling. The area in July 1951, comprised:—

The Commonwealth except Canada, British Mandated Territories, British Protectorates and Protected states, Burma, Irish Republic, Iceland, Iraq and Jordan.

Mechanism

We can now analyze the present mechanism in detail.

Dollar Pool: When the members of the Sterling Area earn dollars they pay them into a central pool in exchange of Sterling. Members can convert these Sterlings into Dollars and U. K. as Central banker does not refuse to do so. But there are important limitations. By import licensing and exchange control, the member countries impose restrictions on visible and invisible transactions. It is a cardinal rule of the membership of the Sterling Area ……… an unwritten rather than a formal rule which requires members to exercise some self-restraint in their demands for dollars. This self-restraint is to the mutual advantage of all the members and if it did not exist Sterling Area would not be able to carry on.

The Common reserve makes it possible for the Sterling Area as a whole and for the individual members of the Sterling Area to conduct their trade with dollar area far more flexibly than would be possible if each individual country was trading with the dollar area on its own. Member countries are able to design and carry out relatively long term overseas trade policies, because of their right as members of the Sterling Area to make use of the Central reserves. Restrictions, however, are increasing day by day, and in July 1949, on the request of Britain, Commonwealth Finance Ministers decided further to cut by 25 per cent their import from Dollar sources. Another feature is the exchange Control.

The present system of exchange Control can be considered in two parts:

(*a*) Control over current transactions (which includes transfer of goods and services).

(*b*) Control over Capital movement, (which implies acquisition of securities and foreign assets).

Control over current transactions: The restrictions over the use of Sterling for current transactions by scheduled territories are imposed mainly by the system of import licenses, and exchange control in case of invisible transactions. Priority lists are drawn and only essentials are to be drawn for which licensing system was introduced. In this way all Sterling Area countries have agreed to restrict the foreign exchange dealings of their nationals.

As a result of monetary agreements negotiated in 1946-48 most countries other than the scheduled territories may be classified:

(*a*) American Accounts Area, which includes U.S.A. dependencies, Mexico, Philippines etc. etc.

(*b*) Transferable Account Area, which includes Egypt, Sudan, U.S.S.R., Iran, Netherlands Monetary Area etc. etc.

(*c*) Bilateral Countries Area, comprising Argentina, Brazil, China, Japan, etc. etc.

S. A. countries have to pay in dollars for purchases from the American Account Area unless sterling is chosen by the latter. Transferable Accounts Area consists of countries with which Sterling Area has no deficits or surpluses yet it increases the area over which sterling is accepted as a means of international payments. The residents of Bilateral countries use their sterling Accounts without the approval of Bank of England only for their internal payments or for payment in the Sterling Area countries. The division is not rigid, but there is clearly an advantage in generally extending the area, where sterling can be used for current transactions. The basic idea behind the exchange control is to ensure maximum amount of multilateral trade between as many countries as possible, without risking the gold and dollar reserves of Sterling area.

Control over Capital Movement: The control over capital movement implies that no resident of the Sterling-Area can purchase" non-Sterling securities or acquire real assets without prior permission from their respective governments. Enforcement of the control of capital movement is a necessary condition of the membership of the Sterling Area.

By such control and regulation the Commonwealth and other countries with close commercial and financial regulations have tried to achieve a high level of trade. Though not of all the members of Sterling Area but U. K.'s exporting capacity was restored. In a number of countries before the crises began to develop in the third quarter of 1951, pound was hardened, and there was even a talk of revaluation. Before we study the future of the area, it is necessary to be clear about the role of the centre and the co-herence of the Sterling Area.

Role of U. K.

The role which U. K. plays as a centre country in the Sterling Area is most interesting. The pivot position is shown in the process involved in building up gold and dollar reserves. When the other members of the Sterling Area earn dollars they hand it over to the dollar pool in return for sterling, and when earning is more than spending sterling balances accumulate to their account in London. The gold and dollar accruing to the Exchange Equalization Account may increase due to a variety of factors. It may be due to a surplus of earning by U. K. or rest of the members of the Sterling Area. Gold also flows to the central reserves if other members of the Sterling Area earn a sufficient surplus from the EPU, and then they secure a claim against

U. K. Gold may also come from export to gold producing countries. Britain is thus said to "Shoulder" the responsibility; for building the gold and dollar Reserves. It is claimed that its existence frees other countries from the necessity of keeping gold and Dollar reserves. It also makes it possible to use the reserves more economically and more effectively, than in arrangement whereby the individual country might maintain her own reserves at a level which would be disturbed by the particular circumstances of that Country's economy and overseas trade relations.

There are distinct advantages which impel U. K. to ''Shoulder" the burden of maintaining the reserves. Britain has the use of the reserves of other countries and sterling is accepted medium for settling the international financial transactions over a wide area.

When Sterling Area is running a surplus, the primary producers in the area make huge profits. Since Britain has large equity investment in the primary industries in the Sterling Area, for example in Malaya, a considerable portion of added earning comes to London.

High level of Sterling Area exports automatically increases U.K.'s invisible income particularly from shipping and insurance. Thus a surplus accruing to other members of the Sterling Area is expected to add to the British balance of payments. This comes to about 1/3 of the rest of the Sterling Area surplus. This is a very substantial benefit indeed!

Members of the Sterling Area maintain their exchange reserves largely in British Treasury Bills through Bank of England. The maintenance and growth of Sterling Area funds in London represented an influx of Capital for U. K. It provided for the domestic currency, base to counteract the effect of international movement as shown by the functions of Exchange Equalization Accounts.

On the other hand, in spite of these advantages it has been asserted that in addition to "Shouldering" the burden of keeping the reserve, the center has to pay interest on the exchange reserve. But it can visualize it as a price for enhanced liquidity, which the centre enjoys by the fact that it uses its own currency as a means of settlement throughout the Sterling Area. Now we shall study the coherence of Sterling Area system.

Causes for the Coherence of S. A.

At this time the question arises what are advantages, and factors working for the co-herence of the Sterling Area. Previously we have seen free convertibility was a great factor in enlarging the volume of international trade. Sterling Area countries having hard currency earnings could have the things they wanted from Sterling Area on as early date and on as competitive price as from dollar area but now the situation as far as U. K.'s supplies are concerned is not satisfactory. These countries then turn to hard currency areas. Here there are Controls. Those countries having surpluses with dollar area have exercised real-abstinence in restricting imports from these sources. So the previous benefit of having goods freely at competitive prices has gone down. Still the members stick to the area due to greater trade with the centre country and with other members of the area. Freedom of trade between members of the Sterling Area and other countries would have been a good deal less if it were necessary for them to involve themselves in bilateral bargaining, which so often has to be the first step in trade between different groups.

Another advantage is that member countries are able to trade freely in sterling with many Non-sterling countries with which Britain has made special agreements. An example is the countries in E.P.U.

However it has been pointed out that the economic disadvantage in restricting imports from dollar area is offset in part by the advantage of access to a large gold and dollar reserve which is conferred by the membership of the Sterling Area. If each country decides to maintain its own dollar reserves it would be necessary for them to keep a much closer watch than they do now on their trade with dollar areas. The advantage of flexible trade offered by the central reserve would be lost. Fluctuation in the export of any individual country with the Dollar area might well require rapid and some times painful readjustment in its dollar import programme. This in turn might easily have a detrimental effect on the country's development programme. Pakistan for example has' been drawing more than her dollar earnings from 1948 uptill now. Moreover the country having favourable balance with dollar areas would find it difficult and hard to accumulate reserves of its own which would be beneficial to her as large central reserve. But on the other hand, many of them might now feel that it would suit them, instead of paying their dollar to the central reserve to keep their reserves as they like. Pakistan for instance has jute to sell, which commands a ready dollar market, West Africa her cocoa, Malaya rubber and tin. And all need capital goods. But the facilities which sterling area provides as being the largest single area of freedom of trade and payment may be working for their co-herence.

But the most important interest which is working against the disruption is the sterling balances. Fear of losing sterling Balances may be letting them to remain in the system if not on other grounds. Under Colombo Plan U. K. is committed to make yearly releases. Recent crises it is feared might come in the way of such releases. But it is a fact that re-payment of these balances in addition to various other things is a basic necessity if Sterling Area is to continue further.

For colonies especially, and for other as well, there are chances of receiving grants and loans. The possibility of this help may be a reason for some countries to be in the system. However we are well aware of the motive of these grants and loans which springs from a desire other than to strengthen Sterling Area system. We have definite case in Malaya, where huge sums of money, men and material are being sent to protect Britain's interest in tin and rubber estates.

Sterling Area is not held together by economic and political factors alone. It is in a way strengthened by the ties of sentiment and estimation of political and non-political benefits which had held Commonwealth together. Mutual advantage, it is advocated makes Sterling Area stand.

Present Problems

We have soon that though Sterling Area has retained certain features it has undergone great many changes in this evolutionary process. Therefore what are the hopes for it in the future it is impossible to predict. Nevertheless there are certain problems, the satisfactory solution of all of which is necessary to counteract the forces which are endangering its very existence.

Firstly the question and problem of fundamental importance to be solved for the system is to free Sterling Area trade from its rigid restrictions and control and to achieve the convertibility. How far the two are objects possible? The answer requires brief examination.

Now removal of import and trade restrictions by Sterling Area on current transaction depends upon.

(*i*) Total demand of Dollar goods in the Sterling Area as a whole does not exceed from the value of export to the dollar Area.

(*ii*) U. K. must run an export surplus with Sterling Area large enough to finance any dollar deficit of its own, otherwise her difficulties will increase and it will be difficult to remove the present restrictions.

(*iii*) Difficulties raised by the Sterling Balances already accumulated are solved.

But the situation is that it is not with. Dollar Area alone but with the whole world U. K. is in deficit. Moreover the trouble is that the policy of making Sterling Area pay its way is directly at variance with the policy of out and out rearmament.

The essential conditions for the restoration of convertibility are somewhat different. It is basically required that sterling should be strong with Adequate gold and dollar reserves. There is thus a necessity for:

(*i*) Dollar and gold reserves to be built to an adequate level, to be safe and capable to withstand the shock of world trade.

(*ii*) Incessible efforts on the part of U. K. to increase her capacities for earning dollar and non-dollar currencies.

It is feared that convertibility may expose the sterling area to a dollar drain which can not be afforded. The demand for dollar is kept artificially low by restrictions and abolition of these restrictions would greatly increase the demand of American goods by U. K. and the other Sterling Area Countries.

The likelihood of easing restrictions on the foreign translations and convertibility depends besides dollar balance of the Sterling Area on the Sterling Balances, The creditor countries like Pakistan might use the balances for transaction with dollar area and then there will be heavy demand of dollar. U.K. realizes that early convertibility will hamper her recovery so she is postponing convertibility.

We can here recall the convertibility attempt made in 1947 which lasted for a month (July and August) and then had to be abandoned due to heavy drain on gold and dollar reserves. The story should not be repeated. Present indications are that failing external aid from outside the area in strengthening the reserve it will take several years to restore the degree of convertibility. Reserves are expected to continue to fall until the middle of this year and are not expected to do better than achieve equilibrium in dollar payments. So before four or five years it is difficult to think about convertibility. It might still be possible to make a move in this direction earlier if help could be obtained from outside the area, to strengthen the reserves. If American investment can be attracted to the Sterling Area projects quickly enough and substantially enough, convertibility, after re-armament is finished, will become possible.

Secondly there is the problem of sterling balances. Agreements have been made or are being made in connection with the Colombo Plan to release blocked sterling of the member countries. It is feared that the agreement may be frustrated since the claims of rearmament are heavy on the economy of U. K. But it is a fact that Britain must provide means for the early releases of these blocked and current account sterling if Sterling Area system is to work at all.

Sterling Area Countries want goods and not future claims on goods which these balances really represent. Forcible non-use of them would have little result, save to discredit sterling as it is hampering the development of less fortunate areas who have money but cannot spend it. Moreover Sterling Area countries fear a further devaluation, or the doubtful prospect of Sterling Area remaining intact. To ally these genuine fears U. K. should see that these balance are paid as early as possible.

Thirdly the present restrictions and controls have led to a distortion or normal pattern of trade. No doubt the encouragement of new industries and possibilities of new sources of raw material supplies are a blessing in disguise to some countries, but there is a danger that in the long run these sources may become uneconomic. The under-developed regions have to postpone their development programme due to the present intricate mechanism of the Sterling Area. Moreover U. K. by following a policy of developing dollar export at the expense of export to Sterling Area has brought "negative welfare". With dollar market restricted the commonwealth countries are compelled to take British goods which are not competitive with American goods in price and quality.

These restrictions have in the past few years created uncertainties. Same is the case with sterling liabilities. U.K. to carry out her armament programmes on the designed scale is finding it difficult to increase her saleable export to pay for necessary import. The welfare of the creditor countries is further undermining. So whatever may be the aims and objects of the centre, Sterling Area trade must be free, so that maximum welfare can be achieved and member countries can maintain full employment. "Commonwealth certainly is not a cure for the centre's solvency."

Need for Greater Co-operation

Last but not the least is the question of governing and directing of Sterling Area. There has in the past been lack of consultation between the members and Britain did not think it worthwhile to consult the members on Devaluation. There was a general resentment throughout on this point. Recently U. K. has allowed the rate of exchange of the pound to find its natural level in controlled but flexible market. This is the issue on which the rest of the members want to have their say. At present Sterling Area Statistical Committee and Commonwealth Liaison Committee are functioning at London; and Commonwealth Finance Ministers meet whenever a crises develops. But this cannot solve the difficulties. What is wanted is a regular interchange of view information and full discussion of policy as and when required. Recently two Committees one to study convertibility possibility and the other on the development and borrowing projects for the Sterling Area have been formed. But there remains the necessity of a machinery to control and direct comprehensively the working of the Sterling Area from the Centre. Main responsibility for the proper working of the Sterling Area rests however on U. K.

Paul Barraunote in a recent article in the “Lloyd Bank Review” wrote “Sterling Area is one of the intangible but extremely valuable assets that are being put in jeopardy by the present inability of Great Britain to make ends meet in overseas payment.” So the main responsibility rests with the centre country and unless and until steps are taken to stabilize the economy of Britain crises will develop again. Convertibility will remain a dream and discontentment of the members of the Sterling Area will grow further.

U. K. has been beyond her means in her over all current deficit, thanks to the generosity of U.S.A. and other members of the Commonwealth. But there is a definite limit to overspending. If Sterling Area is to work U. K. must maintain not only an over all overseas balance of payments but also release at an early date the war time balances.

We have tried to analyze some aspects of the future of Sterling Area. Trends of world are changing and will change in the future. Will the situation be favourable for the removal of restrictions and a return to convertibility? We wish it should be though prospects are not very bright in the near future. U. K. as we have seen as banker has great responsibilities. She must see that security of pound is above suspicion. Untill, she returns to solvency, the rest of the members would have to wait. Should they wait is the question to be decided.