

What does the historical record suggest about the current proposals to reform the international monetary system? ¹

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I Moving from one global currency to another

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 USD'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 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. These questions are similar to those posed during 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.

Although the demand for reserve currencies can be modelled 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

¹ This paper summarises the argument in C.R. Schenk, *The Decline of Sterling: managing the retreat of an international currency 1945-1992*, Cambridge University Press, 2010.

determinants. The important role of inertia is usually attributed to network externalities that prolong reserve currency status beyond the time predicted by economic fundamentals.² These externalities suggest a tipping point or landslide effect should one major creditor switch its assets, so that the retirement of a reserve currency is likely to be non-linear. 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 anticipated 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's contention that more than one important reserve currency can operate at the same time, although this was artificially managed in the 1960s through exchange controls and bilateral agreements.³

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 rich countries pegged their currencies to the USD, while the US 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 restricted in the immediate post-war period by US balance of payments surpluses. The system thus assumed that more than one major reserve currency could operate at the same time over a prolonged period. 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 by 1947 sterling accounted for about 87% of global foreign exchange reserves.⁴ It took ten years after the end of the war (and a 30% devaluation of the pound) before the share

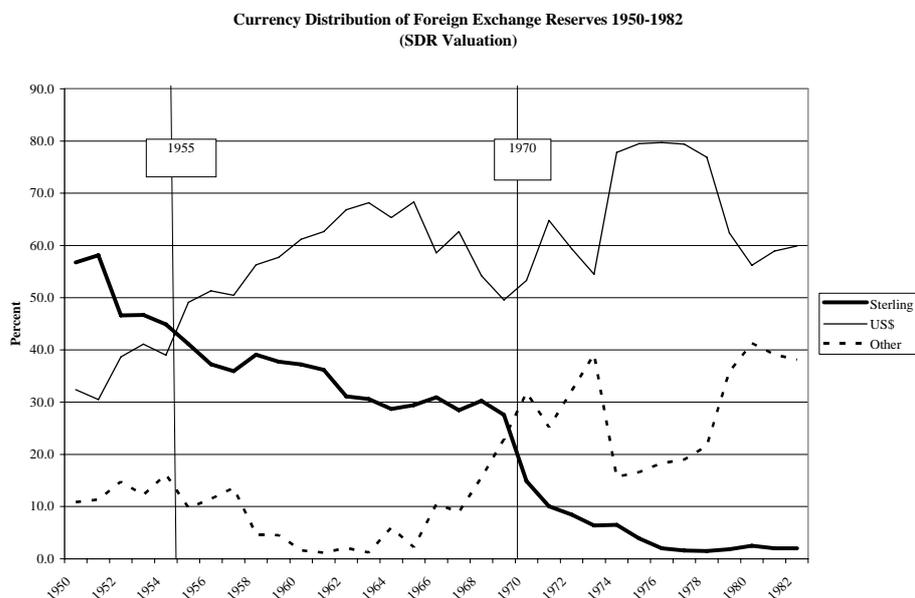
² M. Chinn and J. Frankel, 'Why the Euro will rival the dollar', *International Finance*, 11:1, 2008, pp. 49-73.

³ B. Eichengreen, 'The Dollar Dilemma', *Foreign Affairs*, 88(5), 2009, pp.53-68.

⁴ 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.

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 Global Foreign Exchange Reserves



How do we explain the gradual nature of the decline of sterling, what Paul Krugman refers to as a ‘surprising persistence’?⁵ Was this due to British government efforts to 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? These are the traditional explanations in the literature, but archival evidence shows that from the 1950s many British ministers and officials believed 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 (greater demand for national debt). 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’. Closer examination, however, shows that sterling’s role was prolonged both by the structure of the international monetary system and by collective global interest in its

⁵ 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.

continuation. As the market 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, i.e. positive externalities in terms of global stability were identified and deliberately protected. 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 convertibility, 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 monetary system that would ensue threatened domestic UK priorities of full employment and price stability. 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 toward the Middle East and East Asia. 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 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 securities held 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 while the world debated how to replace reserve currencies.

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 Bank for International Settlements 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 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 sterling 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, marking a final end to sterling's reserve role. Sterling now comprises only about 3% of global reserves.

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 pound's vulnerability because they denominated their trade and debt in sterling and because many currencies remained pegged to sterling. Starting in 1971, however, most sterling pegs were replaced by pegs to the USD or trade-weighted 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 inflation eroded the real value of liabilities and the fact that the nominal value of global sterling reserves was quite stable meant that the falling 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. Rising international liquidity, inflation, geographical redistribution and international cooperation were the cornerstones that eased the retreat of sterling from global to national status.

The world is a different place now with private finance far outweighing central bank resources and more freely floating exchange rates. The problems of sterling were also not identical to those of the USD today. Nevertheless, the main lesson to be drawn from this case is that the decline of sterling was much more prolonged and less damaging than expected at the time, or portrayed in more recent analyses. The transfer was achieved without major implications for global stability because it was a deliberately managed process involving the world's richest economies as well as the formal cooperation of holders of sterling assets. Without the Cold War context that encouraged cooperation in the 1960s, it seems less likely that heroic efforts to postpone a tipping point for the US dollar will be achievable. In this sense, the gradual decline in sterling's share of global reserves after 1945 should not give comfort to those who hope for a similarly unproblematic decline in the USD.

II Why did previous reform efforts fail?

As is the case today, in the 1960s most of the proposals for reform aimed to strengthen the role of the IMF either by hosting separate stabilization funds or creating a new reserve asset distinct from national currencies. The Mutual Currency Account proposed by the British Chancellor of the Exchequer in 1962, for example, was a separate fund into which countries in surplus would contribute reserve currencies in return for claims on the account. These claims would form interest bearing assets with a gold value guarantee that would be part of the donors' national foreign exchange reserves. In 1963, the influential economist Edward Bernstein proposed a new currency reserve unit (CRU) issued through the IMF with the value of a weighted basket of 11 major trading currencies. These plans did not initially attract the approval of either the

USA or the IMF, both of which hoped to postpone any radical changes to the *status quo* in the hopes that the global imbalance would resolve itself automatically over time.

By the mid-1960s both the IMF and the USA had come to the view that more fundamental reform could be desirable and the process began to gain traction in special policy committees set up amongst the G10 states. In the USA, Alfred Hayes, President of the Federal Reserve Bank of New York preferred a scheme that would create reserve assets in the form of unconditional drawing rights on the IMF rather than a new reserve unit. Others disagreed and continued to hope for a new reserve unit representing a claim on a pool of currencies paid in by a group of advanced countries. A reserve unit did not generate much support among the G10, particularly because of the challenges of governance over how and when it should be issued. Instead, IMF staff devised plans for reserve creation that would be open to all members; quasi-automatic drawing rights transferable through the Fund, and/or a new affiliate of the IMF (an International Reserve Fund) that would issue gold guaranteed reserve units transferable between countries as well as to and from the Fund.

From mid-June 1966 progress in the G10 seemed stalled and the forum was widened to include the IMF Executive Board. In the end, the breakthrough came when the EEC Finance Ministers' in April 1967 agreed unanimously (although with varying degrees of enthusiasm) to support a drawing right scheme. In May, IMF staff quickly drafted outline proposals to put to ministers in time for public agreement in the IMF annual meeting in Rio in September 1967. As late as the G10 ministerial meeting in August 1967, there were still divisions over the governance and transferability of the proposed SDRs, however, they arrived at a vague compromise that could be announced at the Rio meetings. The actual implementation and interpretation of the new SDR, however, remained a source of conflict.

The multilateral discussions on the reform of the international monetary system appear in retrospect confused and inconclusive, partly because they lacked urgency or political will from the Americans until 1965, and then because they became embedded in disputes within the EEC in the following years. In the early 1960s the Americans refused to recognise that there was a long term problem partly on doctrinal basis and partly because of the dangers to the USD if plans emerged to replace it as an international currency. In addition to internal American dissention, globally there was no consensus on the nature of the problem and therefore no agreement on solutions. Instead of building consensus, the negotiations in the G10 and in the IMF entrenched

divisions between developing economies, Europe and the USA. In the end, the SDR was a triumph of ambiguity over clarity of purpose in order to meet expectations that had been built up for an announcement at Rio in September 1967.

These year years of negotiations to seek a solution must be considered a failure since they did not prevent the gold anchor falling away in March 1968 or the pegged exchange rate system from crumbled in a series of crises between 1971 and 1973. The final compromise in the form of the SDR did not replace the use of national currencies as reserve assets, nor did it resolve the fundamental problem of the expansion of global USD reserves backed by a shrinking ratio of gold, nor did it redistribute the burden of adjustment. When the SDR was finally activated in 1969 transfers were limited to the need for balance of payments purposes and not to redistribute reserve portfolios to reduce exposure to the USD. After the first allocation of SDR9.3b in 1970-72, the US argued strongly that no continuous allocation should be made in the inflationary environment on the 1970s. However, the huge accumulation of USD reserves from 1970 and the devaluation of the dollar against both gold and other currencies from August to December 1971 renewed enthusiasm for reform. Again, the framework was the IMF and the G10 and then from 1972 the Committee of Twenty (Committee on Reform of the International Monetary System and Related Issues).

Most proposals, as today, involved the extending the SDR through schemes to 'consolidate' reserve currency holdings by substituting them for SDRs. The US suggested a trigger to signal the accumulation of 'excessive' reserves that would require a country to reduce its surplus, but got little support. By early 1973 (before the oil crisis) the US was prepared to envisage a one-time conversion of a portion of existing USD claims into SDRs, which would shift their liability to an IMF Substitution Account rather than sundry national creditors, but they were wary of the financial obligations of exchange guarantee and interest burden. If the terms were too onerous, particularly considering the huge scale of the possible claims through the Stabilisation Account, the US would be unable to agree. If they were too generous, creditors would not participate. As today, without American support or at least acquiescence no arrangement to replace or supplement the USD would be possible.

After two years of complex technical discussions the C20 submitted its report in June 1974. By this time the international context had been transformed by the advent of floating exchange rates, the development of the European monetary system, the explosion of the Eurodollar market and the global imbalance associated with the oil

crisis. These developments undermined collective interest in reforming the reserves system and the Committee's vague recommendations were not taken up. The C20 Report offered no agreed blueprint, but rather listed options; including a Stabilisation Account, changing the name of the SDR to promote its development as a reserve asset, relaxing the restrictions on its use and determining an appropriate yield to make it more attractive. The one tangible outcome was to change the valuation of the SDR to a weighted basket of currencies rather than gold. The records of its meetings show that the C20 was too large and unwieldy a forum to achieve constructive reform.

Despite the failure to devise a blueprint for reform, the presentational attractions of a scheme to replace the USD as a reserve currency were strong, and the Interim Committee of the IMF pursued the idea of a Substitution Account from 1979. By April 1980 the IMF Executive Board had come to a tentative agreement to some principles: on a purely voluntary basis all members of the IMF might be allowed to deposit USD reserves (which would then be transferred to a special account at the US Treasury) in exchange for claims on a Substitution Account (SA) denominated in SDR. The SA would be operated as a trust administered by the IMF with an 'Assembly of Participants' who would manage and control it, although the voting rights and governance were controversial. The SDR claims on the SA would be freely transferable among participants and also to the private sector to develop a secondary market in SDR. If countries could not find partners to accept their SDR claims, they could be converted back to USD as a last resort, although having a 'two-way' exchange through the SA raised fresh obstacles, particularly for the USA, and might facilitate speculation. The maximum value of the SA in the first instance was set at SDR50 billion (41% of official claims on the US in 1980). The US Treasury would pay interest to the SA on its USD liabilities and the SA would in turn pay interest to holders of SDR claims. The rates of return were controversial, as was the burden of exchange risk for variations of the USD-SDR exchange rate. Any profits or losses could be shared between the USA and depositors and perhaps covered by part of the gold reserves of the IMF, but the balance of burden was not agreed. Developing countries also worried that the increase in SDRs through the SA would lead to a reduction of conventional SDR issues in the future. In the end, the plans were abandoned as the USD exchange rate strengthened.

The failed discussions for reform reveal a range of obstacles to the use of the SDR as a primary reserve asset that persist today; the limits on transferability and liquidity,

the lack of a private secondary market, the valuation based on narrow currency weights which is inappropriate for some developing states. The major obstacle to the Substitution Account was how to distribute the burden of exchange rate risk among creditors and debtors. Ancillary concerns included the potential for speculation through a 'two-way' exchange with the SA, the desire among states to retain control over the portfolio distribution of their reserves, and a lack of commitment in the USA for an ongoing rather than one-off (and one way) consolidation of a proportion of existing USD reserves. As the momentum toward European monetary integration was renewed from 1979, the prospects of a future European currency pushed reforms over international reserve currencies further down the agenda of key stakeholders.

The problems of governance of any international currency have inhibited the usefulness of the SDR other than as a unit of account. The controversy over SDR governance is linked to the inertia and inflexibility of the IMF quota system as well as the waxing and waning of international confidence in the IMF's leadership. Nowadays, to reduce the USD share of global reserves would require a huge amount of any new reserve asset: even after recent allocations SDRs now comprise only about 4% of total international reserves. Proposals to supplement rather than replace existing reserves require the SDR to be as attractive as USD in terms of liquidity, value and returns, but this poses a huge burden on the USA if they have to finance this through a liability to the Fund. Holders of SDRs must have confidence in their liquidity (marketability, acceptability by all countries, convertibility to USD as well as other currencies) that will require a huge multilateral commitment to develop the market for SDR. The C20 of the 1970s also provides lessons for the process of reform. There was a clear trade-off between efficiency in policy-making and the breadth required for legitimacy of any emerging proposals. Similar challenges will affect the Group of 20 as it adopts more policy-making responsibilities. In the 1970s, reform proposals were over-run by market solutions that reduced the need for precautionary reserves. Rather than focusing on how to manage such huge imbalances today, the emphasis might instead be on how to reduce the incidence of (or provide other forms of insurance for) the sudden stops that encourage the accumulation of owned reserves.