

New Zealand's Exchange Rate Regime, the Collapse of Bretton Woods, and the Twilight of the Sterling Area¹

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Abstract

In the mid-1960s New Zealand held the bulk of its foreign reserves in sterling and pegged its currency to the British pound. This paper looks at how New Zealand policy makers responded to the Bretton Woods and sterling crises in the late 1960s and early 1970s. The decisions of policy makers in New Zealand did not accord with what might have been expected of a small 'developing' economy. New Zealand was torn between following the UK and Australia in its external financial policy. Between 1968 and 1974, New Zealand (and Australia) undertook to hold agreed minimum sterling proportions of reserves. In December 1971 New Zealand followed Australia in pegging to the US\$ rather than to sterling, but there was no accompanying switch out of sterling into US\$ reserves. In fact the US\$ peg proved transitory, and New Zealand began to peg against a basket (in which sterling was the main component) in July 1973. It was not until after the introduction of the basket and the unwinding of the sterling agreements that New Zealand made decisive changes in the composition of its reserves. This paper contributes to the understanding of the choice of exchange rate anchors and reserve currencies in the wake of the collapse of an exchange rate system.

New Zealand has played the sterling game at least as well as, and probably better than, many other countries. We should therefore gain some advantage from our past behaviour.

N.R. Davis, Secretary to the New Zealand Treasury, July 1968.²

The late 1960s and early 1970s was a challenging period for the New Zealand economy. The prospect of British accession to the EEC and the collapse of Bretton Woods created a series of crises and opportunities to re-shape New Zealand's position in the international economy. It was also a time when Britain re-oriented its policy priorities toward Europe. Extricating sterling from the post-war sterling area arrangements, with their ties of reserve currency and capital flows, was an even more challenging and prolonged process for Britain. The crumbling of the international

¹ We thank the RBNZ for access to its archives, and the staff of its Knowledge Centre for their assistance.

² Archives New Zealand (ANZ), AALR 873, Acc. W3158/84, 61/4/2/1, pt 1, Memorandum from N.R. Davis to Minister of Finance, 19 July 1968.

monetary system required New Zealand to formulate an independent exchange rate and reserves management policy. We argue that New Zealand offers an interesting case study of the decision-making process, in relation to exchange rate policy, for a small economy dependent on primary production with close economic and political links to two larger partners.

The optimum exchange rate regime for ‘developing’ countries has been the subject of a large economics literature since the end of the Bretton Woods system. During the 1990s there was a general policy prescription that developing countries with weak institutional structures should adopt strong pegs to healthy and stable anchor currencies like the US\$, even to the extreme case of adopting a currency board or dollarisation to impose policy discipline and to enhance credibility. The opportunity cost of abandoning an independent monetary policy in an environment of globalised capital markets was deemed to be insubstantial. On the other hand, after spectacular crises in the late 1990s, when many emerging economies were forced to abandon their pegged exchange rates, most adopted inflation targeting with floating (albeit dirty floating) exchange rates.³

Anchor currencies are usually considered to have certain properties including stability (store of value), liquidity and the size of the issuing country’s economy, while the choice of reserve currency is positively related to the proportion of trade and debt denominated in that currency (medium of exchange function). The primary roles of foreign exchange reserves are to cushion against fluctuations in the balance of payments and as debt security, so there is also an important store of value element to reserve currency choice. The determinant of the anchor currency and the reserve currency are related through the transactions cost explanation of both the choice of anchor (optimum currency area theory relating to the openness of the economy to the anchor country) and the choice of reserve currency (volume of transactions in that currency). As we shall demonstrate, decisions over the anchor and reserve currencies were, for better or worse, not coordinated in New Zealand in the early 1970s. An additional role of international currencies is as a unit of account, where the advantages reflect the number of countries that share a vehicle currency. This last attribute tends to lead to network externalities that increase the cost of abandoning a dominant international currency and give rise to inertia that can be interrupted by ‘tipping points’ marking rapid transformations in the league table of reserve assets.⁴ Traditionally, for smaller economies most official reserves are denominated in the intervention (or anchor) currency to avoid exchange risk.

In the 1950s exchange controls on current and capital account increased the network externalities of holding sterling reserves and pegging to sterling among sterling area countries, but these receded with liberalisation of commercial payments in the 1960s. With regard to sterling’s stability and liquidity, in the 1960s the credibility of the fixed rate was repeatedly under threat and the market value of many British government securities sank well below face value. Moreover, as Britain’s

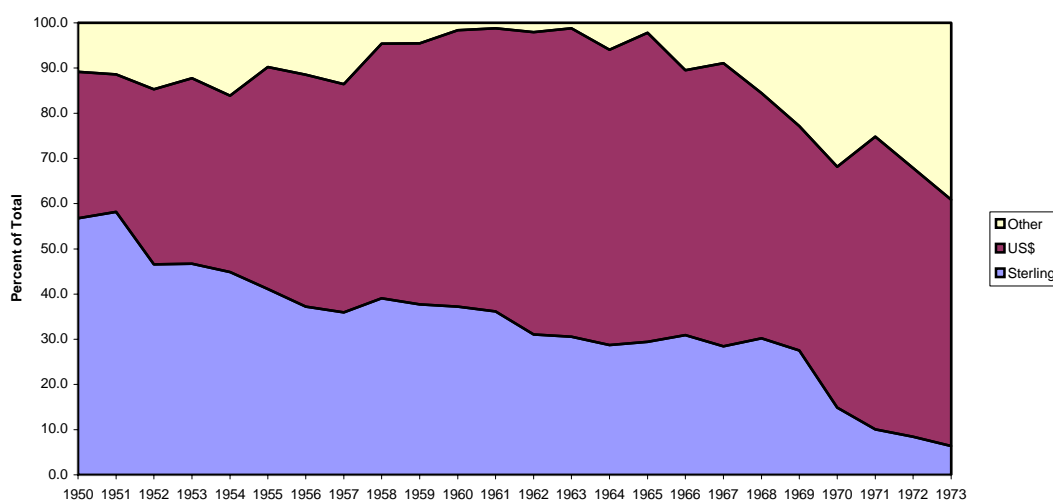
³ For a survey see, GS Tavlas, ‘The Economics of Exchange Rate Regimes: a review essay’, *World Economy*, 2003. Rose describes this system as ‘Bretton Woods reversed’. AK Rose, ‘A Stable International Monetary System Emerges: Inflation Targeting is Bretton Woods, Reversed’, NBER Working Paper, 12711, November 2006.

⁴ There is some debate over whether more than one reserve currency is feasible. This depends on the strength of the network externalities, which in the 1950s were reinforced by exchange controls of the sterling area system.

share of world trade declined and the capital market in US\$ (and DM) accelerated during the 1950s and 1960s, the transactions cost savings of holding sterling reserves receded. One opposing trend was an increase in the importance of London as an international financial centre during this period due to controls in New York, but this owed more to the rise of the Eurodollar than to sterling transactions. What is perhaps most surprising is that sterling was an anchor currency for so many countries (34 currencies by 1968) for so long despite the recurring external crises of the British economy, their waning trade position and the devaluation of the pound in 1967. On the other hand, by the mid-1960s abandoning sterling was complicated by the instability of the US\$ and the weaknesses of the US economy, which made the US\$ an unattractive alternative. While sterling declined as an international reserve asset throughout the postwar period, this process was uneven and the tipping point for abandoning sterling did not come until 1970.

Figure 1 shows that the use of sterling as a reserve currency declined sharply in the early 1950s when the wartime accumulations were run down. The share then stabilized in the early 1960s before falling precipitously in 1970 and 1971 as many countries abandoned sterling as their intervention currency in favour of the US\$. The fall in sterling's share is even more stark given that sterling was revalued against the dollar at the end of 1971.

Fig 1: Denomination of World Foreign Exchange Reserves



Eichengreen has explained the persistence with sterling reserves as ‘a matter of loyalty by members of the Commonwealth and by British colonies with limited choice in the matter’.⁵ This works best for the 1940s, since by 1961 most colonies had achieved independence, yet sterling’s decline as a reserve currency slowed down at this time. Eichengreen also cites the fear that by dumping sterling, the health of the British economy (on which many members of the sterling area depended) would be undermined. An important practical issue was the threat to the value of remaining sterling assets if diversification pushed sterling off its peg – there were network

⁵ B. Eichengreen, *Global Imbalances and the Lessons of Bretton Woods*, MIT Press, 2007. p. 134.

externalities associated with sterling both in transactions with other sterling area countries as well as the need for collective discipline in the collective interest. Eichengreen should also have noted that a rapid diversification of sterling could have provoked the UK to evict a country from the sterling area, thus restricting the convertibility of remaining sterling assets, although this threat was more real during the 1950s than the 1960s. The case of Singapore in the mid-1960s showed that diversification by accumulating non-sterling assets rather than selling sterling assets was possible without London knowing (and therefore without retribution). The case of Hong Kong showed that where a territory's banks had large commercial sterling assets, eviction from the sterling area was not an option because of the threat that these privately held balances would be dumped.⁶

On the British side, by the early 1960s there was support in both the Treasury and the Bank of England to gradually reduce the reserve role of sterling but the method for achieving this goal was vigorously disputed and ultimately delegated to international negotiations. The diversification of sterling reserves posed a risk to the credibility of the fixed exchange rate, but on the other hand large outstanding liabilities relative to the UK's foreign assets also undermined confidence and were deemed to inhibit other policy initiatives (including accession to the EEC⁷). Given these constraints on a unilateral UK initiative and the general acceptance that the entire international monetary system needed some collective reform, the Bank of England and the Treasury spent the 1960s seeking a negotiated global solution to retiring sterling as a reserve currency through the BIS, the IMF and the G10. The Bank of England, however, was averse to any suggestions that would reduce the commercial use of sterling that generated earnings for their constituents in the City of London. The overlap between the commercial and reserve roles of sterling therefore posed a conflict for them and complicated the management of the end of sterling's reserve role.

Unlike other members of the sterling area, the longevity of the sterling peg for Australia and New Zealand is not so easily explained by loyalty or historical legacy. These countries were not newly post-colonial, had high levels of GDP per capita and their traditional historic ties with Britain had already become strained by the UK's plans for EEC accession.⁸ Australia had good prospects for industrialisation and diversification of trade and therefore for raising international debt from somewhere other than London. By 1965 Japan had overtaken the UK as Australia's largest export market. New Zealand was in a different position with continued reliance on the British market, although this dependence was decreasing inexorably from 1960, as is evident in Figure 2. The UK absorbed half of New Zealand's exports in 1965 but only about one third by 1971. While Australia did not become New Zealand's second largest trading partner until the early 1970s, the exchange rate between the two countries was still an important determinant of New Zealand's balance of payments and domestic price level. New Zealand's structural diversification depended on the Australian market, which was the sole external outlet for manufactured exports. That Australia competed in a range of New Zealand's export markets (e.g. for wool) also

⁶ C.R. Schenk, 'The Empire Strikes Back; Hong Kong and the Decline of Sterling in the 1960s', *Economic History Review*, LVII (3) August 2004, pp. 551-580.

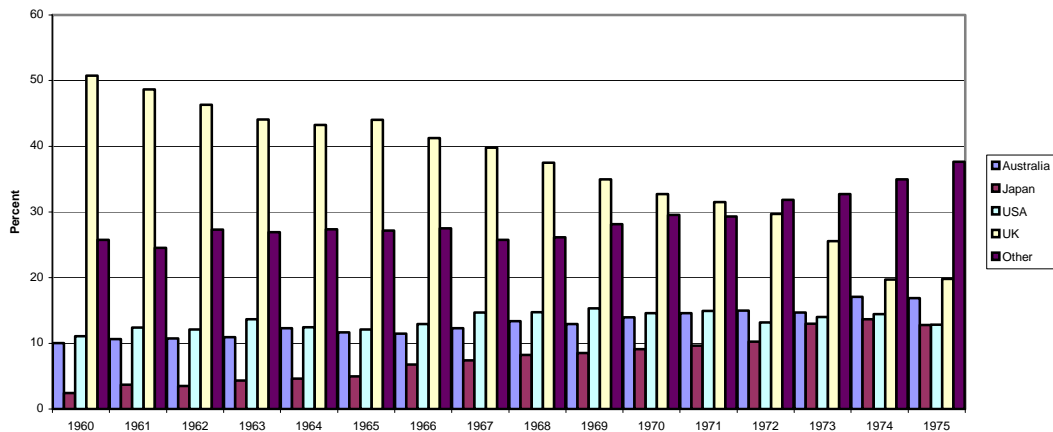
⁷ C.R. Schenk, 'Sterling, International Monetary Reform and Britain's Applications to the EEC in the 1960s', *Contemporary European History*, 11(3), pp. 345-369, 2002.

⁸ J. Singleton and P.L. Robertson (2002), *Economic Relations Between Britain and Australasia 1945-1970* (Basingstoke: Palgrave).

made the AUD/NZD exchange rate an important policy issue for the New Zealand government. New Zealand's links with sterling were further stretched by the deliberate increase in non-sterling national debt, particularly DM from 1965.

Figure 2 shows the distribution of New Zealand's total trade (imports plus exports). The decline in the share of the UK was accompanied by diversification towards 'other' markets as well as towards the USA, Japan and Australia.

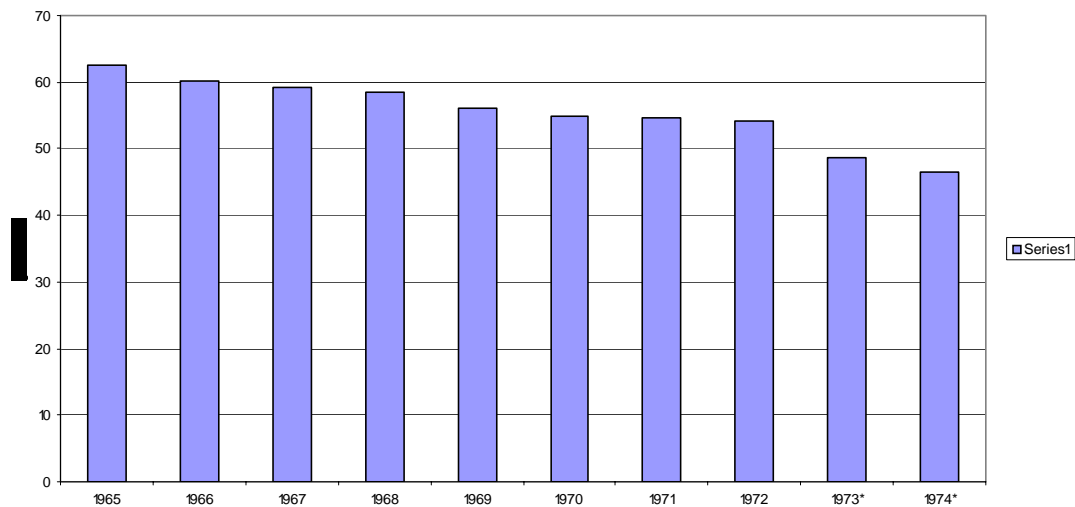
Fig 2. Share of New Zealand's Total Trade



Source: www.stats.govt.nz

Figure 3, however, shows that the relative decline in New Zealand's trade with other sterling area countries was not as precipitous as with the UK alone, which prolonged sterling's commercial role. In 1972 close to 55% of New Zealand's trade was still denominated in sterling. The share of trade denominated in sterling provides a reasonable baseline for the optimum proportion of reserves that should be held in sterling. However, the actual sterling proportion was considerably higher than this and rising from 1970.

Fig 3. NZ Trade with Sterling Area as Share of Total Trade



In the case of New Zealand and Australia, the choice of intervention currency (or anchor currency in a fixed exchange rate system) was separated from the choice of reserve currency. The latter was determined in part by formal agreements over the minimum sterling proportion of reserve assets, concluded in the summer of 1968 between Britain and 34 overseas sterling area (OSA) countries, which prolonged the inertia and postponed the tipping point for the transition to the US\$. Australia, with a wider trade and investment network successfully diversified its currency reserves away from sterling before signing the Sterling Agreements. Canberra also chose not to follow sterling through the devaluation of 1967 and instead maintained its peg with the US\$, while officially at least continuing to use sterling as the intervention currency. When the first break in the Bretton Woods system happened at the end of 1971 with a general realignment of exchange rates, Australia took the opportunity to move formally to a peg to the US\$, a step which was followed the next day by New Zealand. Nevertheless, New Zealand continued to keep the bulk of its official reserves in sterling. Indeed, although the minimum agreed proportion was reduced to 63% in September 1971 the actual share of sterling was still 73% in 1973. Explaining why New Zealand's did not alter its reserves strategy to conform to its new US\$ based exchange rate regime, in 1971-73, is one of the objectives of this paper.

Foreign Exchange Rate Policy

Initially, a primary goal of New Zealand was conforming to the prevailing rules of the international monetary system (i.e. maintaining a pegged rate until after the collapse of Bretton Woods) but this did not imply a passive exchange rate policy. New Zealand policy-makers were willing to grasp opportunities to improve their competitive situation during times of adjustment of the pegged system. They took the opportunity to devalue relative to the AUD in 1967. As Figure 4 shows, New Zealand tried to maintain the highest level of nominal exchange rate stability possible as the system collapsed from August 1971. According to Figure 5, the depreciation of the real exchange rate, due to the devaluation of 1967, continued until 1970-71. The new peg to the US\$ at the end of 1971 ushered in three years of appreciation of the real

exchange rate, due in part to domestic inflationary pressure. The nominal trade weighted index in contrast was stable from 1969 until the oil crisis of 1973 (Figure 6).

The different paths chosen by Australia and New Zealand in 1967 contrast with New Zealand's decision to follow Australia in 1971 and peg to the US\$. This difference can be explained by the deficit in New Zealand's external position in 1967 compared to the inflationary surplus in 1971. Depreciating the NZD against the AUD and the US\$ and Yen in 1967 increased export competitiveness. But the concurrent choice to raise non-sterling debt, especially in DM, without diversifying reserves created problems for reserves management. Australia on the other hand chose to accept losses on their sterling foreign exchange reserves to gain cheaper sterling imports, and to avoid increasing the burden of servicing US\$ denominated debt.

Fig 4: AUD and NZD per US\$ 1964-73

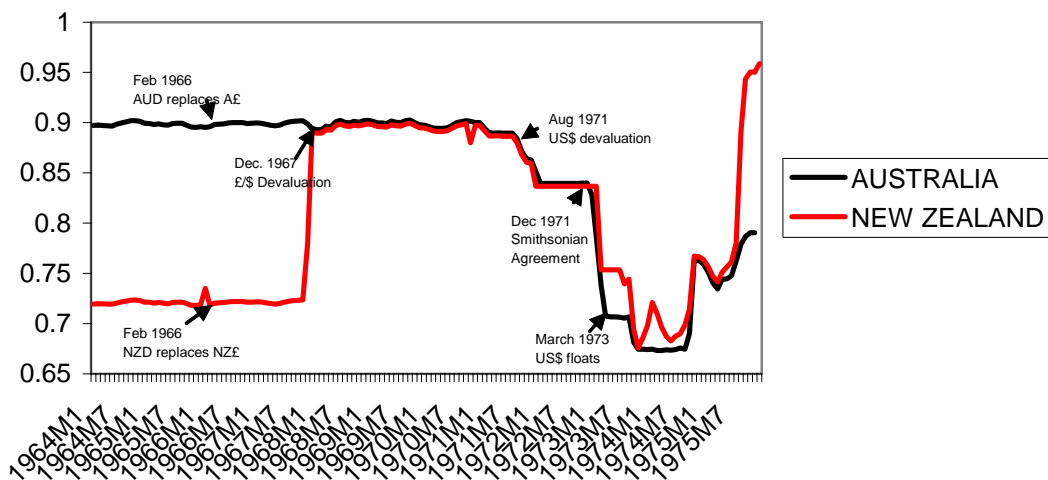
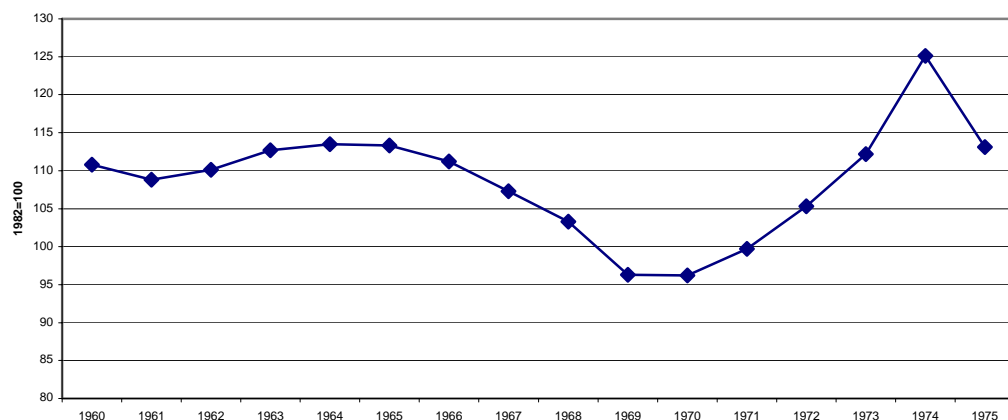
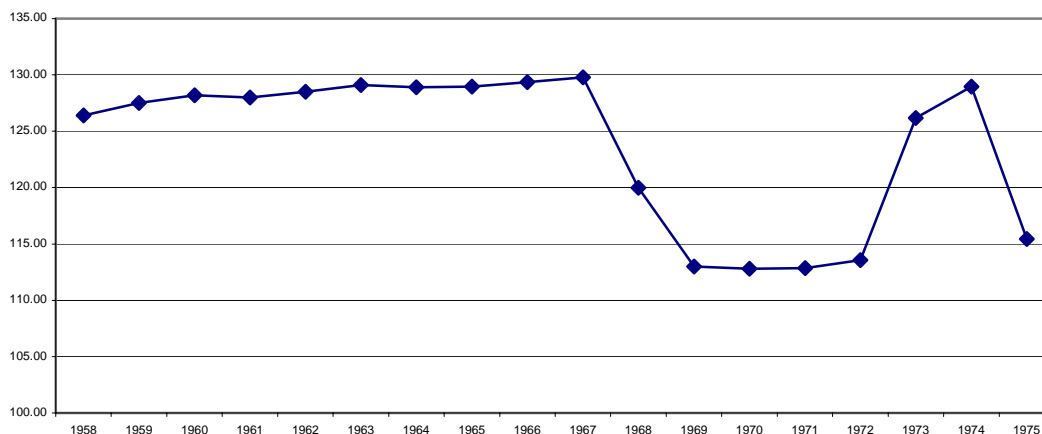


Fig 5: NZD Real Exchange Rate Index 1960-1975



Source: www.stats.gov.nz

Fig 6: NZD Trade Weighted Nominal Exchange Rate Index (1979=100)



Source: www.stats.gov.nz

New Zealand was no less concerned than other nations about the stresses in the international monetary system in the late 1960s. Despite being a recent adherent to the Bretton Woods system (joining the IMF only in 1961), New Zealand was a firm believer in the merits of a fixed exchange rate system, as it made clear to the IMF in July 1971: ‘In our view the need to provide stable exchange rate for trade purposes is paramount.’⁹ Dependence on London exchange markets and the lack of a developed local exchange market were technical impediments to the adoption of greater flexibility. This aversion to nominal exchange rate fluctuations was compounded by the economy’s reliance on primary product exports, with their high degree of seasonality.

A Treasury discussion paper, drafted in June 1971 on the eve of the Nixon Shock, set out New Zealand thinking on international monetary affairs. Although New Zealand wished to preserve a fixed exchange rate system, it would be prepared to live with smaller, more frequent changes in parities in order to avoid the prolonged bouts of overvaluation (e.g. of sterling) and undervaluation (e.g. of DM) that prevailed in the 1960s. At the 1970 IMF meeting, the New Zealand minister had indicated that a small widening of margins around parities could be acceptable, but that any more substantial widening of margins would need careful thought and justification. Treasury agreed: ‘Without being unduly rigid ... it is suggested that we should continue to be cool (if not actually opposed) to even a limited (and general) widening of margins...’¹⁰ A margin of plus or minus 3% would mean a fluctuation of up to 6% for countries such as New Zealand that maintained their pars (in terms of US\$) via third currencies (e.g. sterling). New Zealand understood the reasons for the temporary float of some countries – Germany in 1969, and the Netherlands, Canada, and Germany in 1971 – but did not want the IMF to ‘legalise’ such actions. Treasury

⁹ RBNZ Archives, Box A0371, File 466, Cable: Wellington (Tsy) to Washington (for L.G. Brand – IMF Exec Director), 19 July 1971.

¹⁰ RBNZ Archives, Box A0371, File 466, Draft notes for discussion: International Monetary System, drafted by D. Stacey [Tsy], 29 June 1971, p. 3.

was not convinced that the US\$ was overvalued, and concluded that its weakness was primarily the result of short-term capital flows propelled by interest rate changes and speculation. The appropriate solution was neither devaluation nor floating, but the use of exchange controls by other countries to prevent or offset destabilizing capital inflows.¹¹

A regime of floating exchange rates was not an attractive proposition:

From New Zealand's own point of view it would be administratively difficult (but not impossible) to operate a system of flexible exchange rates. Rates might be fixed daily but daily transactions are so erratic that it would be difficult to establish a rational basis.¹²

The situation changed in August 1971 with the suspension of convertibility by the US. New Zealand was not alone in hoping for a speedy decision on the future of the international monetary system. Like other small members of the IMF, however, New Zealand was concerned 'to see the major decisions ... being made without their participation.'¹³ (Australia spoke for New Zealand in most negotiations, but even Australia had limited clout.)

A Reserve Bank (RBNZ) memo, written in September or October 1971, discussed the prospects for the international system and the implications for New Zealand. It was unclear whether the world was moving towards a regime of floating exchange rates, or whether Bretton Woods would be patched up. The future of national currencies and gold as reserve assets was also in the air. New Zealand, argued the Bank, should consider six main factors when formulating its exchange rate strategy:

- The relative weighting of the major countries in total exchange transactions. (42% of New Zealand's total exchange transactions were with the UK, 16% with Australia, and 18% with the US and Canada.)
- 'The traditional relationship with sterling which has on the whole served us so well in the past.'
- 'Special need of our non-traditional exports on which we rely for so much growth in total export receipts.'
- Implications for agriculture
- Effects on cost of living¹⁴

The first three of these considerations pointed toward a continued close relationship with sterling. What were New Zealand's options in the event of a general revaluation of currencies against the US\$? Maintaining an unchanged peg against the US\$ was not considered, as this would have involved a significant (and perhaps inflationary) devaluation against other currencies. Essentially, the Reserve Bank felt

¹¹ Ibid., p. 7.

¹² RBNZ Archives, Box A0068, File 50, Memorandum for the Directors: Exchange rate adjustment, 11 Aug 1971.

¹³ RBNZ Archives, Box A0068, File 50, The Confusion in International Finance (Report on IMF Annual Meeting, September 1971) [undated, for 14 Oct RBNZ Board meeting].

¹⁴ RBNZ Archives, Box A0068, File 50, Memo for the Directors: The future of gold and par values [undated, Sept or Oct 1971], Appendix.

that New Zealand would have to choose between following sterling and following the A\$. It was assumed that sterling would be revalued by more than the A\$. Thus, if New Zealand stuck with sterling, the NZ\$ would experience a small revaluation against the rest of the world (perhaps of 0.75% to 2.5%). If New Zealand went with the A\$, however, it would experience a small depreciation against the rest of the world (say of 0.9% to 1.5%). The author(s) concluded that ‘there is not much in it either way, but it is presumably better to have a small devaluation than the opposite.’¹⁵ On the other hand, there were grounds for staying with sterling:

As this country has no foreign exchange market of its own our currency derives its “usefulness” in an international context by convertibility into sterling at a fixed price. This has been the position for many years and will probably remain this way as long as we trade extensively with the United Kingdom.¹⁶

After months of negotiation among the G10, on 18 December 1971 there was a major currency realignment (the Smithsonian Agreement) that, in the end, merely prolonged the death throes of the Bretton Woods system. The IMF agreed that actual exchange rates could fluctuate on either side of the new par (or central) rates by up to 2¼% (as opposed to 1% under Bretton Woods). New Zealand, Australia, and Britain retained their existing gold parities, and thus were revalued against the US\$. The choice of intervention currency, however, was determined by the new wider margins of fluctuation. Australia declared the US\$ (not sterling) as its intervention currency, so that fluctuations of the AUD would be confined to a maximum of plus or minus 2¼% around the US\$ par value compared to a possible plus or minus 4.5% if the peg were through sterling. The wider margin thus applied to the cross-rate with sterling. With effect from 23 December, Australia began to peg at the bottom of its margin against the US\$. If New Zealand had chosen to retain sterling as its intervention currency, the cross-rate between the NZ\$ and A\$ could have fluctuated by up to 5½%. Instead, New Zealand followed the Australian lead, adopting the US\$ as its intervention currency and moving to the bottom of the permissible margin (Deane, Nicholl and Walsh 1981: 142-3). New Zealand’s justification was as follows:

In view of the developing trade in manufactured exports [with Australia] a fluctuation of this magnitude [i.e. up to 5 ½%], which could not be controlled by New Zealand, was clearly undesirable. Accordingly it was decided to follow the same policy as had Australia, in order to maintain a fixed relationship with that country.¹⁷

Even though one third of New Zealand’s trade was still with the UK, the combination of Australian and US trade together comprised almost 30%. As the NZ\$ peg was formally with the US\$ and not with the A\$, however, it was possibility to retain some flexibility in relations with Australia as well as access to more liquid markets in US\$.

¹⁵ Ibid.

¹⁶ RBNZ Archives, Box A0068, File 50, Memorandum for the Directors: Exchange rate adjustment, 11 Aug 1971.

¹⁷ RBNZ (1972), *Annual Report 1971-72*, p. 20. See also RBNZ Archives, Box A0068, File 51, Memorandum for the Directors: Currency Realignment, 5 Jan. 1972.

After the Smithsonian Agreement was concluded, Governor Low envisaged further changes in the international monetary system, although he remained committed to the principle of fixed exchange rates. He contemplated the substitution of the SDR, perhaps renamed the 'bancor', for the US\$ as numeraire of the par value system. Convertibility would be into SDRs, which would have a gold guarantee. He also expressed an interest in the dual exchange rate regimes operating in France and Belgium. Current account and official transactions were at a fixed exchange rate, but capital transactions were at a fluctuating rate. Low felt that this type of mechanism, which was designed to prevent capital flows from putting pressure on the fixed rate, merited examination by other countries.¹⁸ In a meeting with the Minister of Finance in January 1973, Low expressed some sympathy for a policy, not of floating, but of frequent small changes in the exchange rate. The minister, however, was unconvinced.¹⁹

In December 1972, Australia revalued by 4.85% against the US dollar (and effectively by 7.05% against the NZ\$). Australia moved against the background of a robust trade surplus, there being a commodity boom, and large speculative inflows of capital. New Zealand also had a strong current account in late 1972. The speculative element was not present in view of tight capital account controls, but New Zealand's external reserves were approaching record levels. Would Wellington follow Canberra again? On the one hand, revaluing the NZ\$ would dampen rising inflationary pressure. But, on the other hand, the NZ\$ had already appreciated by about 4% since sterling had begun to float in June, and it was not clear that further revaluation was warranted, especially in the light of the impending shock to the farming sector from Britain's entry into the EEC in January 1973. The RBNZ recommended that New Zealand should take no action, and thus gain a short-term trade advantage over Australia. As Australia was not yet a dominant trade partner, the Bank argued that keeping a fixed parity with the A\$ should not be seen as a matter of general principle. Ministers accepted this advice.²⁰

The US devalued unilaterally by 10% in February 1973. This time New Zealand and Australia stuck to their existing US\$ parities, and participated to an extent in the US devaluation. Given New Zealand's persistent external surplus and inflationary pressure, however, officials began to argue that the NZ\$ should not be tied to a weaker currency, such as the US\$. In July 1973, the NZ\$ was revalued by 3% against the US\$ (and the A\$). The government also announced that henceforth the NZ\$ would be fixed in relation to a basket of currencies instead of the US\$ alone. The records of the RBNZ suggest that this innovative decision was the outcome of considerable frustration at the difficulty of maintaining exchange rate stability against a range of currencies at the same time as the US\$, given the dollar float. Using a basket allowed for a more dynamic and practical strategy that could moderate fluctuations in exporters' incomes and curb the depreciation arising from the peg to the US\$.

¹⁸ RBNZ Archives, Box A0068, File 52, Paper for New Zealand Association of Economists Meeting, August 1972: The Reform of the International Monetary System: Some General Comments, by A.R. Low.

¹⁹ RBNZ Archives, Box of Miscellaneous Papers: Interviews with Minister of Finance 1937-1979, File note: Interview with W.E. Rowling, 9 Jan 1973.

²⁰ RBNZ Archives, Box A0081, Draft memo: Revaluation of the Australian dollar, 8 Jan 1973; Box A0384, Press statement by Min of Finance (W.E. Rowling), 23 Dec 1972.

Although ten currencies were in the initial basket, four – sterling (40%), the US\$ (18%), the A\$ (20%) and the yen (11%) – dominated the weighting. By introducing the basket New Zealand hoped to reduce swings in cross exchange rates. The US\$ and A\$ exchange rates were not the only ones that mattered. Indeed the NZ\$/sterling rate was still very important since the UK was still a major market. Another merit of the basket mechanism was its flexibility and its obscurity:

The proposed procedure leaves all our options open. The “basket” formula can be modified at any time; the calculations can be “shaded” to allow for special situation [sic], and if a decision is later made to move our “anchor” up or down (devaluation or revaluation) we are as free as ever we were to act.²¹

The details of the components of the basket were kept secret to allow them to be changed without affecting market sentiment and to confound speculators. Even the IMF was rebuffed when they asked for guidance on how the system operated, although they accepted New Zealand’s innovation as ‘appropriate... both from a domestic and an international point of view’.²² Obscurity and flexibility are attributes of a basket currency that still have great appeal, for example for China. Given that the rate was no longer fixed against any particular currency, the basket was effectively a float from the perspective of the IMF. But (dirty) floating was in any case the norm by this time. New Zealand was one of several nations to begin pegging against a basket of currencies in 1973. (The others were Cyprus, Finland, Malawi, Malta and Morocco.) However, New Zealand’s version of the basket mechanism was distinctive, involving daily adjustment to the exchange rate for the US\$ to compensate for changes in the value of the basket.²³

Contemporaneously with New Zealand’s move, the Australians indicated that they might change their parity within a couple of months. The Reserve Bank of Australia (RBA) was attracted to the basket concept, although the Australian Treasury felt that a peg to a single currency was more likely to encourage monetary discipline.²⁴ In the event, Australia revalued by 5% against the US\$ in September 1973 but maintained the link. New Zealand responded immediately with a 10% revaluation against each currency in the basket (although the revaluation against the A\$ was of course smaller).

By the middle of 1974, circumstances had changed, largely as a result of the oil shock. Both the A\$ and NZ\$ weakened and the US\$ began to climb due to its use as a petrocurrency. In September 1974, the Australians devalued by 12%, and introduced the basket. New Zealand reacted defensively by devaluing by 6.2%

²¹ RBNZ Archives, Box A0068, File 56, Memo for the Minister of Finance: Revaluation of New Zealand dollar: supplementary notes, 6 July 1973.

²² IMF Consultation 1973, Meeting re Exchange Rates, 7 Nov 1973, RBNZ Box A0096.

²³ IMF Annual Report on Exchange Rate Restrictions 1973, pp. XXXX. For details of New Zealand’s basket arrangement see Deane, Nicoll and Walsh (1981: 147-8).

²⁴ RBNZ Archives, Box A0384, RBA Memo: Australia’s exchange rate: breaking the rigid link with the U.S. dollar, 29 June 1973; Handwritten notes of visit to RBA, July 1973.

against its own currency basket.²⁵ The New Zealand authorities stated that their ‘decision ... was taken in view of the recent fall in farm incomes and the need to retain a competitive position for our manufacturers in the Australian market.’²⁶

Further alarming developments occurred in New Zealand’s external accounts in the following year, and in August 1975 the NZ\$ was devalued by a further 15%. (This was not in response to any Australian action.) In a press statement, Bob Tizard, the Minister of Finance, explained that, with the world in its worst postwar recession, he had to take action to stimulate the economy:

Dealing with the timing of the exchange rate change, Mr Tizard said that in present world conditions of floating exchange rates, inflation and rapid changes in terms of trade, it was imperative for a small trade-dependent country such as New Zealand to review its exchange rate more frequently than had been the case in the past.²⁷

The case of New Zealand conforms to the general literature on the appropriate exchange rate regime for developing economies with weak institutional structures and dependence on primary products. New Zealand desired a stable exchange rate regime. The problem in the late 1960s and early 1970s was to find an appropriate anchor to ensure discipline and internal stability and growth as both the UK and USA economies underwent severe strains. The move to the US\$ at the end of 1971 had more to do with the way the Smithsonian Agreement established margins than with the credibility of the US\$ as against the pound. In the early 1970s high export prices and balance of payments surpluses exerted inflationary pressure on the domestic economy that prompted wage and price controls as well as periodic revaluations. The peg to the depreciating US\$ increased these pressures. Once the US\$ ceased to be managed, New Zealand opted for a basket currency and a managed float from July 1973, but the operation of this system was complicated by the disarray in exchange markets that followed the oil crisis.

The policies of Australia were an important determinant of New Zealand’s choices, but they were not always decisive. The move to the US\$ as intervention currency at the end of 1971 was prompted by the desire for greater stability in the exchange rate against the AUD than would be possible through sterling under the Smithsonian Agreements of December 1971. On the other hand New Zealand led the move to using a basket rather than a single reference currency in July 1973, and took advantage of changes in the AUD exchange rate to improve competitiveness. However, the case of reserve currency management discussed below shows that New Zealand’s links to sterling were much stronger than those of Australia and indeed strengthened despite the changes in exchange rate policy.

With hindsight, it could have been a mistake to peg to the US\$ (and the A\$) in December 1971, especially at a ‘low’ rate. This decision exposed New Zealand to rising inflationary pressure, and to swings in cross rates vis-à-vis other important

²⁵ The devaluation was technically 9% against all currencies except A\$, against which there was a revaluation of 3% because of the 12% devaluation by Australia (Deane, Nicholl and Walsh 1981: 149).

²⁶ RBNZ Archives, Box A0046, Memo for the Directors: Exchange rates: the devaluation of the New Zealand dollar, 4 Oct 1974.

²⁷ RBNZ Archives, Box A0046, Press statement by Minister of Finance, 10 Aug 1975.

currencies, including sterling after the June 1972 British float. On the other hand, it is by no means clear what the best strategy would have been, in the midst of such uncertainty, in late 1971. The adoption of the basket in mid-1973, by which time the prospects for salvaging the Bretton Woods system had receded, made a lot of sense and could have served New Zealand well if international conditions had been stable in the following few years.

Reserve Currency Management

New Zealand traditionally held the bulk of its reserves in sterling. In 1967 almost 80% of the reserves were in sterling. Although New Zealand held sterling voluntarily, it started to diversify in the mid-1960s, as the prospects for sterling and Anglo-New Zealand trade became dimmer. By 1980 only 18% of the reserves were still in sterling (Deane, Nicholl and Walsh 1981: 337). Until the mid-1970s, however, the extent of diversification was modest.

Paradoxically, while a lack of credibility in the exchange rate of sterling prompted a desire to diversify reserves in the 1960s, selling sterling would threaten the 'market value' of remaining sterling assets, thus there were countervailing pressures to retain sterling assets. Nevertheless, Australia diversified its reserves steadily during the 1960s by accumulating non-sterling assets and selling off official sterling securities. By the middle of the decade only 70% of Australian reserves were in sterling. This reflected both the diversification of their trade and borrowing as well as waning confidence in sterling's future exchange rate stability. New Zealand, on the other hand, remained more reliant on the UK market. New Zealand's pattern of reserve holdings more closely resembled that of Malaysia or Singapore in the mid-1960s. From early 1967, however, Singapore adopted an aggressive but secret diversification strategy so that immediately after the devaluation London learned for the first time that Singapore held only 50% of its reserves in sterling. New Zealand and Malaysia were thus rather left behind by the more strategic reserves policy of Australia and Singapore on the eve of the devaluation.

Table 1: Proportion of sterling in official reserves

	Australia	New Zealand	India	Pakistan	Malaysia	Singapore
1964	79		98	44	60	96
1965	70		97	40	56	96
1966	69		97	20	46	90
Jun-67	64		80	20	37	87
Oct-67	60		85	21	32	82
Sept-68	45		77			

Source: BE OV44/116. 1968 from T312/2811, T312/2804

The lack of an obvious anchor currency complicated the choice of reserve currency asset. The store of value as well as medium of exchange tasks of reserve assets suggested that diversification was the most risk-averse strategy. However, for New Zealand the denomination of reserves was also a negotiated outcome with the UK through the 1968 Sterling Agreements. New Zealand policy-makers hoped to diversify down to about 50% of their reserve assets in sterling but this was not

accomplished. The 1968 Sterling Agreement set the proportion at 70% (below the 80% initially suggested by the British) until September 1971 and 63% thereafter. Figure 7 below shows the dramatic accumulation of reserves from the end of 1970 as balance of payments surpluses mounted.

Fig 7: Value of New Zealand Reserves



Source: National Archives, London, Treasury Files

Between 1968 and 1974 New Zealand participated in a system of agreements between Britain and OSA countries, which committed signatories to holding a minimum sterling proportion (MSP) of official reserves, in exchange for a guarantee in sterling of the US\$ value of 90 per cent of sterling reserve holdings. Overseas reserves of the trading banks were included in the definition of official reserves. Figure 8 and Table 2 shows the share of sterling in New Zealand's official reserves. The MSP system made special allowance for maturing sterling loans that were not refinanced. Thus, after New Zealand chose not to renew a £15m in September 1968, an equal amount was added to the calculation of their sterling reserves. This kept the total above the statutory minimum 70% at the end of 1969 and 1970. By the end of 1971 the MSP was down to 63% but the actual proportion of sterling climbed due to balance of payments surpluses. The MSP was reduced to 56% in 1974, and New Zealand complied with this figure until the agreement ran out in December of that year. In November 1974, 59% of New Zealand's official overseas assets were still in sterling.²⁸

²⁸ RBNZ Archives, Box A0046, Memo for Directors: International Report December 1974, 7 Dec 1974.

Fig 8: New Zealand: Share of Sterling in Total Reserves

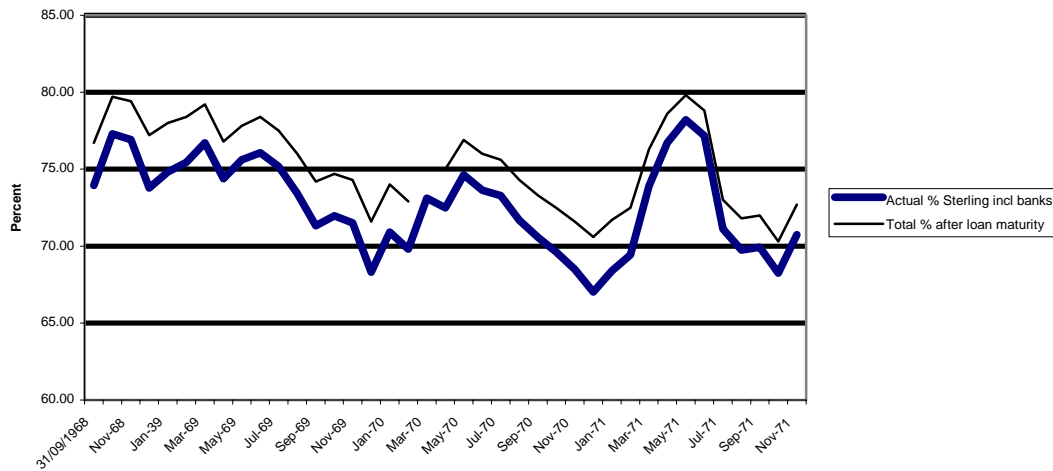


Table 2: Reserve Bank and Treasury Overseas Assets (NZ\$m), 1970-2, 1976

	US\$	stg	DM	DG	SwFr	Yen	Other	SDR	Reserve Posn @ IMF	Tot
1970	32.6	152.0	23.9	-	0.5	-	0.9	23.6	-	235.5
1971	15.1	153.9	32.0	0.2	0.3	-	0.4	19.6	45.1	266.6
1972	25.1	383.5	33.5	-	0.6	11.3	0.6	47.5	45.1	547.2
1976	197.7	165.8	167.6	11.5	-	9.3	2.1	9.7	-	563.7

NB: breakdown between sterling and European currencies not available 1973-6

Source: Deane, Nicholl and Walsh (1981: 337)

In June 1968 the British introduced their MSP proposals, which they said would bring greater stability to the Sterling Area. The MSP concept was devised by the Bank of England and their counterpart creditor central banks at the Bank for International Settlements. In brief, the Bank of England had approached central banks of the G10 through the BIS for support in case of the further diversification of sterling reserves. Having offered short term credit in the past, these banks were unwilling to extend their support further unless the UK got an undertaking from sterling area governments that they would restrict the diversification of their reserves. In turn, it became clear that such an undertaking would not be forthcoming without the offer of a guarantee of the exchange value of at least a substantial part of those sterling reserves. With the general terms of so-called Sterling Agreements set in Basle in June 1968, British officials were sent out to all 34 sterling area members to negotiate MSP agreements.²⁹ The deadline was September, when the central banks of Europe and the

²⁹ Initially London hoped to offer an exchange guarantee for only 80% of sterling reserves and to charge 1% interest on these balances, but the interest had to be

USA would convene again to offer their formal support for sterling, which was contingent on the conclusion of agreements with at least all the major sterling holders.

Governor Low assessed the British proposals in the context of New Zealand's overseas reserves strategy. He told the government that the British wished to retain a reserve currency role for sterling, albeit a reduced one, and wanted to discourage rapid diversification of reserves by OSA countries. Low noted that New Zealand's situation was rather peculiar:

Already some O.S.A. countries have taken the matter into their own hands and have diversified more than the United Kingdom wants. New Zealand has diversified hardly at all until recently and then to only a limited extent. ... I have already made it clear to the Bank of England that we wish to diversify our reserves to some extent, both on general grounds and in the light of the large volume of non-sterling debt which will be falling due for payment over the next few years. *If the proposed scheme comes into operation we can consider going further in this direction than we might otherwise have done.*³⁰

Low went on to discuss New Zealand's evolving reserves policy. It would be sensible to hold a small amount of gold, as gold was expected to appreciate over the next decade. Although the US\$ was weakening, it would be worth holding more US\$ reserves. Low did not expect the US\$ to depreciate relative to sterling, and thought that the British would match any US devaluation. Of course, in this assumption they were wrong and when, in 1971, the US\$ was devalued against sterling the benefits of the guarantee, which was linked to the pre-1971 US\$/£ exchange rate, were effectively eliminated until sterling floated 10 months later. Even then, the guarantee was not invoked until October 1972.

By 1968, New Zealand had started to accumulate US\$ by retaining some dollar earnings rather than selling them to the Bank of England. Low believed that this practice should continue, and that New Zealand could also retain the proceeds of US\$ borrowing. The issue of returns on reserves was also important, and while US interest rates were attractive, they were not as high as nominal rates on British assets, perhaps reflecting differences in risk. The strongest European currencies, that might be alternative reserve assets, were the DM and (for the time being) the lira and the Dutch guilder. However, these countries did not wish their currencies to become reserve currencies, and did not welcome deposits by non-residents, although New Zealand could use the facilities of the BIS for borrowing and depositing such currencies. Low pointed out that when New Zealand borrowed currencies that could appreciate, it should cover this risk by leaving the borrowed funds in the same currency. (The government already had an official £13m DM liability, and a further loan in DMs was being negotiated.)

Overall, however, Low did not favour a decisive switch out of sterling: 'While ... alternative forms of reserve holdings are available to us there continue to be significant advantages in holding sterling, notwithstanding the risk that sterling might be devalued.' Any future sterling devaluation would probably be in the context of a general realignment of currencies. Sterling was still a 'usable' currency for almost all

dropped because countries refused to pay it and the proportion guaranteed had to be raised to 90%.

³⁰ Emphasis added. RBNZ Archives, Box A0088, Memo for Minister of Finance: The Sterling Balances – A Proposed Scheme, 20 June 1968, pp. 3-4.

purposes. 'London continues to offer the best interest rates and the best facilities for the investment of funds, and most of our trade will continue to be denominated in sterling. We should continue to regard sterling as the basic component of our reserves.'³¹

Low was optimistic that New Zealand could *speed up* the diversification of its reserves by negotiating a lower MSP than the existing share of sterling in reserves. He added that, 'The degree of diversification which the Bank of England would accept as reasonable will depend on our non-sterling debts (NZ\$136 million in the next five years) and our pattern of trade and payments.' As a rough guide, New Zealand might aim for the following distribution of official reserves: sterling (50-60%), USD (20-25%), European currencies (10%), gold (10-15%).³² In fact, New Zealand did not achieve such a diversification until after 1974.

On behalf of the Treasury, Davis signified general approval of the British proposals. 'Basically this appears to be a reasonable approach to strengthen sterling and to provide some protection against a further sterling devaluation.'³³ However, the initial British offer, which included an MSP of 80 per cent, was unacceptable. 'Agreement to these proposals in toto would penalise New Zealand "for having played the game" while other sterling area countries have been diversifying their reserves as rapidly as practicable.'³⁴ Again, as with the Reserve Bank, the Treasury was counting on good will from London and New Zealand's loyalty in the past to influence Britain's negotiating position, despite the wrangling that had already taken place over Britain's applications to the EEC.

New Zealand held 84 per cent of its reserves in sterling in June 1968. Davis and his colleagues felt that more room for manoeuvre was required. Total official overseas debt was NZ\$625 million, of which NZ\$329 million was in sterling. NZ\$170 million of non-sterling debt was due to mature over the next five years. As New Zealand expected to raise more non-sterling loans, Davis argue that it would be prudent to retain some, if not all, of the proceeds outside the Sterling Area in other currencies. Some extra funds could be held in Germany to cover possible DM revaluation. Davis hoped that New Zealand could avoid making any firm commitment to an MSP, but thought 70 per cent would be a reasonable compromise. Treasury wanted strong assurances about continued access to the British capital market, and believed that the seven-year agreement proposed by the British should be shortened. The British would be asked about their long term plans for sterling as a reserve currency with New Zealand to underpin the agreement.³⁵

The official briefing for the New Zealand negotiators, who met British representatives in Wellington in July 1968 to discuss the scheme, included some wry observations. The briefing enumerated the traditional benefits of Sterling Area membership:

- 'Freedom to buy from the U.K. for [sic] non-sterling currencies that are required for any purposes.
- Access to the U.K. capital market for reasonable capital requirements.

³¹ Ibid, p. 6.

³² Ibid., p. 7.

³³ ANZ, AALR 873, Acc. W3158/84, 61/4/2/1, pt 1, Memo from N.R. Davis [Sec to NZTsy] to Minister of Finance, 19 July 1968 , p. 1.

³⁴ Ibid, p. 3.

³⁵ Ibid., pp. 3-4.

- Minimal exchange risks.
- Use of London's financial facilities.³⁶

but went on to lament that, 'under the stress of sterling difficulties New Zealand has had to forgo the most worthwhile benefits of being a member of the sterling area. [For example, private capital outflows to the OSA were subject to voluntary restraint.] Now it is being asked to pay for the partial restoration of these benefits.' Fortunately, however, there was 'no reason to anticipate a sticky attitude of the United Kingdom authorities'. Britain understood that New Zealand's trade pattern was changing and that its non-sterling liabilities were growing. New Zealand had always 'played the sterling game', and this would weigh in its favour.³⁷ Once again, the New Zealanders were relying on historical legacy and traditional relations for good will from London.

In addition, the New Zealand negotiators were anxious to coordinate their response to the British proposals with the response of Australia. Alan Low and J.G. Phillips, his counterpart at the RBA, discussed the impending negotiations by telephone. The Australians took a harder line with London than Wellington did, and would delay the conclusion of their agreement with London for a further two months by refusing to negotiate. Phillips was not impressed by Britain's proposal merely to guarantee the value of sterling balances in relation to the 'second weakest' major currency, namely the US\$. He was also disappointed that the UK was apparently offering no guarantees on access to the London capital market and the free outflow of portfolio investment. Phillips and Low agreed to exchange information on the negotiations and both expected the British to make concessions.³⁸

The British team visited Wellington first. They were prepared to compromise on most issues, including the level of the MSP.³⁹ But they were coy over the long term role of sterling, and were reluctant to acknowledge any link between the MSP and the issues of capital market access and private capital flows. In the end it was Canberra that was able to overturn this approach through brinkmanship. As Britain's September 1968 deadline approached, the Australians negotiated a side letter to the effect that any sterling debt that could not be refinanced would be counted as part of the sterling reserves when calculating the MSP, and that if the UK considered further restrictions on portfolio investment in Australia this would trigger renegotiation of the sterling agreements. These side letters were extended to New Zealand in November 1968, three months after a £15m sterling loan matured but was not refinanced by the New Zealand authorities because of the high interest rates prevailing in London. Although this maturity pre-dated the side agreement, the UK Treasury agreed in April 1969 to treat it as if it had been covered and added £15m to the nominal calculation of New Zealand's sterling assets.⁴⁰ In all respects other than the level of MSP, therefore, the British undertook to give New Zealand the same treatment as Australia.

³⁶ ANZ, AALR 873, Acc. W3158/84, 61/4/2/1, pt 1, Briefing for Sterling Area Negotiations July 1968, undated, p. 5.

³⁷ *Ibid.*, p. 6.

³⁸ ANZ, AALR 873, Acc. W3158/84, 61/4/2/1, pt 1, File note: Sterling Area Arrangements by A.R. Low, Governor RBNZ, 16 July 1968.

³⁹ ANZ, AALR 873, Acc. W3158/84, 61/4/2/1, pt 1, Memo from N.R. Davis to Minister of Finance, 31 July 1968; Cable, Wellington to Canberra (from Davis to Sir Richard Randall), 26 July 1968.

⁴⁰ Minute for Mr. Hay by AF Case, 2/3/70. National Archives, London, T312/2811.

Wellington essentially delegated its negotiations to the more powerful influences in Canberra.⁴¹

Under the agreement of September 1968, New Zealand promised to hold an MSP of 70% in return for a guarantee of the US\$ value (at the rate of £1 = US\$2.40) of 90 per cent of its sterling balances. In a side understanding, confirmed in April 1969, New Zealand undertook to aim for an 80% sterling proportion. The agreement was for three years, with provision for an extension by mutual agreement.⁴²

Australia became the benchmark for New Zealand (as well as Malaysia and Singapore) and during the operation of the agreements these four countries consulted together about their approaches to the UK. However, New Zealand's MSP, based on the status quo at the time of negotiations, was much higher (70%) than those of Australia, Malaysia and Singapore (40% each). This made it among the highest of all countries. It is clear from the archive record that, unlike the Australians, New Zealand policy-makers continued to believe that they could negotiate concessions from British negotiators by evoking the responsibility of the UK to reward New Zealand's loyalty to the sterling area system. On the other hand, they did not have the bargaining power of having large sterling assets compared to other countries like Australia, Malaysia or Singapore. Their strategy of getting MFN treatment with Australia (except for the MSP) might therefore be considered strategically successful, especially as regards the coveted access to the London capital market.

What is even more striking than the conclusion of the 1968 sterling agreements, is that they were renewed in 1971 and again in amended form in 1973, despite the fact that the US\$ had been devalued several times, that Australia and New Zealand had adopted the US\$ as their intervention currency, and that the sterling area had been effectively disbanded in June 1972 when sterling was floated and capital controls were imposed on the OSA. Access to the London capital market to refinance existing debt continued but it did not actually enhance New Zealand's ability to undertake such refinancing, nor was Wellington keen to increase its external debt. On the other hand, because un-refinanced debt was added to sterling assets under the MSP, the inability to refinance these debts reduced the actual amount of sterling required as foreign exchange reserves while retaining the guarantee. The archives suggest that policy-makers continued to find the exchange rate guarantee an important advantage of the sterling agreements, and Britain did make compensation payments under the scheme, after prolonged negotiations. Australia and New Zealand renewed

⁴¹ Reliance on Australian brinkmanship is a recurring theme in New Zealand's postwar economic diplomacy. New Zealand sat on the sidelines in 1947 when Australia threatened to wreck the GATT negotiations in protest against an increase in the US wool tariff. New Zealand also played soft cop to Australia's hard cop in negotiations over the terms of Britain's proposed membership of the EEC. Singleton and Robertson (2002), *Economic Relations Between Britain and Australasia*, pp. 38-9, 166.

⁴² Treaty Series No. 118 (1968), *Exchanges of Notes and Letters Concerning the Guarantee by the U-K and the Maintenance of the Minimum Sterling Proportion by Certain Overseas Sterling Area Governments (The Sterling Area Agreements)*, Cmnd. 3834, November 1968, pp. 67-70; ANZ, AALR 873, Acc. W3158/84, 61/4/2/1, pt 2, Roy Jenkins to Rob Muldoon, 24 Sept 1968; Roy Jenkins to Rob Muldoon, 1 October 1968; Sir Ian Maclennan to Rob Muldoon, 19 November 1968; National Archives, T312/2811, Correspondence in April 1969 between Lang and Sir Frank Figgures of HMT.

the agreements because it cost them so little to do so (from 1971 they were offered unilaterally in return for reporting the MSP each month to the Bank of England) since MSPs were not constraining, and the guarantee clauses provided a periodic dividend.

The sterling agreements changed in character from the British side as well. In 1968 the UK wanted to stem diversification, but from 1971 the agreements were a way to reduce in a controlled way the amount of sterling held in national reserves as part of the UK policy to reduce sterling's reserve role (by reducing MSPs), while maintaining market confidence that there would not be a wholesale liquidation of overseas held official sterling assets. From the UK perspective the agreements were renewed because not to do so would have unsettled market confidence in sterling. But renewal entailed making compensation payments, although these were not that great – £58m after the float in 1972 and £100m in 1973-74. The de facto lower MSP due to the refinancing clauses suited both sides in the case of Australia and New Zealand, but the UK continued to fight to have higher MSPs for Singapore and Malaysia whose sterling reserves were larger in terms of value. So the capital market allowances provided for greater de facto diversification for Australia and New Zealand while not setting a precedent for the larger reluctant sterling holders such as Malaysia, Singapore and Hong Kong.

Anthony Barber, the Chancellor of the Exchequer, proposed a two-year extension without modification to the MSP and associated guarantee in March 1971.⁴³ The New Zealand Treasury was sympathetic to this offer. While an MSP of 70% could be rather awkward in view of the continuing decline in official sterling and US\$ liabilities relative to liabilities in other currencies, especially the DM (which reflected the high cost of borrowing in the UK and improved borrowing opportunities elsewhere), there was considerable flexibility in the MSP mechanism.

In view of these understandings [on the application of the MSP], and having regard to the limited period of extension, and to other general considerations in our relationship with the United Kingdom Government [for example the need for British goodwill on European trade issues], it is suggested that the proposal should be agreed to. It is not considered practicable to seek a reduction in our minimum sterling proportion to a lower figure than 70 per cent at this stage. In the event of any further renewal or extension of the Agreement beyond September 1973, a figure of 70 per cent could be unsatisfactory because of increased liabilities in currencies other than sterling.⁴⁴

In the end, the British unilaterally reduced the MSP for everyone by 10%, so that New Zealand's MSP was 63% from September 1971.

After sterling came under renewed pressure, in June 1972, the British announced a 'temporary' float and introduced restrictions on capital transactions with the OSA. The implications of these measures for the MSP agreements would have to be discussed with OSA countries. The British also took this opportunity to raise the matter of the future of the sterling agreements after 1973. London hoped that OSA countries would agree to a revised MSP agreement and guarantee, to run from

⁴³ ANZ, AALR 873, Acc. W3158/84, 61/4/2/1, pt 3, Chancellor of Exchequer to NZ Minister of Finance, 4 March 1971.

⁴⁴ ANZ, AALR 873, Acc. W3158/84, 61/4/2/1, pt 3, Memo from Sec Tsy for Minister of Finance: Sterling Guarantee, 26 March 1971.

September 1973 (or earlier) to 1975, with the possibility of further extension, but with the guarantee limited to the amount of sterling held on 30 June 1972.⁴⁵ (Thus if OSA countries accumulated more sterling it would not be covered by any guarantee.)

Although the New Zealand authorities did not regard the future of the MSP agreements as a matter of urgency, the British were insistent on discussions. Before these talks could take place, however, New Zealand officials consulted with their Australian, Singaporean and Malaysian counterparts at a weekend session in Canberra. There was some uncertainty over how the compensation procedures for any decline in the value of sterling below US\$2.40 would work while the pound continued to float. Australia and New Zealand were in principle in favour of a new agreement in 1973 in order to protect the value of their sterling balances. However Singapore and Malaysia were sceptical. They wanted the current agreement amended to include compensation if sterling fell below US\$2.60. Considerable support emerged for linking the guarantee to the sterling/SDR rate rather than the sterling/US\$ rate, and for making compensation payable in US\$, gold or SDRs. The future of the sterling balances once Britain joined the EEC exercised the Australians. Overall, 'The basic line of thought [at Canberra]... was to seek to obtain the highest possible amount to be covered by the guarantee with the lowest MSP.'⁴⁶

For New Zealand, as Bernie Galvin [Treasury] explained, there was a special difficulty:

If the British idea that the maximum amount guaranteed should be the lesser of the amount of sterling held at the 30th June 1972 and the amount of sterling held as at the date of the signing of the agreement is accepted, the seasonality of New Zealand's balance of payments might reduce the maximum quite severely if the agreement was signed towards the end of the year.⁴⁷

When British negotiators visited Wellington at the end of July 1972 they wanted to finalise a new agreement as soon as possible. Continued uncertainty about the future of the international monetary system and the effects of Britain's membership of the EEC could be unsettling for sterling. A new MSP agreement, they said, would help to ensure stability for a couple of years. New Zealand expressed agreement in principle, but there were several sticking points. The British rejected New Zealand's suggestion that the guarantee should be set in relation to the sterling/SDR rate or sterling's rate vis-à-vis a currency basket, but they were prepared to consider an alternative to US\$2.40. New Zealand officials regarded the British proposals for limiting the amount of sterling holdings covered by the guarantee as 'just not acceptable'. The British were adamant on the principle of an absolute limit, but indicated that they might be prepared to agree on a level that would satisfy New Zealand. With respect to the MSP itself, the British said that, for presentational reasons, they would much prefer to continue with the current fiddles than to make a

⁴⁵ ANZ, AALR 873, Acc. W3158/84, 61/4/2/1, pt 3, Chancellor of Exch to Muldoon, undated June 1972.

⁴⁶ ANZ, AALR 873, Acc. W3158/84, 61/4/2/1, pt 3, Memo from Sec Tsy to Minister of Finance: Canberra meeting of officials from Australia, Malaysia, Singapore and New Zealand on 14 July 1972, dated 21 July 1972.

⁴⁷ But 'Other delegates were not greatly concerned about this...' RBNZ Archives, Box A0068, File 53, Report of visit by R.W.R. White to Australia, Malaysia and Indonesia 13th – 22nd July, 1972, 27 July 1972.

formal reduction in the MSP. New Zealand was assured that, despite the introduction of exchange controls against the OSA, the area continued to receive favourable treatment.⁴⁸

The Minister of Finance, Rob Muldoon, informed the British that New Zealand would be prepared to countenance an extension until 1975 'if sufficient other sterling holders are also willing to agree to an extension to make the exercise worthwhile.' But he did not like the detailed British proposals, and pointed out that, if the amount of sterling guaranteed was unreasonably low, 'it would not be in our interest to use sterling as an active reserve currency, instead we would merely hold in sterling the guaranteed amount.' He also noted that the 'course of events since last December [devaluation of the US\$] casts doubt upon the value of the guarantee being expressed in terms of the U.S. dollar. Instead we would prefer that the guarantee should be expressed in terms of the SDR.'⁴⁹ Since most OSA countries were reluctant to accept the British proposals, the matter was allowed to drop until the following year. As one British official put it, 'the biggest obstacle to an extended Agreement had been a marked apathy' in the OSA.⁵⁰ Another obstacle, as was explained by those present at a meeting of Sterling Area central bankers in London, was the uncertainty caused by the pound's float.⁵¹

Sterling floated down against the US\$ and, in November 1972, New Zealand became eligible for compensation (in sterling) under the MSP agreement when the pound fell below the threshold for more than 30 days. After ongoing negotiations, New Zealand was paid £3.7m for this episode (payment only arriving in March and May 1973).⁵² They received a further £6.937m after the threshold was breached again between September 1973 and March 1974.⁵³

New Zealand shared in the frustrations of other sterling holders. Visiting the BIS in January 1973, Ray White, the Deputy Governor of the RBNZ, found BIS officials 'very pessimistic about the future of sterling because of the internal economic situation of the United Kingdom. Mr Daltry [a BIS economist] said quite bluntly that we should move out of sterling to the maximum extent possible.'⁵⁴ There was also some annoyance in the OSA about the tardiness of the Bank of England in paying compensation due under the MSP agreement.⁵⁵ On a visit to London in February 1973, Governor Low found British morale at a low ebb:

⁴⁸ ANZ, AALR 873, Acc. W3158/84, 61/4/2/1, pt 3, Notes on meetings on Sterling Area Agreements held in Treasury on July 27th and 28th 1972; RBNZ Archives, Box A0068, Memo for Directors: Sterling Reserves Agreement, 8 Aug 1972.

⁴⁹ ANZ, AALR 873, Acc. W3158/84, 61/4/2/1, pt 3, Muldoon to Chancellor, 15 August 1972.

⁵⁰ ANZ, AALR 873, Acc. W3158/84, 61/4/2/1, pt 3, Notes on meeting on Sterling Area held in Mr H.G. Lang's room on Monday 19 February [1973].

⁵¹ RBNZ Archives, Box A0068, File 53, Report on the Deputy Governor's Visit Overseas from 7th September to 6th October, 1972, Ray White.

⁵² 28/9/73 Chancellor's brief for meeting with Joseph [Bill?] Rowling, NZ minister of overseas trade, National Archives London, T358/19.

⁵³ Brief for meeting of Henry Lang, Sec of NZ Tsy with Mr Wass 11 October 1974. National Archives, London, T258/19.

⁵⁴ RBNZ Archives, Box A0068, File 53, Report on the Deputy Governor's Visit Overseas from 7th September to 6th October, 1972, Ray White.

⁵⁵ ANZ, AALR 873, Acc. W3158/84, 61/4/2/1 pt 4, Minimum Sterling Proportion (Report on Discussion with the Bank of England on 30th January, 1973) Low (RBNZ).

It was very clear that the United Kingdom officials were thoroughly fed up with the whole business of sorting out the compensation and would be very happy to get rid of the whole scheme. It had been politically difficult and embarrassingly complex. ... There is widespread disenchantment on all sides with the whole arrangement, with a desire for greater freedom of action.⁵⁶

In July 1973 the British returned to the theme of the sterling agreements. Barber invited OSA governments to suggest what arrangement, if any, should succeed the existing MSP agreement when it expired in September. New Zealand officials were firmly of the view that any further arrangement should be for a lower MSP and include a guarantee in SDRs.⁵⁷ Finance Minister Rowling's response to Barber was lukewarm. He said that New Zealand's reservations about the MSP had strengthened over the past year, and knocked the ball back into the British court by asking them for ideas.⁵⁸

The UK made a formal offer to OSA countries in September 1973, basically to extend the existing agreement with minor modifications for six months. It was a unilateral 'take it or leave it' offer to which no response was required. New Zealand officials warned against rejecting this arrangement. Not only would rejection be at odds with the government's previously expressed desire for cooperation, but it could be costly. Rejection would have to be 'accompanied by a prompt shift of reserves out of sterling so as to precede any similar movement by other countries.' As New Zealand had a large share of its sterling reserves in medium to long term securities, the authorities would incur substantial losses on their sale.⁵⁹ Most countries were prepared to go along with the latest British initiative as an interim measure.⁶⁰ New Zealand expressed no objection. The level of sterling balances to be covered by the US\$ guarantee would be the lower of the amount held on 24 September 1973 and 29 March 1974, and compensation would be paid if the average sterling/US\$ exchange rate fell below US\$2.4213.⁶¹

New Zealand officials continued to work closely with their Australian counterparts. The RBA was interested in developing a new guarantee mechanism on a permanent basis.⁶² Senior RBNZ officials were in two minds over what should be done when the sterling agreement lapsed in March 1974. Ray White hoped for some sort of new agreement because it was not in New Zealand's interest for sterling to collapse, and because New Zealand was locked into sterling by a high (13%) bank rate. But Dick Wilks did not find these arguments persuasive: 'I am inclined to be

⁵⁶ ANZ, AALR 873, Acc. W3158/84, 61/4/2/1 pt 4, Minimum Sterling Proportion (Report on Discussion with the Bank of England on 30th January, 1973) Low (RBNZ).

⁵⁷ ANZ, AALR 873, Acc. W3158/84, 61/4/2/1 pt 4, Dep Sec Tsy to Minister of Finance: Sterling Agreements, 10 Aug 1973.

⁵⁸ ANZ, AALR 873, Acc. W3158/84, 61/4/2/1 pt 4, W.E. Rowling (Minister of Finance) to Barber, 9 Aug 1973.

⁵⁹ ANZ, AALR 873, Acc. W3158/84, 61/4/2/1 pt 4, Notes for brief: Sterling Reserves Agreement, undated [Sept 1973].

⁶⁰ RBNZ Archives, Box A0068, File 57, Memo for the Directors: Sterling reserves agreement [10 Oct 1973].

⁶¹ RBNZ, Box A0068, File 57, Memo for the Directors: Sterling reserves agreement, 10 October 1973.

⁶² RBNZ Archives, Box A0088, File note: Sterling guarantee, 8 Oct 1973 (by Wilks).

more bloody minded... We have helped to prop up sterling for 5½ years. Isn't it about time they [the British?] and we faced facts?'⁶³ New Zealand needed more 'freedom of action'. If the MSP system came to an end, it would be in the interests of others (including the UK) to prop up sterling, whatever New Zealand chose to do, he concluded.

The early months of 1974 brought a new round of negotiations. The British, still worried about their financial imbalances, hoped to persuade the remaining significant OSA countries, including Australia and New Zealand, to consent to gentlemen's agreements, limiting the speed at which they could run down their sterling balances and diversify their reserve holdings over the following two or three years. They offered no further guarantee of the foreign currency value of remaining sterling holdings. The British message was simple. All parties stood to lose from a sterling crisis. New Zealand did not reject the British proposals. Rowling saw that a deal could offer some advantages. His approach was to wait and see whether the British could reach a settlement with the Australians before committing New Zealand one way or the other. He hoped (in vain) that Australia or Hong Kong would force the British to come up with a guarantee in SDRs or a basket.⁶⁴ In the event Australia rejected the notion of a gentlemen's agreement. The British now offered to continue the existing agreement for a further nine months. This was in the event 'warmly welcomed' by New Zealand.⁶⁵ The MSP was reduced to 56%, while compensation was based on any depreciation of sterling against a currency basket rather than the US\$.⁶⁶ No agreement was reached on further extensions.

The basis on which New Zealand's external reserves policy was run by 1974 was set out in an undated Treasury memorandum. New Zealand required sufficient liquidity for transactions purposes in different locations. But the choice of locations for reserve holdings was limited. (It would be difficult, for example, to 'lodge' reserves in Australia.) The authorities also had to bear in mind that international monetary reform could lead to new constraints or requirements. Current policy was to hold 65% of reserves in sterling, 20% in the US\$, and 15% in other currencies.

In broad terms, our objectives should be to lower the proportion of our reserves held in sterling and to acquire greater freedom of choice in their management, subject to the requirements of international monetary reform.⁶⁷

After the first few months in 1968-69, when there were teething problems, New Zealand experienced few difficulties in complying with the terms of their MSP. In other words, the MSP agreement did not seriously constrain New Zealand's

⁶³ RBNZ Archives, Box A0088, Memo for the Governor: M.S.P, 15 Nov 1973 (from Dick Wilks).

⁶⁴ ANZ, AALR 873, Acc. W3158/83, 61/4/1, Notes of meeting held in the British Embassy, Rome, on Wednesday, 16 January 1974 to discuss the form of future arrangements after the expiry on 31 March 1974 of the Sterling Reserves Agreement; Note for File: By N.V. Lough for Governor RBNZ, 30 Jan 1974; ANZ, AALR 873, Acc. W3158/84, 61/4/2/1 pt 4, Note on Sterling Reserves Agreement, undated 1974.

⁶⁵ Brief for meeting of Henry Lang, Sec of NZ Tsy with Mr Wass 11 October 1974. National Archives, London, T358/19.

⁶⁶ RBNZ (1974), *Annual Report 1973/74*, p. 23.

⁶⁷ ANZ, AALR 873, Acc. W3158/84, 61/4/2/1 pt 4, Note on Sterling Reserves Agreement, undated 1974.

freedom for manoeuvre with respect to the denomination of foreign currency reserves. (Another interpretation might be that New Zealand was serious about playing the sterling game and made sure that its compliance was not in doubt.) Abandoning the MSP (and guarantee) and building up US\$ reserves might not have been the optimal strategy in the wake of the adoption of the US\$ as New Zealand's anchor currency in 1971. Not only would it have been costly to extricate New Zealand from its sterling portfolio, but the US\$ was no more attractive than sterling at the time. Moreover, as it turned out the US\$ peg was in the event an interim position pending the introduction of the basket. After the basket came into being and the MSP agreement was wound down, there was a large relative shift from sterling to US\$ and DM assets. Although the weightings in New Zealand's reserves portfolio did not match those in the basket, both the reserves and exchange rate strategies were now based on the principle of diversification.

Conclusion

The advantages of playing the 'sterling game' were diminishing for New Zealand by the mid-1960s even before the devaluation of 1967, but it was not in New Zealand's interests to abandon this game altogether. Neither the US\$ nor the A\$ were entirely satisfactory alternative anchor currencies. Similarly, while New Zealand was interested in diversifying its holdings of foreign reserves, there was no obviously superior alternative to sterling. Confidence in the US\$ was almost as weak as in the pound in the late 1960s, and the attractions of the US\$ were further undermined when the link to gold was abandoned in March 1968. New Zealand, moreover, was persuaded by the British in 1968 to continue to hold the bulk of its reserves in sterling, in return for a guarantee of the US\$ value of 90% of sterling holdings. Wellington chose to cooperate with the British for a variety of reasons: it was unsure what else to do; Britain's goodwill was required on other matters including trade policy; a flight from sterling reserves could have been costly; and there was the possibility - however dim - that the dollar guarantee would evolve into a guarantee in terms of SDRs or a package of currencies. New Zealand invariably kept a close watch on the policies of Australia, its big sister and main competitor, and sought to take advantage of arrangements negotiated by the Australians. In the end, the appreciation of sterling assets in terms of the US\$ under the Smithsonian Agreement coincided with the accumulation of reserves in the early 1970s, and the share of sterling in New Zealand's reserves increased rather than decreased at the same time as the peg to sterling was abandoned.

The need for greater discretion in managing the exchange rate was acknowledged by the New Zealand authorities in July 1973, when they decided to peg the NZ\$ to a basket of currencies rather than either sterling, the US\$ or the Australian dollar exclusively, in order to better manage domestic inflationary pressures and minimise the impact of exchange rate fluctuations on producers. Sterling's initial weighting in this basket was equal to that of the US\$ and A\$ combined despite the rapid decline of trade with the UK and a deliberate policy of diversifying trade away from the UK.

New Zealand's experience is illustrative of the dilemmas facing a small, export-dependent country when choosing a new exchange rate regime and foreign reserves strategy. In the early 1970s New Zealand was able to orchestrate a benign exit strategy from Bretton Woods because of the coincidence of strong demand for

exports, pressures for appreciation rather than depreciation, and rising reserves.⁶⁸ Since the US\$ peg was in practice a transitional rather than a permanent solution to the exchange rate question, the fact that New Zealand did not change its reserves strategy in 1971-72 was not necessarily a disadvantage. That a wait and see approach to the holding of reserves was encouraged by the MSP agreements was not harmful. As in the early 1990s, the RBNZ came up with an innovative solution to external and internal economic pressures, but with the onset of the first oil crisis and the downturn in non-oil commodity prices in the mid-1970s, these issues needed looking at afresh by Wellington. But that is another story.

⁶⁸ For optimal exit strategies by developing countries see, Eichengreen et al, *Exit Strategies: Policy Options for Countries Seeking Greater Exchange Rate Flexibility*, IMF Occasional Paper 168, 1998.