Paul Bareau is one of the most prominent financial journalists in "the city" of London. He has specialised particularly in problems of international finance. He is deputy City Editor of the "News Chronicle," an assistant editor of "The Economist," and associate editor of "The Banker." In 1945-46, he was a member of the U.K. Treasury delegation in Washington. In that capacity, Bareau was one of the team which, under the leadership of Lord Keynes, negotiated the Anglo-American Financial Agreement of 1945. He was also a British Government delegate at the inaugural meeting of Governors of the International Monetary Fund and International Bank in Georgia in 1946.

Paul Bareau is thus uniquely qualified to write on the future of the sterling area, a problem of surpassing importance to the British peoples throughout the world. All thinking Australians should know something of this vital matter which concerns the whole future of the British Commonwealth and of sterling as an international currency. In this article—written for "Review" at our invitation—Bareau has achieved the most lucid explanation of the history, and the significance of the severe problems now facing "the sterling area," which we have had the privilege to read. He has written of a technical complex subject in simple non-technical terms which can be understood by all.

THE FUTURE OF THE STERLING AREA

By PAUL BAREAU

THE stresses and strains to which the British Commonwealth has been subjected over the eventful decade that lies behind us, have not spared the sterling area which, in large part, may be regarded as the monetary expression of that Commonwealth. It is true that the sterling area is by no means synonymous with the Commonwealth; Canada and Newfoundland lie outside it while the sterling world extends over considerable areas that are not within the Commonwealth. But the fate of the sterling area mechanism is in many respects one facet of the greater problem of the evolution of that community of nations which had its political and economic genesis in the combined roles of Great Britain as coloniser, administrator, teacher, merchant and banker.

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The evolution of the British Commonwealth and of the sterling area has many traits in common. Each of them reflects the essentially British qualities of empiricism, of adjustability to changing circumstances, of capacity to move with the times and therefore incapacity of ever being definable within the rigid compass of a statute or treaty or formal agreement. This looseness of structure has undoubtedly contributed to the strength and endurance of both political and economic organisations of the Commonwealth. If, however, the sterling system has endured, it is not only by reason of the looseness and adjustability of the structure but, even more, because of the unquestioned confidence which all its members had in the solidity, solvency and judgment of the banker at the centre, in London.

ITS MEANING

Let us look back at this unique phenomenon of the sterling area, for it is only by retrospect that we can measure the prospects that lie before it. The sterling area is a group of countries which over the course of the years have come to base their currencies on sterling, to choose sterling as the anchor to which they have tied the exchange rates of their currencies and to maintain in London both the major part of their currency reserves and the bulk of their working external balances. This sterling system grew up imperceptibly over the 19th and 20th centuries as a result of the commercial and financial importance of Great Britain to the countries in question. As British traders developed their activities in colonies and dominions they naturally tended to take their currency with them. That trade was done in sterling even when the territories in question sold their produce to countries other than the United Kingdom. In large part those transactions, even those between third parties, were made in sterling through one of the great produce markets situated in Britain, financed in sterling through a London credit, shipped in a sterling vessel, insured in the London market. It was this commercial and financial supremacy of London which lay at the root of this growth of the sterling area. It was an imperceptible growth because in those decades of the 19th and early 20th century the sterling mechanism was merely part of the wider international gold standard which itself was dominated and guided by London. It might with some justification be claimed that in those years the whole world was in the sterling area. But those, let it be noted, were years when there was no exchange control in London, when the pound could be exchanged for any currency in the world, when sterling and gold were virtually synonymous terms.

This sterling area first became recognisable after the departure of the pound sterling from gold in 1931. This event set a choice before all important commercial countries of the world. Should they follow sterling or cling to gold as the anchor of their exchange policy? The divergent answers which came to this question created on the one hand the gold bloc and on the other what was first known as the sterling bloc, and was later to become the sterling area. Among the countries which chose sterling were most of the members of the Commonwealth. The membership of the sterling bloc, however, extended well beyond the Commonwealth. It included the Baltic countries, Egypt, Portugal, Iran and later Japan, Argentina and France. It should be stressed that within this group there was no formality of admission and membership, no recognition of set rules and regulations, no commitment to take orders or even advice from London, and certainly no pretensions on the part of London to rule the affairs of the other members—with the one reservation that the Colonial territories and dependencies within the sterling area have throughout had their monetary policies formulated for them in the appropriate government departments in London.

Although these countries in the sterling bloc maintained their exchange rates stable in terms of sterling, there was no rigid consistency even about this fact. Certain parities were changed without reference to London, some countries came into the group and others left it, without a by-your-leave. Moreover, some countries kept the bulk of their external reserves by way of London funds, others only maintained working balances here and kept the greater part of their reserve in the form of gold. In other words, this was a typically British institution, defying any attempt at codification, based not on compulsion or on the logic of a definite set of rules but on the convenience and self-interest of the countries concerned. They adhered to the sterling bloc for the good and adequate reason that this served their interests. Great Britain

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succeeded in avoiding the worst of the economic blizzard that was to sweep over the greater part of the world in the early 1930's—and that, in its turn, added to the attraction of the sterling bloc. One by one the members of the gold bloc were compelled to escape from the virulent deflation of that period, either by devaluing their currencies in terms of gold or, as in the case of France, by choosing sterling as the anchor for their exchange rates. During this period of the 1930's the sterling area gradually acquired recognisable shape and very considerable substance—but be it noted that throughout this period sterling, though no longer anchored to gold, remained a fully convertible currency, free from exchange control and continuing to serve as the basis for invoicing and financing the bulk of the world's trade.

THE EFFECT OF THE WAR

Then came the outbreak of the war and with it exchange control. In the weeks immediately preceding the war the sterling area had lost most of its neutral adherents and comprised solely the British Commonwealth (apart from Canada and Newfoundland) plus Egypt, the Sudan and Iraq. Since it was decided to keep payments within the sterling area as a whole, it was necessary to give the sterling area a statutory definition. That definition was first made in Statutory Rules and Orders issued under the Defence Regulations. It was later to be made in schedules to the Exchange Control Act of 1947, since when the sterling area has become technically known as the "Scheduled Territories." Although the net of exchange control was thrown round the sterling area as a whole that control has not been operated by a central authority. Each member of the sterling area has been left to operate its own exchange control and to determine its own import licensing policy. In the case of the colonial territories, these matters have been largely dictated by London; but for the rest of the sterling area the necessary homogeneity in exchange control and import policies has been the product of voluntary co-operation, of readiness to appreciate the obvious advantages of operating these controls on similar lines, of general recognition of the fact that the common advantage could best be secured by acting in concert, by economising dollar imports and by pooling not only their policies but their reserves.

It must now be questioned, however, whether this very loosely knit monetary structure will emerge intact from the strains to which it has been and is being subjected. The wonder is that it has escaped so unscathed from the turmoil of the past decade, a period during which many of the basic ingredients of the system have changed beyond recognition. Let us look at some of the items in this revolution.

(1) Before the war even when the pound was fluctuating in terms of gold and dollars, it was a completely free currency; now it is subject to control. Until 1939, it was fully convertible, now it is unconvertible and a considerable volume of sterling deposited in London on overseas account is in fact blocked. Sterling is still a great and widely used world currency but it has unquestionably though perhaps temporarily lost some of the qualities on the basis of which it acquired that greatness.

(2) Great Britain, the banker at the centre of the sterling area, owed his position to his strength. Immediately before the war the current liabilities of the United Kingdom to overseas countries amounted to £556 million. At the same time the gold and dollar reserves of the United Kingdom were in the neighbourhood of £800 million. In addition to these gold and dollar reserves Britain before the war held overseas assets worth £3,545 million, a part of which was in the form of short-term credits which could be called in virtually overnight. The banker's liabilities, in other words, were amply covered.

Today partly as a result of the financial recklessness with which the war was waged (a recklessness which may well have tipped the scale in securing the victory), but also as a result of balance of payments deficits which Great Britain has run since the end of the war, that relation between banker and customers has been reversed. Now the sight liabilities are in excess of £4,000 million, while the gold and dollar reserve on June 30 last amounted to £1,380 million. The most marketable of the overseas investments were sold during the war and by the end of 1948 their total had fallen below £2,000 million. In the immediate aftermath of the war Great Britain acquired credits from the United States and Canada amounting all told to over $5,500 million, the burden of which will

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begin to weigh on the balance of payments as from the end of this year. The position has therefore deteriorated considerably. Although the current account showed a remarkable improvement in 1950, when Great Britain succeeded in amassing an overall balance of payments surplus of £229 million there has been a return to deficit in 1951, notably in the relations between Great Britain and the rest of the sterling area. That latest deterioration will find itself duly reflected in a further increase in the British sterling liabilities owing to the rest of the sterling area. The banker, in other words, is allowing his liabilities at the moment to rise faster than his assets, which is not a recipe for good or enduring banking.

(3) Another change in the loose structure of the sterling area to which insufficient attention has as yet been given, has been the admission of the new Asian dominions as members possessing full financial autonomy. Their monetary policy is no longer one of the "reserved subjects" which in the past were ultimately settled by London. These dominions have brought with them ideas based on centuries of gold hoarding and on a traditional monetary use of the precious metals. Since some of them are on balance net dollar earners, they may find it difficult to resist the temptation of holding on to their hard currency earnings, of building up their own separate gold reserves. This temptation will grow with every evidence that the non-convertibility of sterling is a permanent feature of the situation and that the dominions concerned will find it difficult to spend their mounting sterling balances in buying what they want at competitive prices in Great Britain.

(4) It should finally be noted that many members of the sterling area have also become members of the International Monetary Fund. Up to now membership of the I.M.F. has been tempered by the transitional clauses of the Fund Agreement under which members have been sheltered from the full rigours of the rules during the immediate post-war period. But a time may come when certain incompatibilities between the two loyalties may emerge and this would undoubtedly add to the strains to which the sterling area is subjected. The International Monetary Fund stands for a monetary system in which there will be full multilateral convertibility of currencies at least for current transactions. There

is no inevitable antagonism between that objective and those of the sterling area; but the sterling area as it has necessarily evolved over the past twelve years, may well have become a currency bloc between which and the dollar world the bridge of full convertibility will not be thrown in any foreseeable future. If that be so, this clash of loyalties will sooner or later occur.

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In the light of these fundamental changes in certain of the basic ingredients that make up the sterling area system, we can now consider the main problems that face the sterling area.

THE DOLLAR POOL

The first of these concerns the pooling of hard currency earnings of the whole membership. This pooling is not a result of hard and fast rules. It is a process which evolves almost automatically from the fact that the British Commonwealth conducts the bulk of its trade in sterling—even its trade with non-sterling countries. This tradition has grown up as part of the evolution of the sterling area, as a reflection of the facts that Britain provided the principal commodity markets where the produce of the Empire could be sold, that London financed, insured and arranged the shipment for these transactions. Thus Malaya sells the bulk of its rubber in sterling, largely through the London market. Similarly West Africa sells its cocoa in sterling. These commodities may be destined for hard currency markets and be ultimately paid for in currencies other than sterling. But as far as the producing countries are concerned, the trade is conducted without anyone going consciously through the process of "pooling" hard currency earnings. Long before the concept of the sterling area was thought of, this process of pooling was taking place. The countries in question maintain the bulk of their external working balances in London funds and hold the bulk of their currency reserves invested in Great Britain. The war years did little more than give a slightly greater sense of

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formality and conscious volition to this process. Some of the countries which previously maintained separate gold reserves were prepared to pool these resources in the common cause, realising full well, especially in the pre-Lend-Lease period of the war that dollars were as essential a munition of war as any scarce strategic material.

This habit of pooling, ingrained in tradition and convenience as it is, should not however be regarded as something that will endure irrespective of what may be happening to sterling and to the British balance of payments. There is nothing artificial in the policy of pooling gold and hard currency reserves if this occurs within a framework of reasonably equated balances of trade. Malayan rubber may be sold to the United States, the dollars may be used to buy American cotton and tobacco for Britain and the triangle completed by sales of British textiles, mining equipment and motorcars to Malaya. But if this pattern of multilateral trade is not balanced, if the rest of the sterling area is called upon to pile up balances of unconvertible sterling—unconvertible either in dollars or into the goods that the rest of the sterling area needs—these age old habits will begin to lose their force.

There is already some evidence that these traditions are becoming eroded. Certain net dollar earners within the Commonwealth, Ceylon and Pakistan for example, are striving to divert their trade from sterling to dollar channels. They are trying to sell direct those goods which will ultimately earn dollars instead of going through the traditional sterling markets. They may lose some of the advantages and facilities which those markets provide them but they are prepared to risk that loss in order to acquire greater direct control of the ultimate hard currency proceeds of their exports. This waning of old habits is also evident in the fact that these two countries have recently signed financial agreements with the United Kingdom under which they have obtained gold from the central pool so as to serve as currency reserves for their newly established central banks. It is true that most members of the sterling area maintain small separate reserves of gold and, in addition, hold working balances in currencies other than sterling; but hitherto these separate reserves have, except in the very special case of South Africa, remained comparatively modest and static while the truly fluctuating and dominant element in the external reserves of the rest of the sterling area has been found in the volume of their London funds. Nevertheless, the existence of these separate reserves introduces an element of potential disruption in the system. These reserves could be built up and a menacing inroad made into the principle of pooling. The prospects for the sterling club would become decidedly unpromising if it became a collection of countries running dollar deficits. If the net dollar earners are to remain within the system, they must be given clear assurances, in deeds as well as words, that Britain can deliver the goods, that the sterling proceeds of the hard currencies they earn will be available to purchase what they want at competitive prices and with reasonably rapid delivery.

The attitude of members of the sterling area towards the gold and dollar pool held by the Exchange Equalisation Account in London, may change not only in the readiness of members to pool but in the forbearance which they exercise in dipping into that reserve. Access to the pool is in no way controlled by London. It is a function of import licensing by the authorities in the member countries. Any operation for which an import licence has been granted and which involves payment of dollars is automatically accepted as justification for securing dollars from the pool. If, however, it becomes increasingly evident that some members of the club are bearing the main part of the burden of maintaining payments equilibrium with the non-sterling world and that others are content to run overall deficits, the highly commendable restraint which has hitherto been shown may be weakened. Some members, conscious of the work they are doing in earning the dollars and seeing the proceeds of their earnings pile up in London in the shape of sterling balances, may make considerable changes in the criterion of essentiality which they apply to goods for which they grant dollar import licences. This trend is already apparent. It may gather momentum if Great Britain, owing to rearmament and high domestic consumption, runs into increasing balance of payments difficulties. In that event the rest of the sterling area will tend to import what it cannot get in the United Kingdom from the dollar world or from the industrial countries of Europe—in either case dipping into the pool directly or through the mechanism of the European Payments Union.

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THE ADMINISTRATION OF THE STERLING AREA

The next set of problems which faces the sterling area is that which concerns nothing less than the government of this monetary system. Since the sterling area developed gradually as a functional response to the convenience and needs of traders in Britain and other sterling countries, no system of government for the sterling area has ever been recognised or formalised. It was only after 1931 that the need for such a government could have been conceived. The countries in question, other than the United Kingdom, were tacitly prepared to leave to London matters which concerned them closely, including the day to day adjustment of rates of exchange and the consequent fixing of the sterling price of gold. These were decisions that had to be taken on the spot by a small handful of technicians handling the affairs of the Exchange Equalisation Account. The need to devise a more representative government for the sterling area, began to crystallise after the war, when sterling area problems began to involve such questions, as the unification of exchange control technique among the members and the acceptance of common measures to economise dollars. These matters came to a head in the financial crisis which preceded the suspension of the short-lived post-war convertibility of sterling in September, 1947, a crisis which called to London most of the Finance Ministers of the Commonwealth, who then considered the broad issues of sterling policy. This was the first of a series of such meetings of Finance Ministers. They are now regular occurrences, which fortunately no longer require an emergency to call them into being. They usually take place about the time of the annual meetings of governors of the International Monetary Fund.

These high level meetings of ministers are not, however, the forum in which detailed problems of policy and technique can be worked out. To meet the need for day to day contact and exchange of information a Sterling Area Statistical Committee was set up in London in 1947 on the initiative of the British Treasury. This, as its name implies, exists largely for the mutual exchange of information that may have a common interest to all members of the sterling area. The problem of sterling area policy is one that may tentatively be considered by another body, also located in London, the Commonwealth Liaison Committee. This is a clearing house for ideas and suggestions and not an executive instrument of policy; its members are, however, in constant touch with their governments, they consider all wider issues of sterling area policy and there can be no doubt that their deliberations in London have considerable influence on the policy decisions which are ultimately taken.

Beyond the occasional meeting of Finance Ministers and the continuous session of these two committees in London, the work of co-ordinating sterling area policy is also furthered by the closest and most friendly co-operation between the Bank of England and central banking and monetary authorities in the Dominions and Colonies. It may be doubted, however, whether this machinery, effectively as it has functioned, provides a sufficient response to the challenge that will be made in years to come to the loyalty and complete unity of the sterling area system. The devaluation of sterling in 1949 was a striking example of an issue in which decisions fundamentally affecting the whole sterling area were taken with next to no consultation with the other members and, indeed, with the bare minimum notice to most of them. It is very much open to doubt whether any repetition of this incident could occur without striking a serious blow at the hegemony of the sterling area. The Asian dominions have made it abundantly clear that they resented the abruptness with which at that time they were pushed into policy decisions in the formulation of which they had had no say. One of them, Pakistan, pushed its resentment to the point of refusing to follow sterling in its devaluation against gold and the dollar.

This problem of sterling area government and formulation of policy would become acute if the advice of those who are suggesting that the rate of sterling should be allowed to go free were followed. A floating sterling rate would necessarily call for some official intervention which, as in the 1930's, would have to be operated by a handful of technicians in London and not by committee decisions. If, therefore, the rest of the sterling area were to follow faithfully the movements of a floating sterling rate it is hardly conceivable that this could be achieved without a considerable readjustment of the present sterling area mechanism, without in fact creating what scarcely exists today, a form of representative sterling area government.

THE SOLVENCY OF "THE BANKER"

These are some of the vital problems that face the sterling area today. But the most vital of them all is the position of the banker at the centre. The sterling area was built on the basis of a strong and solvent Britain, on a currency whose stability, world-wide acceptability and convertibility, were taken for granted. That system had to be adjusted to allow for the impoverishing impact of the war and the emergence of exchange control. On looking back it is astonishing how well this loose piece of machinery adjusted itself to the strains to which it was subjected. But looking to the future, its endurance must surely depend on the banker at the centre retaining the confidence of the other members. He must honour the cheques drawn on him—that is the only way in which he can remain a banker. If he does so, whether by making sterling ultimately convertible or by his ability to deliver goods at competitive prices, we need have no fear for the future of the sterling mechanism. If not, the process of disintegration may go faster than we imagine.

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