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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

THE CREDITWORTHINESS

OF THE

STERLING AREA

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The Creditworthiness of the Sterling Area

Summary and Conclusions

The sterling area is a rather stable grouping of countries. It is held together by considerations of mutual interest, in particular access by the other members to the London capital market and to the central hard currency reserves. The most important net contributors to the dollar pool are Malaya and British West Africa which in their present status are hardly in a position to withdraw from the group.

If the sterling area is to be viable in the long run, 1) the United Kingdom must be restored to her traditional role of a net capital exporter, and 2) the dollar accounts of the whole sterling area must balance.

The United Kingdom's balance of payments difficulties in recent years are due not only to the war and its aftermath, but to structural causes such as the deterioration in her terms of trade, changes in the pattern of capital movements, new developments in British social and economic policy, and increased military commitments. Over the next few years the United Kingdom should be able to achieve a modest current account surplus with the rest of the world. Such a solution, however, implies continued austerity at home.

Concurrently the sterling area could balance its dollar accounts, the United Kingdom's dollar deficit being covered mainly by the net dollar earnings of the colonies and by gold sales by South Africa to meet her sterling deficit. Although a more or less satisfactory solution of the sterling area's dollar problem can be visualized on fairly conservative assumptions, the position will remain at best precarious. Furthermore, the margin of error is great, and it is impossible to say whether such a solution will in fact be achieved.

The long term external debt of the sterling area now totals almost $7 billion, almost all in dollars. Of this total the United Kingdom accounts for over $6 billion. This is a substantial burden, but, compared with the dollar income and outgo of the sterling area, it is not, in itself, sufficiently large to create a serious balance of payments problem. The United Kingdom can be relied upon to give top priority to debt service payments and to take whatever measures are within her power to avoid defaults.

Because of both the magnitudes and the uncertainties involved, it is not possible to say within even a few hundred million dollars how much dollar debt the sterling area can service. Under present conditions a reasonable solution would be for the Bank not to make loans to the sterling area which would increase substantially the outstanding dollar debt owed or guaranteed by the United Kingdom. Annual amortization payments on such debt now amount to about $70 million.

In considering future loans to the sterling area, attention should be given to the direct or indirect contribution they might make towards strengthening the area's dollar position. In general, loans to the dependent overseas territories appear particularly appropriate for this purpose.
In considering loans to the independent members of the sterling area, the Bank has in the past based its judgment on their bilateral dollar creditworthiness. In view of the sterling area's precarious dollar position, this policy should be continued. For the independent sterling area countries the pooling of hard currency reserves is a safety factor, but, under present circumstances, they can hardly count on a large net annual contribution from the dollar pool.
Introduction

Both the meaning and the membership of the sterling area have changed substantially since the early thirties when the term first came into common use. Before 1939, three major features of the sterling area were that its members held whole or part of their monetary reserves in the form of sterling balances, had most of their foreign trade invoiced in sterling, and usually kept their currencies stable in terms of sterling rather than dollars. With the coming of the war most of the non-Commonwealth countries, e.g. Denmark, fell away from the sterling bloc, while a new feature, the "dollar pool", was added to it. The dollar income of the members was pooled at the Bank of England, which acted as banker for the whole area. From the pool the dollar requirements of the individual members were met.

For the purposes of this paper the sterling area comprises the United Kingdom, her dependent overseas territories, the rest of the British Commonwealth (excluding Canada and the Union of South Africa), the Irish Republic, Burma, Iceland, Iraq and Jordan. The Union of South Africa, which is formally within the "Scheduled Territories", has been excluded because it settles its dollar deficit independently rather than through the sterling area dollar pool.

The Stability of the Sterling Area

The question at once arises whether the sterling area is a stable group or whether important members might secede from it, for only if its disintegration is judged to be unlikely can the question of its dollar creditworthiness be considered at all. At the same time an examination of the ties which hold it together will bring out more clearly some of the risks implied in lending to its members.

Some of these ties have already been mentioned. There are very close trading relationships, especially between the U.K. and the other individual members. Today the U.K. sends about one-half of her exports to sterling area countries and receives from them more than one-third of her imports. It follows rather naturally that much of this trade is invoiced in sterling and financed through London. Although the tendency will probably continue for rather less of the sterling area's trade to go through London and indeed to be invoiced in sterling, these trade patterns and the financial arrangements developed to suit them are slow to change and may be expected to persist.

Because of these trade and financial arrangements, sterling area members are accustomed to dealing in sterling and maintain large sterling balances which are freely transferable within the area and also, through the EFU, throughout most of Europe. But the increase in the U.K.'s sterling liabilities has been abnormal in the last decade. During the war much of it resulted from military expenditures by the U.K. Since then it has been attributable largely to the U.K.'s inability to provide a volume of exports to the other members large enough to offset their sterling claims against her. In the future the willingness of these countries to hold sterling, insofar as they have discretion in the matter, will depend on the ability of the U.K. to provide the goods they require and make possible a decrease in the U.K.'s liabilities to the other members.
A rather close tie exists between the U.K. and the rest of the area in that practically all the other members are structural net capital importers. They have ready access to the London capital market, have derived considerable benefit from British capital imports in the past, and hope to continue to do so in the future. The extent to which they will, in fact, be able to do so will, of course, depend on the U.K.'s ability to develop a current account surplus. Of this more will be said later but it should be made clear at this point that access to the London capital market is for the other independent members one of the greatest attractions of membership. Conversely, the more limited their opportunity to import capital through London the weaker will be their desire to stay within the group.

There has recently been a tendency, visible in Pakistan, Ceylon and Australia, for independent sterling area countries to hold an increasing proportion of their monetary reserves in hard currencies rather than sterling. Is this a prelude to their leaving the group? The identity of the net contributors to and net takers from the dollar pool is a most important consideration in judging the cohesiveness of the sterling area. Of the independent sterling area countries only Iraq and Ceylon can be considered net contributors in a structural sense, Ceylon because of her true dollar surplus at least for the time being, Iraq because her oil exports enable her to save the dollar pool more than she, Iraq, obtains from it. Other things being equal, they might leave the group if they took the view that the benefits from British capital imports were less than those they might derive if they maintained their contribution to the central reserves. That contribution, however, is not very large, and their withdrawal would hardly cause the sterling area to disintegrate.

The other independent members have since the war been substantial net takers from the pool and have, therefore, benefitted from it. They can leave at any time, as Egypt did in 1947, but as long as they do not develop substantial dollar surpluses they would not appear to have much incentive to leave the group since, on balance, they are more likely to gain than to lose by remaining inside. Furthermore, for some of the primary products they produce, the U.K. offers a market which they could hardly do without. On the whole, therefore, although certain independent sterling area countries will probably continue to hold more of their reserves in hard currencies, this should not disrupt the existing arrangements.

By far the most important contributors to the pool are the British dependent overseas territories, in particular Malaya and West Africa. They have no central banks and no independent reserves. In their present status they are hardly in a position to secede from the area. Some of them, for instance the Gold Coast, may soon acquire Dominion status and might thereafter follow an independent dollar policy. Again, political and military conditions in British Malaya could so deteriorate as to make Malaya neither an effective member of the group nor a large contributor to the dollar pool. But neither of these risks can, under present circumstances, be considered probabilities. They are risks which the Bank must take into account in considering loans to the sterling area, but risks it can hardly do otherwise than accept.
The Structure of Sterling Area Trade and Payments

The future of the sterling area is of course closely connected with the development of world trade. In the United Kingdom the value of foreign trade is equivalent to more than one-third of national income. In most of the colonies and some of the independent members such as Australia and New Zealand, the proportion is considerably higher. Economic trends in the United States are particularly important, for much of the dollar earnings of the sterling area consist of primary products or luxury goods and services (including tourism), the demand for which is affected markedly by changes in economic conditions in the United States.

If the sterling area is to be viable in the long run, at least two economic conditions must be satisfied.

1) The United Kingdom must fulfill her traditional role of providing capital for the rest of the sterling area. If she is to do this she must be able to achieve and maintain a current account surplus in her balance of payments with the rest of the world.

2) The dollar account of the sterling area as a whole must balance. Here the traditional payments pattern has been, in broad outline, that the United Kingdom ran a dollar deficit which was covered by earnings of gold from her export surplus with the Union of South Africa and by the net hard currency earnings of other parts of the sterling area, notably Malaya and British West Africa.

The United Kingdom Balance of Payments with the Rest of the World

Though aggravated by the war and its aftermath, the present United Kingdom balance of payments difficulties also arise from long-run economic and social changes. Between the two wars the terms of trade moved steadily in the U.K.'s favor so that she was able to obtain a given volume of imports for a progressively smaller volume of exports. Since the end of the second world war the terms of trade have moved sharply against the industrial countries, including the United Kingdom, and in favor of the primary producers. Because of the world's increasing population and the slow rate of annual increase in the output of foodstuffs and raw materials, the terms of trade of the United Kingdom can hardly be expected to revert in a structural sense to anything like their prewar position. They may, however, continue to improve somewhat from their present position, which is still considerably worse than that prevailing before Korea. Even a slight change in the terms of trade would have a substantial effect on the balance of payments. A 1% improvement, for instance, would reduce the United Kingdom's current account deficit in 1951 by over $30 million or about £100 million.

From the Napoleonic wars to the first world war the United Kingdom was the largest exporter of capital in the world, first from domestic savings and, after 1875, mainly from the reinvestment of profits on her investments abroad. In the period between the two world wars the export of British capital on long term was very largely made possible and to some extent induced by an inflow of short-term funds from other countries, particularly in Europe. The net export of British capital in this period was small, and in the thirties there was probably some net repatriation. In other words, the United Kingdom
was tending to consume her capital. An inflow of funds into London of the size that occurred in the interwar period appears unlikely under present circumstances. For the United Kingdom, the achievement of a net capital export on an increasing scale, therefore, means not merely getting back to her prewar position but reversing the interwar trend.

The full employment and social welfare policies followed by the British Government since the war have placed a strain on the British balance of payments which did not exist in the thirties, when the unemployed totalled about 2 million. Despite the change of government it is only realistic to assume that the policy of maintaining a high level of employment and a high rate of expenditures on social services will continue to be accepted by any British Government. This will give British economic policy an inflationary rather than a deflationary bias.

The post-Korean rearmament program has also aggravated the United Kingdom's balance of payments difficulties, particularly since it started from a position of full or even overfull employment, and since the industries on which the main burden of rearmament must fall (metal, engineering and vehicles) account for half the U.K.'s exports and for the greater part of the postwar increase. Although it is possible to visualize a decline in the armaments burden after the build-up of the next year or so, the armed services must be assumed to continue making a greater claim on resources available in the United Kingdom than they did either in prewar times or in the immediate postwar years.

These are some of the main parts of the framework within which British economic policy will have to operate in the coming years. What are the chances, under these conditions, of achieving balance within a year or so and then maintaining a current account surplus with the rest of the world to make possible a satisfactory rate of net investment abroad, particularly in the overseas sterling area? This net investment could be either new lending through London or the reduction of accumulated sterling balances.

From 1948 to June 1950 the United Kingdom's balance of payments was virtually in overall equilibrium on current account, its visible trade deficit being counterbalanced by net income from invisibles. In the second half of 1950, a surplus of close to £ 200 million was achieved, but in 1951 this changed to an overall deficit of more than £ 500 million. Neither of these periods can be considered normal. In the second half of 1950, for instance, the United Kingdom was running down raw material stocks and these had to be replenished, often at substantially higher prices, in 1951. But, though abnormal, these figures do give a rough idea of the order of magnitude of the adjustment required. A current account deficit of £ 250 million would be equivalent to about 2% of the gross national product and about 5% of the value of industrial output. To change a deficit of £ 250 million into a surplus of say £ 250 million in the course of a few years would not seem too difficult under favorable circumstances. With rearmament demand claiming a large part of the very resources urgently required for capital development abroad, and with competition from Germany and Japan increasing in many lines, it becomes formidable. Nevertheless, if account is taken of the postwar government policy of restricting imports and consumption, and if it is assumed that some United States aid continues to support the rearmament program, the United Kingdom should be able to bring her balance of payments
with the rest of the world into equilibrium and even to achieve a modest surplus within the next few years. However, this will require continued strict controls, particularly over consumption and imports; in other words, continued austerity for the British people. To the extent that the terms of trade were to improve, of course, the burden would be eased.

The United Kingdom Dollar Accounts

Although the United Kingdom is at present running a deficit with all major areas, the dollar deficit is the hard core of her balance of payments problem. After being reduced to $300 million in 1950, the United Kingdom dollar deficit quadrupled in 1951, when it was larger than in either 1948 or 1949. Can this deficit of $1.25 billion be reduced to manageable proportions?

Exports to the dollar area amounted to about $0.9 billion in 1950 and $1.1 billion in 1951. Further measures have been taken in the United Kingdom to increase British dollar exports. The prices of some seem more likely to increase than to decrease. On the other hand, the rearmament program will take its toll, while competition in dollar markets should become progressively keener, especially from Germany and Japan. Future British dollar exports may be estimated, very tentatively, at $1.1-1.2 billion.

Though severe restrictions on imports from the dollar area have been maintained since the end of the war, these imports have varied considerably from year to year. In 1950 there was substantial destocking in the United Kingdom and dollar imports dropped to only $1.2 billion. In 1951, on the contrary, raw material stocks were replenished at a time when prices were considerably higher, while the Iranian crisis brought larger imports of dollar oil. Dollar imports thus rose to over $2 billion. The level of future dollar imports will, of course, depend on the exchange available to pay for them. Judging by recent experience, however, one may hazard a guess that unless prices rise sharply they could, if necessary, be cut to some $1.5-1.7 billion without affecting production seriously. With dollar exports estimated at $1.1-1.2 billion, this would give a deficit in dollar trade amounting to $300-600 million.

Dollar income and expenditure on invisibles were about balanced from January 1950 to June 1951. In the last half of 1951 a deficit of $280 million was recorded, mainly because of interest payments amounting to more than $100 million on the U.S. and Canadian loans and the stoppage of oil operations in Iran. Unless the conditions for invoking the waiver clauses are fulfilled and the U.K. wishes to make use of them, a deficit of the order of $100 million on account of invisibles is likely to occur in the coming years, and this would bring an estimated current account deficit with the dollar area to $400-700 million.

The forecasting of capital movements is even more difficult. Fortunately, however, their effect on the dollar balance is not likely to be very great. Private American funds are not likely to be invested in the United Kingdom in large amounts. On the other hand, amortization of the American and Canadian loans and the lend-lease settlement credit began in December 1951 and will amount to between $64 and $122 million a year for the
next twenty-five years. In view of these considerations it does not seem likely that there will be a surplus on capital items. In fact, a deficit of up to £100 million would not seem improbable.

This would bring the United Kingdom's total dollar deficit to an estimated £500-800 million. While no allowance is made for the repatriation of dollar capital to the United States, or for a dollar drain arising from exchange control leakages, the assumptions underlying the estimates are on the whole conservative. They are perhaps too static. Private United States investment in the United Kingdom is assumed to remain at its present low level and no allowance is made for dollar earnings accruing to the United Kingdom as a result of exports of dollar capital to countries outside the sterling area. To the extent that such "offshore purchases" occur, or that the rate of private United States investment in the United Kingdom increases, the deficit will be smaller.

**Financing the Dollar Deficit**

The United Kingdom's ability to finance such a dollar deficit depends in the first line on the dollar earning power of the dependent overseas territories. These earnings vary widely, however. They ran at an annual rate of no less than £550 million in the year following Korea and fell to an annual rate of less than £250 million in the last half of 1951. There are several reasons for this variability. First, the dollar earnings of the colonies come from a few primary products, notably rubber, tin and cocoa. Both the prices of these and the amounts demanded traditionally fluctuate more than those of most commodities. Second, the prices of tin and rubber have been affected by changes in the buying and inventory policies both of the U.S. Government and of private importers. Furthermore, the advent of large-scale synthetic rubber production in the United States will place a ceiling on natural rubber prices and probably a floor on United States production of synthetic rubber, while the future of cocoa production in West Africa appears to depend on the control of "swollen shoot" disease, for which no cure has yet been found. On the other hand, rising production and incomes in the United States should mean a growing demand for most raw materials including those produced in the British Overseas Territories, while, despite the ground nut scheme, the rather high rate of British investment in the colonies should in the long run bring increased output both of dollar-earning and dollar saving commodities. The expansion of Rhodesian copper, for instance, should make the sterling area self-sufficient in that metal by 1953. The contribution of the dependent overseas territories to the sterling area dollar pool is likely to be lower than the extraordinarily high figure achieved in the year following Korea but higher than that reached in the last half of 1951. The "normal" annual rate in the 1950's might reasonably be put at £350-400 million, or about the same as in 1950, when the first half was rather unfavorable and the second unusually favorable.

Sales of newly-mined gold from South Africa to the United Kingdom to cover South Africa's sterling deficit provide substantial amounts of hard currency to finance the United Kingdom's dollar deficit. Over the last four years they have averaged close to £250 million per annum and the United Kingdom should at least be able to continue to earn gold from South Africa at this rate. Indeed as the new mines come into production in the Orange
Free State and West Rand she could increase her earnings substantially if she can provide in return the necessary volume of goods for South Africa.

During the raw material price boom in 1950-51, the independent countries of the sterling area made a small net contribution to the dollar pool for the first time since the war. From the middle of 1951, however, prices for their most important dollar-earning products, wool and jute, fell substantially. Furthermore, the inflation, in part generated by the high prices obtained earlier, increased their demand for imports. As a result they again drew heavily on the dollar pool and their net drawings for the whole of 1951 exceeded $200 million. All these countries are seeking to carry out ambitious development programs. For this reason alone it is improbable that they will make significant sustained net contributions to the central dollar pool. The most that can be expected of them is that they will keep their drawings on the pool within reasonable limits, and, indeed, balance their dollar accounts if circumstances should require. This in turn can be expected of them only if the United Kingdom is able to provide a net contribution to their development in the form of British capital and exports. In other words, their sterling balances must go down rather than up. In Australia and New Zealand this decline has already taken place.

Recently the United Kingdom has again been paying out large amounts of hard currency to cover the sterling area's deficit with Western Europe. Although the United Kingdom received substantial gold payments from EPB in the ten months after it was established, net gold payments to OEEC countries have exceeded £100 million since July 1949. As the measures taken by the United Kingdom and other sterling area countries to curb imports take effect, however, this drain should be eliminated. In the long run, the United Kingdom does not expect either to pay significant amounts of gold to other OEEC countries or to receive gold from them. If she succeeds in this aim, various other countries of Western Europe will, of course, find it more difficult to balance their dollar accounts, since before the war the United Kingdom made available to them a surplus of convertible currency which helped to finance their deficits with the dollar area.

The above estimates, which are, of course, extremely rough and subject to a wide margin of error, indicate that, on fairly conservative assumptions, a more or less satisfactory solution of the sterling area's dollar problem can reasonably be visualized. It is impossible to say whether it will be realized or not. Such a solution will, however, impose a very severe strain on the United Kingdom, particularly in the form of continued restrictions on domestic consumption. Furthermore, the position will remain very vulnerable. Although the central reserves may recover some of the ground lost over the past year, any substantial and lasting accumulation of reserves seems unlikely. This, together with the continued bias of policy towards inflation, with the large sterling liabilities to the rest of the world and the variability of the colonies' dollar earnings, makes it likely that the 1951 crisis of confidence will not be the last.

The Dollar Debt Burden

The long-term external debt of the United Kingdom now amounts to about £6.1 billion, practically all of which represents obligations to the United States and Canadian Governments incurred since the end of the second world war. In addition there are various other United Kingdom obligations
outstanding, including notably a purchase of $300 million from the IMF.

Total annual interest charges on the long-term debt average $112 million from 1951 to 1960 and amortization payments average $74 million in the same period. Thus, total annual service payments amount to $186 million. These charges represent only about 2% of the United Kingdom's total current account receipts in 1951 but about 15% of her current dollar receipts. They represent about 10% of the combined dollar earnings of the United Kingdom and her dependent territories. It should be noted, however, that the most important loan contracts contain a clause providing for the waiving of interest in adverse economic conditions. If the waiver were granted, payments in the 1950's would be reduced by half. Although circumstances might have warranted it, the clause was not invoked by the United Kingdom for the service payments due at the end of 1951.

The long-term external debts of the other independent members of the sterling area (excluding South Africa) are also significant. They amount to the equivalent of nearly $800 million, practically all in dollars. The service charges amount only to about $30 million in 1952, but because of large Australian maturities they are about $60 million in 1954/57 and over $100 million in 1955. It is reported, however, that a large part of the bonds in question are held within the sterling area and would not, therefore, cause a drain on the dollar pool. Furthermore, these countries also have various other non-sterling obligations including dollar purchases from the IMF amounting to $150 million.

The Creditworthiness of the Sterling Area

There is no need for concern about the willingness of the United Kingdom to meet her obligations. She can be relied upon to give top priority to debt service payments and to take whatever measures are within her power to avoid default on outstanding obligations. Her existing dollar debt burden is substantial, but, particularly if related to the gross dollar earnings of the United Kingdom and the dependent overseas territories combined, would not by itself create a very serious balance of payments problem.

It does not seem impossible for the sterling area to balance its dollar accounts. However, its prospective dollar position appears at best precariously balanced, and it remains to be seen whether the United Kingdom will be able to carry out the adjustments in her economy which would make it possible for her to discharge both her dollar and sterling obligations while at the same time maintaining a politically tolerable standard of living for her people. The recent measures taken by other members of the Commonwealth to restore internal and external equilibrium have also yet to take effect.

The additional burden represented by the service even on several hundred million dollars of new debts would be extremely small compared with the total dollar payments and receipts of the United Kingdom and her colonies, not to mention those of the whole sterling area. Lending at the rate of $100 million per annum would add an interest burden of about $40 million after ten years. If the loans were on a twenty-five year basis, repayment of principal would then be of the same order of magnitude. This is well within the margin of error of the preceding balance of payments estimates.
Because of both the magnitudes and the uncertainties involved, it is not possible to say within even a few hundred million dollars how much dollar debt the sterling area can service. The United Kingdom's debt burden should be progressively reduced from its present level, but part of the burden at least can be shifted to the overseas sterling area. Under present conditions, a reasonable solution would be for the Bank not to make loans to the sterling area which would result in a substantial net increase in the dollar debt owed or guaranteed by the United Kingdom. Amortization payments on such debt amount to about $70 million in 1952 and rise gradually thereafter.

In choosing the geographical areas or economic sectors to which loans might be granted, attention should be given to the direct or indirect contribution which such loans would make toward strengthening the dollar position of the sterling area. Loans to the dependent overseas territories appear particularly appropriate for this purpose and it would appear as natural for them at their stage of development to increase their external indebtedness as it would be for the United Kingdom to reduce hers.

In considering loans to the independent members of the sterling area such as Australia, India, and Pakistan, the Bank has based its judgment on their bilateral dollar creditworthiness, taking into account their ability to draw on the sterling area dollar pool in times of need. In view of the precarious position of the sterling area dollar balance, large loans should continue to be made to the independent members of the sterling area only if it is judged that these countries could balance their dollar accounts bilaterally should the occasion demand. This is so not because the sterling area is expected to break up, but because the prospective earnings of the dollar pool do not now appear large enough to make any other solution possible. For the independent sterling area countries the pooling of reserves in London is a safety factor, but under present circumstances it would not seem wise for them to count on a large annual net contribution from the dollar pool to cover dollar deficits.