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PAKISTAN AND THE STERLING AREA

by

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P R E F A C E

There have been many books written on the subject of the sterling area, but none so far, to the knowledge of the writer, that covers comprehensively the economic relations of Pakistan with the sterling area. It is, therefore, the hope of the writer that this study, modest as it is, might lead to a more comprehensive work on the subject.

The writer here wishes to express his debt of gratitude to Dr. Salim Hoss, under whose careful guidance the study of the present work was conducted, for his help, patience, and encouragement. The writer however, accepts ungrudgingly responsibility for all the shortcomings of the paper.

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ABSTRACT

The sterling area is a loose association of sterling using countries: These countries linked their currencies to the sterling for several reasons; many of them were mere colonies as the sterling area took shape and as such had little choice; others found it more convenient for reasons of trade.

As a development of the British Colonial policy, Pakistan's economy complements that of Britain to a large extent. Jute has been an important dollar earner during the periods of dollar scarcity. Pakistan's developing economy, moreover, provides ready market for British export of machinery and equipment.

On the other hand Pakistan also derives important advantages from her membership of the sterling area. These advantages are owing to her links with the sterling area as a currency union and also owing to other unique characteristics of the sterling area. The sterling area as a currency union provides stability to the economy of Pakistan, facilitates her trade and payments, helps maintain confidence in the solvency of the country and last but not the least provides banking facilities centred in London. The sterling area, however, is much more than a mere currency union. The relatively free trade within its boundaries, the traditional flow of capital funds specially from the United Kingdom to the rest of the sterling area, and the economies in the need for international liquidity are some of the economic reasons that keep Pakistan in the sterling area.

Sterling is an important trade currency which is used to finance a large percentage of world trade. The sterling area, however, has been greatly weakened since the war. The easing of the world dollar shortage has eliminated one

important source of post-war cohesion of the sterling area. The swelling of the British short term liabilities mainly in the form of sterling balances, unmatched by a proportionate increase in British gold and foreign exchange reserves, culminated in the waning of international confidence that was once reposed in sterling as a reserve currency. The British monetary management had to grapple with the frequent problem of the flight of short term funds.

The balance of payments of the United Kingdom has been in no better condition. The supply of capital funds to the sterling area, therefore, has neither been adequate nor consistent. In brief a future development of an international monetary system around sterling is highly unlikely.

The proposed entry of the United Kingdom into the European Common Market would call for some adjustment on the part of Pakistan, though the future entry of the United Kingdom in the European Common Market is not likely to change Pakistan's trading patterns fundamentally. Pakistan's need for capital investments might, indeed, be better served by Britain eventually going into the common markets.

Since the non-devaluation decision regarding Pak rupee in 1949, Pakistan has increasingly asserted and exercised her economic independence to safeguard her financial integrity. Pakistan, then, is expected to continue to be associated in the sterling area.

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CHAPTER I

THE STERLING AREA SYSTEM

The sterling area can be described as a monetary union between the United Kingdom and certain other countries that make use of the pound sterling as a means of payment and as a unit of account. Officially the sterling area is used in reference to the group of countries, who under the British exchange control regulations are considered as members of the area¹.

The sterling system refers to a complex of rules and regulations imposed by the United Kingdom, the sterling area countries, and others on the use of sterling as a medium of payments². The sterling area in world finance, therefore, has two meanings: It refers to the payments mechanism whereby international transactions among a certain group of countries, and as between that group of countries and the rest of the world, are settled through London. It also refers to the specially close relations between the sterling area countries, cemented by history and tested by wars and crises that generally facilitate a co-ordinated approach to the solution of the problems of balance of payments between the sterling area and the rest of the world.

(1) Judd Polk, Sterling: its meaning in World Finance, (New York: Herper and Brothers; 1956), p. 30.

(2) The distinction between the sterling area and the sterling system is not strictly observed.

Sterling is the official name given to the British pound and the sterling area is so-called because the currencies of the member countries are bound to sterling by very close economic ties. Many of the member countries, more specifically the British Colonies, maintain a high portion of their currency reserves in the form of sterling assets. Furthermore, as sterling has grown to be widely accepted in the settlement of international claims, members, as well as many non-member European countries, traditionally keep some minimum of their working balances in London to facilitate their international trades. The balances are placed under the management of the Bank of England and in effect afford the sterling area countries a limited line of credit for the temporary payments imbalances among one another.

Most of the gold and dollar receipts of the member countries are added to the central reserves in London, which are then used to meet all current payments of the member countries. The Bank of England is charged, on behalf of the sterling area, with the function of the management of such reserves. Though the bulk of receipts are still placed in the central reserves, lately, members have also built up their own gold and convertible currency reserves independent of the sterling area.

A. EVOLUTION OF THE STERLING AREA SYSTEM

A monetary event of great importance occurred in 1931, when Britain went off the gold standard. Countries having important trade relations with Great Britain were, as a result, left with three choices; to keep to the gold standard or link their currencies to the U.S. dollar which was linked

to gold; to keep independent of any foreign currencies; or follow Britain and leave the gold standard. The countries of the sterling area, like many others preferred the last and maintained their close economic links with sterling. The sterling bloc was comprised of Norway, Sweden, Denmark, Iran, Ireland and Japan besides the countries of the British Commonwealth. They were later joined by Argentina, Uruguay, Yugoslavia and Greece³.

The threat of war in 1939 prompted the flight of capital in significant amounts from the United Kingdom to the United States of America in search for a safe haven. Many of the countries, hitherto considered members of the - as yet loose - sterling area partnership, discontinued the policy of linking their currencies to the sterling. A wall of monetary control had be drawn up between the sterling area and the rest of the world. The exchange rate between the dollar and the sterling was fixed by the British monetary authorities. Great Britain started pooling dollar and hard currency reserves of the sterling area countries to reserve them for war efforts and undertook to release funds needed for any expenditures sanctioned by authorities in the overseas sterling area.

The major sources of the dollar earnings were tin and rubber exports from Malaya, jute and tea from Indo-Pak sub-continent and the spending of the American forces in the sterling area countries. Britain also financed her war efforts by running 'charge accounts' and financing her purchases in the sterling area countries by the simple method of crediting to the sterling balances of the overseas members in London, the proceeds of such payments.

(3) Economic Co-operation Administration, The Sterling Area: An American Analysis (London: 1951), p. 26.

"During the war a close-knit sterling area became an instrument of economic strategy. A clear frontier was put around the sterling area through its definition under the United Kingdom statute. The frontiers did not co-incide with the Commonwealth, because Canada was excluded and some other countries included, but the war-time operation of the sterling area was in effect carried on by Britain with the Consent and Co-operation of the other member of the Commonwealth"⁴.

The control exercised by the United Kingdom over the management and the use of the central reserves and, therefore, on the monetary policies of the overseas sterling area, was always considered transitory both by the United Kingdom and the other members of the sterling area. Similarly, the dollar discrimination and the inconvertibility of pound sterling were viewed as temporary measures meant to tide over the difficulties of the time. The sterling area, therefore, did not mean an inward looking, discriminatory economic bloc as was suggested at the time in certain quarters.

A monetary mechanism with fool-proof working arrangements would have been hardly possible but for the traditional close co-operation between the sterling area countries and for the world wide acceptability of sterling as an international medium of payments. The very efficient British banking system and the large amount of reserves kept by Britain's trading partners in London made sterling instead of gold the most important international monetary standard.

The great surge of demand for goods after the war and the termination of lend-lease agreements with the United States raised balance of payments problems for the United Kingdom. Trade and payments arrangements, therefore,

(4) Patrick Gordon Walker, The Commonwealth (London: Sacker and Warburg; 1961), p. 259.

had to be continued. As the general demand for the U.S. dollars was far in excess of available dollar and convertible currency reserves, the working of the sterling system became more difficult and necessitated tighter exchange controls over payments of the sterling area to the rest of the world and specially payments to the dollar area.

The large accumulations of sterling balances with the overseas sterling area was another problem facing the United Kingdom. These balances had grown by £3000 million between 1938-45 and the only way these balances could be brought down was through exports of British goods and services to these countries. Britain's trade and industry was greatly handicapped by war dislocation, obsolete machinery and generally higher level of costs; The potential threat of the withdrawel of the sterling balances by the members was temporarily warded off with their immobilization and transfer to a blocked account established with the Bank of England. The Commonwealth ministerial conference in 1949 further agreed to cut all dollar expenditures of the member countries by 25% in order to meet the problem of world wide dollar shortage.

* In the post-war period sterling area countries continued their association in the area, despite a battered United Kingdom trade because they believed that their sterling balances could only be utilized when the health of the sterling area had been restored. Sterling, moreover, was still the most widely circulated currency and the payments of deficits was made simpler by acceptance of sterling, in limited amounts, by European Payments Union, in the settlement of international claims. The relatively free flow of Capital movements from the United Kingdom to members of the overseas sterling area, specially the newly independent developing countries was highly beneficial to these countries. The members also realized that

they would have to build larger reserves in case they broke with the sterling. "Indeed if each member had possessed its own independent currency, several of them might well have been involved in the difficulties of the kind experienced by a number of Latin American Countries, entangled in a web of bilateral payments agreements"⁵. The membership of the sterling area also enhanced the financial status of each country in the sphere of international finance.

"The most far reaching consequence of the evolution of the sterling area containing a number of economically mature nations was the rise of independent and parallel banking systems. Commercial banks in other parts of the Commonwealth to a considerable extent displaced the branch system of the London banks, which had before the war handled the financial business of the sterling area. Even more significant was the setting up of the central banks, which increasingly came under government direction. Thereby the other members acquired the means of conducting the finances of their countries according to their own calculations of their national interests"⁶.

The economic independence thus achieved was used, not infrequently, to further national economic ends. Ceylon in 1949 used the occasion of devaluation to break the formal link of her currency not only with the pound but also with the Indian rupee. Pakistan, likewise, refused to fall in line with Britain and the rest of the sterling area and maintained its exchange parity with the dollar and gold. Member countries built up their own reserves. - Australia started building independent gold reserves - Ceylon insisted on keeping

(5) The Economist Intelligence Unit, The Commonwealth and Europe (London: Tonbridge: the white friars Press; 1960), p. 27.

(6) Patrick Gordon Walker, The Commonwealth, p. 267.

first one million dollars of her hard currency earnings, and the Bank of England remarked another 4 million dollars for the purchase of independent gold reserves. By 1959 sterling area reserves held outside London amounted to \$950 million.

This, however, had the welcome effect of relieving some strains on the central reserves as the members could now borrow outside the sterling area. Members, specifically Australia and Newzealand, made contributions to International Monetary Fund from their independently held reserves. By 1950 the problem of sterling balances was greatly eased. In 1951 the sterling was made convertible for current transactions with all but the dollar area countries. In 1954 discriminatory accounts⁷ were eliminated altogether throughout the non-dollar world. South Africa abolished all dollar discrimination.- Pakistan followed. Sterling 'leaks' had made sterling fully convertible before Dec. 1958, when full convertibility for non-residents of the sterling area was formally introduced.

Another post-war arrangement in the sterling area has been the development of regional payments system within the different parts of the sterling area world. Indo-Pak trade and payments agreement provides for the settlement of inter-country claims in rupees to a limited extent, with their final settlement, of course, in London.

The dilution of exchange restrictions and the development of freer trade and payments should not reduce the importance of the sterling area. Sterling still is the most important trading currency of the world and the area still provides a complementary economy which can be geared to meet any needs that might arise in the future.

(7) For a full discussion on discriminatory accounts see page 18.

B. WORKING OF THE SYSTEM

The working of the system of payments was simple in the days of the gold standard. When Britain left the gold standard in 1931, she continued to settle her international claims and obligations in gold with the non-sterling area, and was willing to convert all sterling held by non-residents into gold. Many changes were introduced in the sterling area system during and after the war. Sterling was made inconvertible, and the payments between the sterling area and the rest of the world were regulated through closely co-ordinated exchange control system of the United Kingdom and the overseas sterling area. The administration of the dollar pool and even the flow of Capital from the United Kingdom to the rest of the sterling area came to be regulated under British statutory provision.

The working of the sterling area system may be described with reference to such aspects as the administration of reserves; the problem of post-war sterling balances; the question of the rates of exchange as between the sterling area countries and the rest of the world as well as within the sterling area; the convertibility of sterling and the administration of the dollar pool as well as the capital movements within the sterling area and specially from the United Kingdom to the rest of the sterling area.

MANAGEMENT OF RESERVES:

Within the sterling area the pound sterling is the basic currency. All members, therefore, have to keep adequate supply of sterling securities in London. In the process, when overseas sterling area is accumulating

sterling balances, her demand for treasury bills - the form in which sterling balances are kept - would compete with the normal demand for these bills by the commercial banks in the United Kingdom and would leave a deflationary effect causing restriction of credit in the British economy⁸. In 1931, as the system evolved, sterling area countries had to build up reserves. There was a general increase in the sterling reserves from £151 million in 1929 to £254 million in 1937. The United Kingdom liabilities (mainly sterling) rose from £411 million in December 1931 to £808 million in December 1937⁹.

The consequences of such accumulations are contractionary for international trade, at least when the reserves are in the process of being built, because of the substitution effect whereby currently earned sterling would be utilized for reserves rather than for imports of goods and services. From another point of view it may be argued that the 'currently earned' sterling was itself the result of trade.

"Sterling is both a trading currency used by a large number of countries and a reserve currency used by the member countries of the sterling area. Although other members hold some reserves in gold and other currencies amounting to some £400 millions, those non-sterling reserves vary little and the main fluctuations are in their sterling reserves. These reserves are held in the United Kingdom in the form of sterling balances, the

(8) F. V. Myers, Britain, the sterling area, and Europe (Cambridge: Bows and Bows; 1952), p. 40.

(9) ibid., p. 36.

X United Kingdom holding the central reserves and acting as banker for the area"10.

Transactions between the overseas sterling area and the United Kingdom result either in accumulation or reduction of the total sterling balances. Transactions with non-sterling area, however, involve the receipts or payments of foreign exchange, which then is purchased or sold to the Exchange Equalisation Account, in exchange for treasury bills. The money supply in Britain, therefore, is not affected because the sum total of the foreign exchange and treasury bills components of the monetary reserves of the sterling area remain the same.

Trading within the sterling area does not affect central gold and convertible currency reserves of the area and members can freely draw on their sterling balances, subject only to what they themselves might regard as their minimum working balances. These withdrawals do not affect the total sterling balances either (unless these are in connection with trade between the United Kingdom and the overseas sterling area) since settlements would simply amount to accounting debits and credits.

The difference in the balance of payments between the sterling area and the rest of the world has to be settled in gold, dollar or other convertible currencies. During 1953-1956, the United Kingdom incurred an overall deficit with the non-sterling area, while overseas sterling area enjoyed large surpluses with the rest of the world.

(10) Great Britain, Committee on the working of Monetary System: Report (London: Her Majesty's stationary Office; 1959), p. 237.

TABLE I
BALANCE OF PAYMENTS

1953-56								
United Kingdom	:R.S.A.:	N.S.A.:	Total:	Rest of the Sterling Area	:U.K.:	N.S.A.:	Total:	
	:	:	:	:	:	:	:	:
	:	:	:	:	:	:	:	:
Identified Current Account	: 960:	-375 :	585 :	Identified Current Account	:-960:	765 :	-195 :	
Identified long term Capital	:-680:	-155 :	-835 :	Identified long term Capital	680:	*	+680 :	
	:	:	:	(net inflow)	:	:	:	
	:	:	:		:	:	:	
Total	: 280:	-530 :	-250 :	Total	:-280:	+765 :	+485 :	
Unidentified receipts	:	:	:	Unidentified payments	:	:	-130 :	
	:	:	:		:	:	:	
	:	:	:		:	:	:	
	:	:	-150:		:	:	+355 :	
	:	:	:		:	:	:	

Source: A.R. Conan, Rationale of the Sterling Area (London: Macmillan and Co. Ltd.), p. 44.

During 1953-56, while the United Kingdom incurred a deficit of £530 million with non-sterling area countries, the surplus of £765 million realized by the rest of the sterling area more than off-set the deficit.

In case the sterling area also runs into balance of payments difficulties with the non-sterling world, the picture would be entirely different. The Exchange Equalization Account would be called upon to sell gold or other convertible currencies to the overseas members of the sterling area to make settlements with the rest of the world.

TABLE II
STERLING AREA TRANSACTIONS
WITH NON-STERLING WORLD

YEAR	U.K. CURRENT BALANCE	R.S.A CURRENT BALANCE	TOTAL	R.S.A GOLD OUTPUT	R.S.A CAPITAL INFLOW
1950	14	247	261	179	121
1951	-739	-11	-750	178	176
1952	-121	-146	-267	183	257
1953	27	68	95	185	151
1954	-56	-116	-172	203	152
1955	-278	-169	-456	217	136
1956	-64	-217	-281	233	157
1957	-131	-410	-541	249	141
1958	-89	-561	-650	257	374
1959	-84	-224	-308	287	315

* Excluding gold, but including grants

Source: CMND 1188 re A.R. Conan, The Rationale of the Sterling Area,
(London: Macmillan and Co. Ltd.), p. 3.

Lately, the pattern of trade of the overseas sterling area has undergone a change. If the sale of gold and the capital movements are excluded, the overseas sterling area no longer has a surplus on trade account with the non-sterling area. The balance of payments of the overseas sterling area was in deficit with non-sterling countries by £224 million in 1959 as against a surplus of £247 million in 1950. The sterling area, therefore, can no more rely on the traditional support from the overseas sterling area to her overall balance of payments. In 1957, when the sterling went under great pressure, the overseas sterling area actually aggravated the overall payments position by running a deficit with both the non-sterling countries and the United Kingdom. This has been mainly due to the development efforts undertaken by independent sterling area countries as well as continuously declining terms of trade.

Gold and dollar reserves of Britain also constitute the reserves of other sterling area members. Though over the years most of the independent members of the sterling area have built up their own independent reserves, the right to draw on the central reserves is implicit. An unfavourable balance of payments of the overseas sterling area has direct repercussions on the central reserves, because the sterling balances and therefore the central reserves are liable to be used first. The Radcliffe Committee¹¹, therefore, recommended the developments of a respectable ratio¹² between the sterling reserves and liabilities.

(11) The Committee on the working of the Monetary System of Great Britain (1959) is also called 'The Radcliffe Committee' after the name of its Chairman Rt. Hon. The Lord Radcliffe.

(12) Also see page 18.

"The problem is not merely one of increasing the size of the sterling area reserves. In the final analysis it will depend rather on the capacity of the sterling area as a whole to achieve and maintain a sufficiently strong balance of payments position with the rest of the world"¹³. A balance in payments with the non-sterling world, thus far, was maintained mainly through dollar discrimination and the flow of unrequited American imports in the form of grants in aid and medium and long term credits under Marshall aid and other programmes, which are still in existence in one form or another.

The sterling balances held by the non-sterling countries are subject to call at the discretion of the holders of such balances. The sterling area can do little about them except to keep these balances adequately covered. The total reserves of the sterling area, therefore, should be calculated net of the balances held by non-sterling area countries.

The sterling balances are kept in short term securities. The costs of the sterling balances to the United Kingdom are twofold: the interest payable on securities representing these balances; and the reduced exports from the United Kingdom to the rest of the sterling area, as these countries employ the proceeds of their exports in buying sterling securities rather than goods and services, a large part of which traditionally comes from the United Kingdom. The costs of these balances to the overseas sterling area then are reduced imports and thereby reduction of real incomes, specially when stockpiling of sterling balances is accomplished through undervaluation of currencies against sterling to promote a one way traffic of goods and services.

(13) A.R. Conan, The Rationale of the Sterling Area, p. 2.

STERLING BALANCES.

"An important feature of the British monetary system is the volume of sterling (or liquid claims to sterling) held by or for account of overseas holders"¹⁴. This was more than counter balanced prior to the world war II by the British foreign investments abroad. The war effort resulted not only in the liquidation of the British investments abroad, but large balances were also piled up on account of British expenditures in the sterling area, which were financed by the simple method of crediting the account of creditors in London. Britain emerged from the war as a debtor owing large obligations to the rest of the sterling area, specially to undivided India and Egypt. These balances, naturally, could only be paid in British exports of goods and services, for which Britain needed to have a surplus in her balance of payments. The problem was, however, magnified by the swollen demand resulting from long war years and the severely damaged British productive capacity. Britain sought a moratorium by freezing the bulk of these balances in "Account No. 2" with the Bank of England, to be released gradually by agreement between the United Kingdom and the governments concerned.

The Bank of England considers the nature of these balances and classes them "as primary liquid resources held against local currency issues overseas or against future liabilities to be discharged in sterling"¹⁵.

Two points need consideration: The classifications of the sterling balances into primary liquid resources is not justified because of their radically transformed nature. A persistent favourable balance of payments on current account realized by the United Kingdom with the rest of the sterling area should have wiped out all sterling balances. The total sterling

(14) Conan, Op.Cit., p. 64.

(15) ibid., p. 8.

balances at the end of the war stood at £2400 million; while the total United Kingdom surplus (1946-59) amounted to £3500 million. The purchases of gold from the overseas sterling area created new balances. The character of the new balances is, however, quite different since they are equally matched by gold and dollar reserves and, therefore, are quite adequately covered. The balances, moreover, have gravitated towards the overseas sterling area countries and largely towards the British Colonies, who have proved to be more stable holders. (See Table III).

The trend shown in Table III is important. The total holdings of the "non-sterling countries" were reduced from £1170 millions to £732 millions, while that of the "other sterling area countries" were down by £674 million, the two main areas of wide fluctuations. Holdings of the colonies have been rising. This is because the rate of development expenditures has not caught up with their earnings. Moreover, these holdings, infact, reflect most of the British investments in the colonies and could be considered as generally stable. The holdings of the independent members have also been remarkably stable, after their initial downward trend in the early fifties.

The ownership of the central reserves is not clearly established. Traditionally, surpluses of the overseas sterling area have been largely responsible for their build-up. The right of the members to convert their sterling balances into convertible currencies cannot, therefore, be logically limited. The point, however, has only an academic interest, now that the sterling has been made convertible. But in the event of a future trend towards adverse balance of payment, sterling could, conceivably, have to be made

TABLE III
OVERSEAS STERLING HOLDINGS BY AREAS
1945-58

	: :END OF 1945 :	: :END OF 1958 :	: :INCREASE : 1945 to 1958: :	:
OVERSEAS STERLING HOLDINGS	:	:	:	:
STERLING AREA COUNTRIES:	:	:	:	:
United Kingdom Colonies*	: 411	: 1278	: 867	:
Other Sterling Area Countries	: 1986	: 1339	: -647	:
NON-STERLING COUNTRIES:	:	:	:	:
DOLLAR AREA	: 34	: 53	: 19	:
Other Western Hemisphere	: 163	: 24	: -139	:
O.E.E.C. Countries	: 351	: 372	: 21	:
Other non sterling countries	: 621	: 283	: -339	:
② Total non-sterling countries	: 1170	: 732	: -448	:
Total all countries	: 3567	: 3349	: -228	:

* Including Ghana and Federation of Malaya, while became independent members of the Commonwealth during the period and remain in the sterling area.

② The sterling balances of the non-territorial organizations were nil at the end of 1945, and £623 million at the end of 1958.

Source: Great Britain, Committee on the working of the monetary system,

inconvertible again, and it would be interesting to see, what the British position would be, if an important member, with large balances decides to quit the membership of the sterling area.

The Radcliffe Committee emphasized the need for improving the United Kingdom reserves to match its liabilities. This statement should however be qualified with the following:

- i) If we are talking about the sterling area as a whole the sterling balances held within the sterling area should not be included in sterling area liabilities, and only non-sterling area liabilities need be matched.
- ii) The sterling balances themselves have undergone a transformation and the bulk of them are now in the form of working balances, which are fairly stable, and would not need to be matched pound for pound.
- iii) The sterling balances are expressed gross and netting factors like investment and authorized dealers balances, abroad are omitted, which presents an exaggerated picture of sterling area liabilities.
- iv) The important position occupied by Britain, as a trading partner, implies that any serious overseas deficit in payments would be concentrated with Britain, and would not subject central reserves dangerously to pressure.

CONVERTIBILITY & DOLLAR POOL:

The fundamental problems facing the sterling area, and for that matter facing any currency area, is to build adequate foreign exchange reserves to meet any adverse movements in her balance of payments. The foreign exchange reserves of the sterling area in the early post-war period seemed quite inadequate to meet the enormous problems of the dollar shortage.

The demand for consumer goods was dangerously swollen. There was need for modernization and expansion of plants to restore peace-time production. The emerging nations were development hungry. Meanwhile, the costs of

production in Britain were completely out of step with costs in other countries and specially the United States of America owing to inflationary tendencies prevailing in the country. The United States of America was the only country where production could be easily geared to meet world demand. There was, therefore, an immense demand for the U.S. dollars to finance purchases in the American market and there emerged the problem of acute dollar shortage.

Meanwhile, the sterling accumulations were a potential threat to British production. The sterling area chose to solve the problem of dollar scarcity by rationing all available dollar assets of the sterling area and placing them in a central pool. At the commonwealth ministerial conference in Jan. 1952 the members reached what was described as a 'gentlemen's agreement' suggesting measures, including discriminatory purchases, to cut dollar expenditures by 25%. The year 1948 was taken as the base for such plans. For the purposes of convertibility of sterling, Britain divided the world into three main accounts, namely, sterling area (or resident account), Transferable account, and the American account. Within the sterling area payments for trade or for movements of capital remained free, while the non-sterling spending of the area were co-ordinated.

The transferable account applied to all countries outside the sterling and dollar areas which were allowed the facilities of a convertible sterling between these countries and the countries of the sterling area. They were, however, given no access to foreign exchange reserves in London.

TABLE IV
OVERSEAS STERLING HOLDINGS
(END OF PERIOD, £ millions)

YEAR	REST OF STERLING AREA	NON-STERLING COUNTRIES					TOTAL ALL COUNTRIES	NON- TERRITORIAL ORGANIZATIONS
		NORTH AMERICA	LATIN AMERICA	WESTERN EUROPE	OTHER NON-STERLING COUNTRIES			
1955	2764	-	-	-	-	812	3576	469
56	2730	-	-	-	-	692	3422	669
57	2608	41	25	278	321	665	3273	645
58	2519	58	18	408	350	834	3353	623
1959								
March	2574	45	13	345	360	763	3337	538
June	2649	52	14	303	361	730	3379	709
Sept.	2677	54	14	335	363	766	3443	705
Dec.	2704	60	12	387	344	803	3507	705
1960								
March	2670	58	25	408	331	822	3492	688
June	2674	91	41	489	319	940	3614	661
Sept.	2577	133	60	632	341	1166	3743	604
Dec.	2480	303	65	699	340	1407	3887	549
1961								
March	2441	143	48	747	338	1276	3717	553
June	2604	114	35	662	290	1101	3705	552
Sept.	2604	91	22	530	250	890	3497	1090
Dec.								

SOURCE: "ECONOMIST," Dec. 2, 1961, Page 947.

The American account countries had complete access to foreign exchange reserves in London for the conversion of their current earnings. In addition all direct investments and returns on investments made after 1949 could be repatriated¹⁶.

Inconvertibility has value for the sterling area only when the whole area has excess capacity, which can be geared to full use through discriminatory preferences within the area. On the other hand, it can be argued that a convertible currency broadens the markets of the sterling area countries and, therefore, makes it possible to work existing capacity to full use. The enforcement of inconvertibility, moreover, requires a comprehensive exchange control system to prevent excessive evasion of the regulations. In case, however, when a country or a currency union can successfully maintain inconvertibility and discrimination without effective retaliation from the countries discriminated against, the balance of advantage no doubt tilts towards the discriminating countries.

The dollar pool ensured optimum use of the total gold and convertible reserves of the sterling area, and the members thereby could allow themselves greater latitude in trade with the non-sterling countries. From 1946 to 1951, the overseas sterling area remained a net contributor to the pool, while Britain had constant surpluses in her balance of payments with the overseas sterling area, which incidentally, enabled her to re-construct her economy quickly.

(16) Another type of sterling is 'registered sterling' which was obtained by payment in gold, dollar or convertible currency, and then was fully convertible.

The acuteness of the problem of dollar scarcity could be judged from the fact that the total deficit of the world with the United States amounted to \$11.5 billion in 1947, 32 times as large as the average pre-war deficit of \$359 million. Gold and dollar assets transferred to the U.S. in 1946-47 were 6.5 billion, which only covered 1/3 of the total deficit¹⁷.

The sterling area had no problem with the dollar before the war. The United Kingdom traditionally ran a deficit of \$500 million, but this was more than offset by the overseas sterling area trade surplus of \$550 million plus gold export of another \$500 million. The post-war overall situation, however, reflected a deficit of \$4131 million in 1948. The situation improved in 1949-50 and the deficit was reduced to only \$350 million.

The sharp decline in exports and re-exports of the United Kingdom as well as those of the overseas sterling area were largely responsible for the deficits. Terms of trade also moved against the sterling area. Gold exports, though higher by \$100 million over the average of 1934-37 had their purchasing power reduced 50 percent by 1947,¹⁸ while the gap on account of invisibles widened to 5 billion dollars.

These deficits were met by drawings on the International Monetary Fund and through the United States loans and grants. The United States of America, through Marshall Plan provided temporary liquidity aimed at

(17) Economic Co-operation Administration, The Sterling Area, an American Analysis, p. 68.

(18) ibid., p. 68.

enabling Europe to undertake massive re-construction. "Since 1949 the United States has lost gold from its reserve, while the rest of the world has more than doubled its dollar holdings"¹⁹. "Between 1948 and 1958 the rest of the world (excluding the soviet bloc) increased its reserves of gold and dollar from about \$11500 million to about \$26000 million, while the United States reduced its holdings of gold from \$24,400 million to \$20600 million and increased its short term liabilities, official and private, from \$5800 million to \$14600 million. The surplus on the United States balance of payments on current account (excluding gifts and grants, which had been over \$11000 million in 1947, was by 1958 down to \$2500 million. Even more striking is the continued increase in the volume of the United States imports over the past two years, inspite of failure of American production and income to expand"²⁰. Table V shows the means by which the sterling dollar deficit was met.

The sterling area was put to a severe test when, under the Anglo-American Agreement of 1946, Britain undertook on behalf of the sterling area to alter the sterling system to conform to agreements of multilateral payments. Dollar discrimination of the sterling area was to end and the United Kingdom was committed to make foreign earned sterling freely convertible into dollars or any other convertible currency by July 15, 1947. Under the same agreement lend - lease loans of the United States to the United Kingdom were written off and the United States Committed herself to provide a credit of \$3 3/4 billion to cover any additional liquidity needs arising out of convertibility of the pound sterling.

(19) Great Britain, Committee on the working of Monetary System, p. 249

(20) Great Britain, Committee on the working of Monetary System; Report, p. 249.

TABLE V
MEANS OF PAYING OFF DOLLAR DEFICIT

	(Million dollars)		
	1947	1948	1949
1. Transfer of Assets	\$4462	\$780	\$-1496
2. Drawings on IMF & Bank (I.B.R.D.)	672	379	88
3. U.S. Govt. loans	3895	907	360
4. U.S. Govt. grants	1947	4161	4517
5. Others	441	509	490
	11507	6736	3959

Based on: Economic Co-operation Administration, Sterling Area, An American Analysis, p.

Britain, in preparation for the convertibility, widened the scope of the transferable account, allowing the swap of sterling within the account as well as with the sterling area countries. In addition Britain entered into various agreements with the holders of sterling balances to permit their immobilization for the time being. Within six weeks Britain was off the convertible pound again after incurring heavy losses of funds in the costly experiment. "The effects of the six weeks faced the whole sterling area with a terrible problem. The system seemed in danger of disintegration. The reserves were negligible, the obligations represented by sterling balances vast"²¹. The main reasons for this failure

(21) Patrick Gordon Walker, The Commonwealth, p. 259.

were two: Firstly dollar credit required for the effort was seriously underestimated. Secondly and more fundamentally sterling/dollar rate at the existing levels of income was unrealistic. European countries with their dollar hunger found an outlet to convert their currencies into dollars via sterling and in the process begged the sterling to collapse.

Two other principles were also considered detrimental to the working of convertibility. Firstly the annual release of sterling balances was tantamount to the recognition of the right of the creditors to run a current deficit in sterling to liquidate their balances which prevented Britain from solving its balance of payments deficit with the dollar area. Sterling war-debts thereby received pre-emption over the problem of the dollar deficit. Moreover the amount of sterling balances, released yearly, were larger than the British production could cope with. "The sterling was edged to a greater usefulness in the non-dollar world"²². Secondly, the allocations of hard currencies left the sterling area countries no incentive to try and improve their dollar position.

EXCHANGE RATES:

The exchange rates between the pound sterling and local currencies in the sterling area have neither been very rigid nor volatile. They have generally over the years been characteristically stable. They have been stable, for instance when the rest of the world, caught in the grip of the great depression, was marred by over-night depreciations of exchange rates. Stable exchanges, in fact, are one of the advantages derived from the membership of the sterling area; through changes in the exchange rate parties are not altogether ruled out as a possibility. Pakistan, for instance refused

(22) Great Britain, Committee on the Working of the Monetary System, Report, p. 257

in 1949, to devalue its currency and thereby let its currency be up-valued in terms of the pound sterling.²³

A relatively stable exchange rate best serves the interests of the sterling area as well as the world trade, unless the whole sterling area is in persistent imbalance ^{with} the rest of the world. Sterling has twice been allowed to find its own economic rate: after the first world war and after the great depression. "This experience has been sufficient to demonstrate both the inconvenience of a fluctuating pound and the impossibility of altering its value without regard to the interests of other countries, which use sterling as an international currency. Either course of action intimately concerns the other members of the sterling area and would confront them with awkward differences of policies"²⁴.

During the war, despite balance of payments fluctuations the exchange rates within the area were kept stable. The inflationary spiral of prices after the war opened the debate for a proper alignment of the rupee with the sterling. It was suggested that 1s. 6d. did not reflect a true rate. However, since Indo-Pakistan as a sub-continent emerged from the war as a large creditor of the United Kingdom, it was only by running a deficit in the balance of trade with the United Kingdom that undivided India could bring down her sterling balances. A rate of 1s. 4d., however, would not help solve the problem since at that rate the difference in price levels was not sufficient to start a flow of goods and services to India. The debate

x (23) For a discussion on Pakistan's non-devaluation in 1949, see page 35

(24) Great Britain, Committee on the working of Monetary System, Report, p. 257.

was, however, silenced when India in 1946 notified the I.M.F. of her parity with pound sterling to be 1s. 6d.

Conditions in Australia and Newzealand could be cited in marked contrast to those in India and Pakistan. The price levels in those countries rose much less than in India. Australia and Newzealand, moreover, experienced many years of surpluses in their balance of payments. The prices in Newzealand had insured stability owing to her bulk purchase agreements with Britain.

In 1949 Britain devalued the pound by 30%. She was followed in her action by many other countries. The action was stated to be "the most dramatic monetary event since the war"²⁵. The cleavage of prices and costs between the United Kingdom and the United States was more ^{sideredit} fundamental than many con- sideredit. The disequilibrium in purchasing power was kept in check through rigorous exchange controls. The sterling area reserves seemed in danger of complete depletion. By September 18, 1949, the British gold and dollar reserves were down by \$1340 million. In the second quarter of 1949, the dollar gap widened furthur. Wild rumours of an impending devaluation and sharp decline in exports of the United Kingdom and the overseas sterling area (partly owing to postponement of purchases by foreign importers from the sterling area²⁶) marked the end of the third quarter of 1949.

"Although the dollar sterling exchange related in the first instance only to the trade of the United Kingdom, the maintenance of the rate is in fact dependent on the trade of the overseas sterling countries, since they account for a larger part of the dollar earnings of the sterling area"²⁶. The balance

(25) Economic Co-operation Administration, Sterling Area, an American Analysis, p. 75.

(26) A.R. Conan, The Sterling Area (London: Macmillan & Co. Ltd., 1952), p. 102.

of payments with the dollar countries, however, has generally been of secondary importance to the overseas sterling area as the bulk of their trade was carried on within the sterling area. In the gold producing countries of the sterling area the price of gold increased in terms of sterling. South Africa, therefore, perhaps derived the greatest immediate benefit from devaluation.

TABLE VI
DOLLAR TRADE OF THE STERLING AREA *

	1950			\$ millions		
	: Jan.-March:	: April-June:	: July-Sept.:	: Oct.-Dec.:	: Total:	:
<u>United Kingdom:</u>	:	:	:	:	:	:
Exports	: 133	: 163	: 191	: 223	: 709	:
Imports	: 240	: 219	: 224	: 275	: 949	:
Balance	: -107	: -56	: -33	: -52	: -240	:
<u>Rest of the Sterling Area:</u>	:	:	:	:	:	:
Exports	: 304	: 347	: 379	: 461	: 1490	:
Imports	: 247	: 266	: 207	: 247	: 943	:
Balance	: 57	: 79	: 172	: 214	: 547	:
Total Balance	: -50	: 23	: 139	: 162	: 307	:
Total, 1949	: -258	: -440	: -310	: -209	: -1217	:

* Total for the year do not exactly equal the sum of quarterly figures.

Sources: Report on overseas Trade (Board of Trade) as quoted by A.R. Conan,
The Sterling Area, p. 112.

Table VI indicates the improvement in the overall balance of payments position of the sterling area. The deficit in the last quarter of 1949 was the smallest, while in 1950, the deficit of the United Kingdom fell considerably and a surplus appeared on trade in the case of the rest of the sterling area. Compared to 1949 figures the improvement, however, was brought more through a curtailment of imports than an increase in exports²⁷. One factor in the improvement was, however, a favourable development in the balance of invisible trade, which improved from a negative \$100 million in 1949 to a positive \$150 million in 1950.

CAPITAL ACCOUNT:

London has traditionally been one of the great capital markets of the world. The overseas investments built over the years have helped raise the standards of living in various countries of the world. By construction of railways and good roads the British capital has also facilitated the world trade. "Control over capital was unthinkable when the pound was strong"²⁸, but was introduced in the difficult condition of 1930 to forestall large scale "transfer of capital across the exchange"²⁹. The foreign transactions advisory committee was set up for the purpose, which later became the capital issues committee with a more limited object of keeping the capital within the United Kingdom to relieve pressure on home resources.

(27) A.R. Conan, The Sterling Area, p. 112.

(28) Great Britain, Committee on the Working of Monetary System, Report, p. 262.

(29) ibid., p. 262.

The movement of capital within the sterling area continued to be rather easy, though the right to float issues in London was taken from the subordinate bodies³⁰. Commonwealth governments could raise the funds in London, provided the Bank of England was satisfied that no other alternative source was available. Re-investments or the use of retained earnings escaped British Control. Free movements of capital within sterling area, however, was reduced to one way traffic since all governments (except the United Kingdom) within the sterling area restrict the export of capital.

The United Kingdom still remains the most important source of investment for the sterling area countries. The exception, however, is the West Indies and India, where in 1957 the U.S. investments exceeded those of the United Kingdom. The importance of the United Kingdom in the capital sector reflects the importance of the free flow of capital within the sterling area. Britain, however, despite her surpluses, cannot be expected to meet fully the growing needs of the sterling area countries. The United Kingdom is increasingly being replaced by the United States and non-territorial organizations like the International Bank for Re-Construction and Development (I.B.R.D.) to satisfy the capital needs in the sterling area. "The overseas sterling countries have now become quite accustomed to looking elsewhere; in the first six month of this year (1961) alone, they borrowed £281 million from non-sterling sources or almost twice as much as their annual intake from such sources five years ago³¹.

(30) Subordinate bodies refers to all institutions, government and semi-government like municipal boards, Country boroughs etc., subordinate to the sovereign entity within a country.

(31) 'The Economist' October, 21, 1961, p. 272.

The sterling area countries, however, have found it increasingly difficult to raise any capital outside London, on the private level. The only countries who have had any success during 1952-57 were Australia and South Africa, who raised capital mostly in New York but part of it in Switzerland. The other important sources have been the I.B.R.D. and Export-Import Bank of the United States of America, to which Pakistan has also turned frequently. In 1958 the net inflow of long term capital from all sources was estimated at £600 million of which I.B.R.D. supplied £84 million, the United Kingdom £230 million and other countries another £270 million³². Between 1950-1959 the flow of capital into overseas sterling area was said to be about £2000 million, of which £1000 has been on Public Account. "The trend is noteworthy, because an increase in the reserves derived from capital inflow is not the same as an increase earned by trade. In the first place capital flows are characteristically unstable and liable to interruption. Secondly, the process creates at least a contingent liability as the capital may be repatriated. Finally, there is not merely a contingent but an actual liability in respect of return payable on capital received"³³. In the case of import of capital on public account renewal chances or re-investments are naturally not encouraging. This raises the question whether large scale loans are infact, worthwhile.

The sterling area can be roughly divided into developed and the developing nations; the U.K. Australia, Newzealand and South Africa could be placed in the former group, while Pakistan, India, Ceylon, Malaya and Nigeria in the latter. In the first group private capital is playing an

(32) Estimated by the Committee on the Working of the Monetary System of Great Britain.

(33) A.R. Conan, The Rationale of the Sterling Area, p. 6.

an important role since most of the industries have been set-up with European capital. In the second group private capital has not been forthcoming readily and, besides, these countries themselves reserve the 'basic industries' to their own nationals.

C. PAKISTAN IN THE STERLING AREA SYSTEM

Under the Financial Agreement of 1947, Pakistan became an independent member of the sterling area, ^{deriving} her assets from the division of the Issue and Banking departments of the Reserve Bank of India. In addition, "amounts standing to the credit of the central and provincial governments and scheduled banks in Pakistan as on 30th June, were paid over mainly by transfer from the Reserve Bank's sterling account No. 2 (blocked account) with the Bank of England"³⁴.

The sterling balances of the undivided India mainly originated from the peculiar method of war finance adopted by the United Kingdom, whereby exports from India were financed through the issue of sterling securities, instead of a counter movement of goods and services from the United Kingdom to Indo-Pak sub-continent. At the time of independence these balances amounted to £1160 million.

The Financial Agreement of 1947 between the United Kingdom and India required the Reserve Bank of India to open two accounts with the Bank of England called Account No. 1 and Account No. 2. Total sterling assets of the sub-continent were credited to Account No. 2 and all releases from this

(34) J. Russel Andrus and Azizali F. Mohammad, The Economy of Pakistan, (London: Oxford University Press; 1958), p. 285.

account were subject to negotiations between the parties. The free sterling (sterling in Account No. 1) could be spent at the absolute discretion of the holders,³⁵ and included sterling earned from current transactions, in addition to the transfer of sterling from Account No. 2 to Account No. 1. The agreement also provided for Pakistan's share of released sterling to be £6 million.

Pakistan's share of blocked sterling amounted to £147 million. With the establishment of the State Bank of Pakistan, all sterling assets were transferred to two new accounts opened by the State Bank of Pakistan with the Bank of England. The agreements for the release of blocked sterling assets were negotiated with the government of the United Kingdom from time to time.

The first separate financial agreement between the United Kingdom and Pakistan (Feb. 1948) covered the first half of 1948 and provided for a release of £16 million, out of which £6 million was a transfer for current purposes from Account No. 2 to Account No. 1, while another £10 million were released for the purpose of working balances.

In addition the unspent amount of £4 million, carried over from the last release, continued to be available. Pakistan agreed, however, to limit her hard currency expenditure during the period to £3.3 million out of the total release.

The agreement was extended from time to time covering the periods between 1948-49, 1949-50, and 1950-51 providing for sterling releases of £10 million, £15 million, and £17 million respectively. The agreement covering

(35) Except for the 'Gentlemen's Agreement' entered later and referred to elsewhere in the text.

1948-49 provided for a transfer of £5 millions from No. 2 account to No. 1 and another release of £5 million to finance the purchase of capital goods as well as to finance the projects for the re-settlement of refugees. Pakistan, again agreed to limit her hard currency expenditures during the year to £5 million. In the next agreement covering 1949-50 the normal transfer of blocked sterling was increased to £12 million, while an additional £5 million were provided for the purposes of refugees re-settlement. In 1950-51 an over-drawing to the extent of £14 million was regularized in addition to a grant of another £5 million exceptional release of sterling consequent upon trade rupture with India, together with the ordinary release of £15 million provided for in the agreement. By June 1951, the blocked sterling balances were reduced to £57 million.

The new Anglo-Pakistan agreement of 1951, covering a period of 6 years ending June 1957, finally disposed of all other sterling balances blocked in Account No. 2 in the following manner;

- i) An immediate transfer of £30 million to Account No. 1 to form an addition to Pakistan's currency reserves.
- ii) A release of £4 million in order to enable Pakistan to buy gold for the purposes of gold reserves of the State Bank of Pakistan.
- iii) The remainder to be paid in equal instalments over a period of six years beginning July 1951. Provision was also made for accelerated releases should the need for them arise. By July 1951, there virtually remained no limitation on Pakistan's foreign exchange reserves. The inheritance of all sterling balances was either used up or became freely available by 1957. New sterling balances were created as a result of current trade. In the 1951 commodity boom Pakistan's export earnings reached a record level. The sterling securities as a result increased from Rs. 671 million on Dec. 29, 1950 to Rs. 1122 million by Dec. 28, 1951. The sterling assets were heavily drawn up at the collapse of the commodity boom in the following year and touched the low level of Rs. 392 as on Dec. 28, 1952. The devaluation of Pak rupee in 1955 brought some improvement and the sterling

securities rose from Rs. 402 million in Dec. 31, 1954 to Rs. 780 million in Dec. 1955, going up to Rs. 820 in Dec. 1956. With sterling having been restored to convertibility for non-residents in Dec. 1958, the difference between sterling securities and other foreign exchange assets has become less important, while a general improvement in the dollar problem reduced the need for controls on dollar expenditures on the part of the sterling area countries.

Pakistan was a solitary exception to the chain of devaluation of currencies following the depreciation of sterling by 30% by the United Kingdom. Pakistan's decision was not only an assertion of economic independence, but it put the relationship between the sterling area countries in a new perspective and perhaps served notice of the increasingly independent role that the members of the sterling area were to play in the future. Pakistan decided to maintain parity with the dollar and allow pak. rupee to be appreciated as against sterling as well as against the depreciated Indian rupee. India, however, fell in line immediately contending that appreciation of the Indian rupee against the sterling would be harmful to Indian exports since most of the Indian trade was with the sterling area countries.

Pakistan's decision was said to be guided by the following general line of arguments;

- i) Pakistan basically has no balance of payments problem to necessitate any corrective action. Including the trade with India Pakistan infact had a comfortable surplus in her balance of payments in 1948-49.³⁶
- ii) Pakistan, in 1949, was basically an agricultural country and did not expect to increase her exports to any significant degree by lowering her exchange rate. On the contrary, the maintenance of her exchange rate would greatly help in importing cheaply the machinery needed for rapid industrialization and economic development to which she was committed.

(36) Pakistan's balance of payments recorded deficits of Rs. 503 million and Rs. 315 million respectively in the years 1948-49 and 1949-50. This however, excluded trade with India, which if included would result in a surplus. More in the Chapter, International Trade and Payments of Pakistan.

- iii) Pakistani exports mainly consisted of primary commodities, which in the conditions of 1949 did not need any incentive to be sold abroad.

In the controversy that followed India refused to accept the new Pakistani parity. In a statement in the Indian legislature the Indian view was expressed; "On the ratio now proposed by the Pakistan Government Indian manufactures would be compelled in their own interest to refuse to buy raw jute and raw cotton from Pakistan to the same extent as they had done in the past"³⁷.

On the whole Pakistan was motivated by Politico - economic interests of a very tangled nature. The economic justifications of the action can not be established since the Korean war presented an exceptional situation. Pakistan found no difficulty in selling her jute and cotton in markets other than India as the Western European Countries led by the United States started stock piling of primary commodities under the threat of a general extension of war.

Pakistan reduced her current deficit in payments with all the countries of the world during the year 1949-50, as can be observed in Table VII. X

In the economic tug of war that followed, Pakistan fixed her jute prices 25% below those ruling previously, thus surrendering all advantage that might have accrued to her from non-devaluation. India on the other hand increased the export duty on bessians, thus actually helping Pakistan dispose of her raw-jute surplus since it was now now economical to buy low-priced

(37) A.R. Conan, The Sterling Area, p. 93.

TABLE VII
PAKISTAN'S CURRENT BALANCE OF PAYMENTS

	1949		1950	
	Jan.-June	July-Dec.	Jan.-June	July-Dec.
Sterling area*	-15	-19	-16	-17
Dollar area	-10	- 5	- 4	- 1
All countries	-21	-24	-11	- 2

* Excluding India

Source: A.R. Conan, The Sterling Area, p. 95.

Pakistani raw jute rather than Indian finished product and produce it domestically. "In any case par of exchange remained purely theoretical as the central banks of India and Pakistan declined to quote rates for each others currencies; and as a result commerical and monetary transactions between the two countries virtually ceased"³⁸.

The result of this economic warfare was harmful to both countries but in a way Pakistan was spurred to find alternative markets for her exports. The smuggling of goods on a large scale, however, deprived Pakistan of the valuable foreign exchange it could have earned of the legitimate trade.

After six years in 1955, the decision was reversed and Pakistan finally restored the parity of its currency with sterling. Meanwhile, Pakistan had accomplished a transformation from a purely agricultural country to one which could be termed semi-industrialized. The reasons given for this decision were that since 1949, expectations have been more than fulfilled and it was time to consolidate the gains hitherto achieved. The rate of development was fast and infact out of step with the growth rate of the resources of the country. It was time to offer protection and promotion to the industries that had sprung up since 1949. Moreover, the decision stalled once and for all the current rumours of an impending devaluation.

The expectations connected with devaluation seem to have been realized. Foreign exchange earnings went up to £161 million in the year following devaluation as against £139 million of the preceding year. Foreign

(38) Conan, Op.Cit., p. 93.

payments were down by £22 million. As a result gold, dollar, and sterling reserves rose from £68 million in 1954 to £75 million in ¹⁹⁵⁵ and then went on to £87 million at the end of the year 1955, while a spectacular rise was achieved in the export of jute manufactures.

Concluding Summary and Remarks:

The working of the sterling area system, in its evolution, has conditioned itself remarkably to the exigencies of the times. In the early thirties the system was simple: overseas sterling area kept practically all their reserves in London: all transactions within the sterling area and with the rest of the world were indented and financed in sterling: the movements of capital and the movements of goods within the sterling area were free. The war confronted the whole sterling area with the need for conservation of resources; the response was the inconvertibility of sterling and the establishment of the dollar pool.

The post war period saw the sterling area struggling for its very existence and resorting to discriminatory practices to solve the dollar problem. The period also saw the emergence of independent nations within the sterling area, the assertion of greater economic independence and the gradual loosening of the monetary control of the United Kingdom as a result of the establishment of central banking in those countries.

As the adverse balance in payments with the dollar countries assumed threatening proportion, all the members of the sterling area along with many others (excepting Pakistan) devalued their currencies. Earlier Pakistan's sterling balances, as those of many other countries like India and Egypt, had

to be temporarily frozen to ease the pressure on sterling. Finally, with the easing of the dollar shortage, the sterling area has entered a new phase of full convertibility and non-discrimination in international trade.

CHAPTER II

INTERNATIONAL TRADE AND PAYMENTS OF PAKISTAN

The purpose of this chapter is twofold: first to present the geographical distribution of the foreign trade of Pakistan and show the significance of Pakistan's trade with the sterling area countries; and second, to discuss the use of sterling as a means for the settlement of differences in Pakistan's international accounts. The commercial policy of Pakistan is discussed with a view to identifying its role as a determinant of the volume and pattern of the country's foreign trade.

GOVERNMENT'S POLICIES AFFECTING TRADE AND PAYMENTS

The two fundamental problems of the external trade of Pakistan have been the sharp fluctuations on her export earnings and a high degree of trade product concentration, both geographically and commodity wise. Geographically, Pakistan's foreign trade was largely concentrated with India and the United Kingdom; India's offtake being as much as 60 per cent of the total value of exports, while India and the United Kingdom were the source of 50 per cent of the total imports into the country. Commodity wise too, 80 per cent of the export earnings on independence came from the exports of raw jute and raw cotton. Wool, hides and skins and black tea accounted for another 10 per cent of total export trade.

The objectives of the commercial policy under the circumstances were stated to be;

- i) to strengthen external financial position of Pakistan.
- ii) To utilize exchange earnings, as far as possible, for development purposes and completion of industrial projects essential to the economy of the country.

iii) To obtain most favourable terms by tapping diverse sources of supply and finding new markets for her exports.

iv) To obtain sufficient customs revenue to help development³⁹.

The means employed to pursue the objectives of the commercial policy were (i) direct import and export controls, (ii) monetary and fiscal policies and (iii) the provision of incentives^{for}/promoting exports.

Import and Export Controls: Imports may be made only under a license granted by the Chief Controller of imports and exports. Moreover, only firms registered with the office of the Chief Controller of imports and exports are allowed to engage in import trade. Pakistan pursued a very liberal import policy during the first few years of independence, allowing imports of all kinds of goods without any restrictions. The Korean boom in 1951 led to a great rise in the prices of primary commodities and Pakistan's exports rose to a record level, never surpassed since then. Following large export surpluses in 1951, businessmen placed large orders for imports. The ensuing recession in 1952, however, curtailed the export earnings sharply, depriving the country of the means of continuing a liberal import policy. The balance of payments deteriorated. There was a six fold increase in the deficit with sterling area countries; three fold increase in deficit with the dollar area countries; while surplus with the continental countries reduced by 50 percent and the surplus with Japan changed to a deficit⁴⁰. The government had to effect a reduction in the level of imports.

(39) Govt. of Pakistan, Investment Opportunities in Pakistan, p. 84.

(40) United Nations, Economic Survey of Asia and Far East, (1952), p. 47.

Open general licenses were suspended⁴¹, and high deposit margins were introduced on the issue of letters of credit. As these measures proved inadequate to stop the rising level of imports the government on 23rd. November, 1952 cancelled the system of open general licenses altogether and clamped on strict administrative measures of exchange rationing.

The strict regulation of imports and exchange rationing were continued until the beginning of 1959, when radical changes were introduced in the import policy. The system of open general licenses was revived and a new system of automatic licensing was introduced, whereby a license was automatically renewed after the first was completely utilized.

With improvement in the export earnings and large receipts of aid and loan funds, the import policy has been gradually liberalized, while radical 'directional' changes have occurred since 1951 both in Pakistan's exports and imports, which are discussed in the later part of the chapter.

Monetary and Fiscal Policies:

To prosecute the above objectives, commercial policy has been supplemented by several monetary and fiscal measures. In 1949, for example, Pakistan decided not to devalue her currency in line with the general devaluation in the sterling area countries. The favourable rate of exchange of Pakistani rupee thereby cheapened the costs of imports and increased the purchasing power of her export proceeds. As the objectives of industrialization and development were achieved to a fair extent, and the domestic industries achieved potential capacities for exports, the decision was reversed in 1955, to afford protection and encouragement to exports of manufactures from Pakistan.

(41) Open general license refers to a general permit by the Govt. to import a specified items in unlimited quantities.

Another tool employed towards achieving the objectives of the commercial policy are the discriminate use of import and export duties. The imports of machinery and equipment are free from any import duties, while items of luxuries are heavily penalized.

Exports Promotion and incentives

While it is easy to regulate the volume of imports through import controls the attainment of a satisfactory level of exports depends on the decisions of others, who are generally persuaded by factors of world markets and prices. One of the objectives of the export policy has been to keep the costs competitive in world market by increasing efficiency at home. In addition, the export bonus scheme provides another incentive in the form of grant of import licenses, which can be utilized for the import of machinery and spareparts for the improvement and modernization of existing plants in the country. Finally, Pakistan has entered several bilateral agreements, specially with the Communist bloc countries, providing for a barter of commodities.

BALANCE OF PAYMENTS

The balance of payments has been generally unfavourable to Pakistan. In fact, if imports under commodity aid and other loans and grants are included, the only year there was a recorded surplus was 1950-51. Payments on government account, development expenditures and the declining terms of trade have been largely responsible for such imports. A study of balance of payments of Pakistan can be conveniently divided into three periods; from 1949 the year of general devaluation to 1955; from 1955 the year when Pakistan

decided to devalue Pak rupee to 1958 the advent of the 'new regime' and from 1958 to the present time.

1949-55: The first two year of independence were rather abnormal. Pakistan's external trade remained dislocated owing to the influx and efflux of population between India and Pakistan. Records for the trade between India and Pakistan (which was at a high scale, and was carried on like the domestic trade in Indian rupees) are not available. Pakistan's balance of payments during 1949-and 1950 recorded large deficits of Rs. 503 million and Rs. 315 million. This, however, excludes trade with India. The balance of payments picture would be much different if the substantial trade with India were included, which was highly favourable to Pakistan. Another reason for the deficit, specially in 1949 was the devaluation of the sterling and the expectations of a Pak rupee devaluation, which induced importers to defer their purchases and payments in Pakistan.

A surplus of Rs. 577 million was achieved during the year 1950-51, thanks largely to the higher prices of commodity exports at the time. As the crisis in Korea showed signs of easing the prices fell down abruptly Pakistan's balance of payments position swung to a large deficit of Rs. 473 million in 1952, followed by another deficit in 1953 amounting to Rs. 407 million. Foreign exchange earnings fell from Rs. 2406 million in 1951 to Rs. 1521 million in 1952, while Pakistan's gold and sterling reserves were reduced to Rs. 606 million from the 1951 high of Rs. 1482 million.

The reserves in balance of payments necessitated tighter controls of the total imports and the deficit in 1953-54 was brought down to Rs. 28 million as against Rs. 407 million in the previous year, inspite of a

TABLE VIII
PAKISTAN'S BALANCE OF PAYMENTS
CURRENT ACCOUNT

YEAR - JULY-JUNE	MILLION RUPEES																							
	48-49	49-50	50-51	51-52	52-53	53-54	54-55	55-56	56-57	57-58	58-59	59-60	60-61	61-62	62-63									
Receipts: Exports	805	870	2508	2187	1340	1342	1217	1899	1701	1528	1529	1760	1877	1919	2214									
Others	204	79	164	219	179	119	123	607	852	1393	698	1309	1688	1256	1761									
Total Receipts	1009	948	2471	2406	1521	1421	1340	2506	2553	2921	2227	3069	3565	3175	3975									
Payments: Private Imports	756	749	1273	1927	1214	734	736	834	869	910	758	907	1186	1326	1294									
Govt. imports and Others	564	340	433	598	481	489	355	948	1575	2116	1138	1508	1806	1208	2055									
Others	144	209	189	354	233	226	211	361	391	361	299	526	655	742	713									
Total Payments	1464	1298	1895	2879	1928	1449	1303	2143	2835	3387	2195	2941	3647	3276	4062									
Errors and Omissions	-47	+35	-1	+19	+1	-	-	-	-	-	-	-	-	-	-									
Balance	-503	-315	+576	-464	-408	-28	+37	+363	-282	-466	+32	+128	-82	-101	-87									

Based on: Monthly Bulletins, State Bank of Pakistan.

Govt. of Pakistan, Planning Board, Five Years Plan, p. 198.

Economist Intelligence Unit, The Commonwealth and Europe, p. 360.

continued decrease in imports. Pakistan's balance of payments recorded a small surplus of Rs. 37 million during 1954-55, but both receipts and payments continued to be at low levels. The larger crops at home dispensed with the need for any large scale imports of food grains, which was largely responsible for this favourable turn. In addition depressed payments agreements for the purchase of machinery and equipment entered into with some countries, notably Japan and England postponed the payments for current exports.

1955-1958: On 1st. August 1955, Pakistan decided to devalue Pak rupee in terms of the sterling as well as Indian rupee, so as to restore the parity previous to 1949. The object of the depreciation was to correct the balance of payments disequilibrium by promoting exports specially of Pakistani manufactures and to discourage imports. The outcome of devaluation was a surplus of Rs. 363 million in 1955-56. Total foreign receipts increased from Rs. 1340 million in 1954-55 to Rs. 2506 million, in 1955 and an almost 90% increase. The inflow of foreign investment funds contributed another Rs. 97 million. Gold and foreign exchange holdings increased from \$327 million to \$390 million (higher than that attained during the Korean boom).

Two successive payments deficits followed as the terms of trade which moved against Pakistan in 1952 at the end of the Korean boom continued to decline. "Between 1955-56 the first post-devaluation year, and 1958-59 the index of the terms of trade fell by 25%. Meanwhile imports mainly designed to satisfy industry's demand for machinery and materials were allowed to rise again and the short lived surplus on the balance of payments gave place to a deficit of Rs. 282 million in 1950-51 and Rs. 466 million in

1957-58⁴². This does not, however, present the whole picture since without foreign aid of the amount of Rs. 1195, the deficit would have been much larger indeed.

1958-63: The balance of payments during 1958-59 and 1959-60 were favourable to Pakistan, the surplus amounting to Rs 32 million and Rs. 128 million respectively. The surplus in 1958-59 was largely due to the 'austerity policy' pursued by the 'new regime' during that period. The year 1959-60 scored a larger surplus, which was mainly attributable to vigorous government measures of exports promotion, the effect of the export bonus scheme, and the surrender of larger amount of gold and foreign exchange deposits held outside the country. The export earnings increased from Rs. 1529 million in 1958-59 to Rs. 1760 million in 1959-60. The gold, dollar and sterling reserves which rose by Rs. 461.6 million in 1959 went up another Rs. 66.8 million to stand at Rs. 1294 million at the end of 1960⁴³.

The balance of payments picture during 1958-63 has undergone important and radical transformation. The level of imports and exports both has risen tremendously as could be seen from Table VIII. In brief export proceeds rose from Rs. 1528 million in 1957-58 to Rs. 2214 million. The value of imports, likewise, rose from a level of Rs. 2835 million to Rs. 4062 million during the same period. The fact that the adverse balance remained about Rs. 100 million is in fact a tribute to the various policies followed by the government.

(42) Economist Intelligence Unit, The Commonwealth and Europe, p. 362.

(43) Govt. of Pakistan, Budget: 1961-62 (Karachi: Govt. of Pakistan Press, 1961) p. 29.

DISTRIBUTION OF BALANCE OF PAYMENTS BY CURRENCY AREAS

The pattern of Pakistan's trade and payments make it a significant member of the sterling area. Pakistan's major exports of jute and jute manufactures have world wide demand, while Pakistan enjoys near monopoly position in the finer variety of jute. In the scarcity conditions of the early fifties, jute became one of the important dollar earner of the sterling area, thereby contributing to the valuable dollar and other convertible currency reserves at the central gold and dollar pool.

On the import side Pakistan's needs consist of industrial raw materials, machinery and equipment which, again, made the country an important customer of the United Kingdom. Pakistan's economy, therefore, complemented to a large extent the rest of the sterling area. The sterling area, thus, became the most important trading partner to Pakistan accounting for 60% of her total imports on private account and 70% of her total exports in 1948-49. In so far as larger trade within the area economized the use of central reserves, it strengthened the general financial position of the sterling and therefore of the sterling area on the whole.

In 1948-49 India was by far the most important trade partner accounting for 59% of Pakistan's exports and providing 31.8% of total imports. The United Kingdom came next, taking 11.6% of Pakistan's exports and providing 28.1% of her imports. The two countries together accounted for more than 3/5 of Pakistan's total foreign trade. Table IX shows the gradual erosion of India's position as a major trading partner.

TABLE IX

PERCENTAGE OF IMPORTS ON PRIVATE ACCOUNT BY COUNTRIES OF ORIGIN

	: 48-49:	49-50:	50-51:	51-52:	52-53:	53-54:	54-55:
Indian Republic	: 31.8 :	: 24.3 :	: 15.1 :	: 17.7 :	: 13.5 :	: 5.3 :	: 4.0 :
United Kingdom	: 28.1 :	: 25.4 :	: 26.4 :	: 20.4 :	: 28.8 :	: 31.8 :	: 32.2 :
Belgium, France, Germany, Italy	: 6.4 :	: 8.6 :	: 11.7 :	: 12.6 :	: 13.5 :	: 20.8 :	: 16.4 :
China	: 7.3 :	: 3.2 :	: 6.1 :	: 1.2 :	: 0.7 :	: 10.4 :	: 0.2 :
Hong Kong	: 0.5 :	: 0.5 :	: 3.3 :	: 2.2 :	: 0.7 :	: 0.9 :	: 0.1 :
Japan	: 1.2 :	: 11.0 :	: 16.2 :	: 23.8 :	: 15.4 :	: 8.7 :	: 16.3 :
United States	: 8.0 :	: 9.8 :	: 6.6 :	: 6.1 :	: 8.7 :	: 7.0 :	: 9.2 :
Other Countries	: 16.3 :	: 17.2 :	: 14.6 :	: 16.0 :	: 18.5 :	: 23.9 :	: 21.3 :

Source: Govt. of Pakistan, Planning Board, First Five Year Plan: 1955-60, p. 191.

India was replaced on the export side by the United Kingdom as the largest single importer, while the United States became gradually the largest exporter to Pakistan⁴⁴. Trade diversification also led to more trade with France, Germany, Belgium and Italy on the continent and Japan, Hongkong and peoples Republic of China in the far east. India continued to be an important buyer of raw jute, but fairly large buying by the continental countries considerably reduced the country's dependence on India. Meanwhile the crisis in Indo-Pak relations owing to their dispute on devaluation in 1949

(44) See Table XII

brought the trade between the two countries to a stand still. Pakistan entered into bilateral trade agreements with several countries in order to dispose of large stocks of raw jute and raw cotton.

TABLE X
PERCENTAGE OF PRIVATE ACCOUNT EXPORTS BY SELECTED COUNTRIES

	:	:	:	:	:	:	:	:
	:	48-49:	49-50:	50-51:	51-52:	52-53:	53-54:	54-55:
Indian Republic	:	59.6	:26.8	:21.8	:18.8	: 9.9	: 9.1	: 11.6:
United Kingdom	:	11.6	:15.5	:12.6	:13.9	:15.4	:17.9	: 21.4:
Belgium, France, Germany, Italy:	:	11.0	:17.1	:21.3	:23.4	:22.4	:25.8	: 24.8:
China (Peoples Republic)	:	1.2	: 1.8	: 3.5	:12.7	: 7.5	: 6.9	: 2.8:
Hong Kong	:	0.5	: 8.2	: 4.9	: 2.7	: 3.3	: 4.4	: 3.2:
Japan	:	2.6	: 3.7	:13.0	:10.9	:19.1	:14.1	: 11.9:
United States	:	6.4	: 5.7	: 6.2	: 2.6	: 6.9	: 6.0	: 716:
Other Countries	:	7.0	:21.0	:16.6	:14.9	:15.5	:15.6	: 16.5:

Source: Govt. of Pakistan, Planning Board: First Five Year Plan: 1955-60, p. 191.

THE STERLING AREA

The total share of the sterling area in Pakistan's foreign trade has been declining over the past decade. In 1951, the sterling area was responsible for about 45% of the total value of foreign trade of Pakistan. In 1961 the percentage shrank to 35%. Imports from the sterling area continued to rise and were at Rs. 1012 million in 1961 as against Rs. 689 million in 1951. Exports

declined slightly over the same period and amounted to Rs. 77.3 million as against Rs. 1107 million but improved to Rs. 910 during 1962-63. The balance of payments with the sterling area has been consistently unfavourable to Pakistan, while the range of deficits has fluctuated considerably (see Table XI).

The United Kingdom:

The main source of Pakistan's deficit with the sterling area lies in her unfavourable balance of payments with the United Kingdom. Except for a small surplus of Rs. 30 million in 1961-62 Pakistan's balance of payments with the United Kingdom ^{shown} has/ of consistent large deficits. The post-war 'heritage' of sterling balances were largely responsible in Pakistan's first few years of independence to run a maximum balance of payments deficit with the sterling area to ensure a speedy release of her sterling assets blocked in Account No. 2⁴⁵. In addition the collective discrimination against the dollar left the United Kingdom the only major source of supply. The development expenditures were met through unrequited imports using large amounts of the country's sterling balances.

Another source of deficits with the United Kingdom is an adverse showing on balance in invisible. These comprise generally of services; banking, shipping and insurance, interests payable on investments, repatriation of projects, and pensions payable to former servants in the provincial governments of un-divided India now comprising part of Pakistan. An item

(45) For a discussion on Sterling balances, see chapter I.

favourable to Pakistan has emerged recently on account of the remittances to Pakistan of Pakistani nationals living in the United Kingdom. Correct figures are not available, as a large part of these remittances are channelled through unofficial sources.

India:

Pakistan's balance of payments with India recently has fluctuated widely from a surplus in one year to a deficit in another. In the first two years of independence Pakistan earned large surpluses with India through statistics with detailed break down are not available. The Indo-Pak payments agreement of June 1948 provided that a deficit or surplus in either direction upto a maximum of Rs. 150 million would be accommodated by either country holding the other's currency, while any difference beyond that amount was to be paid for in free sterling upto a maximum of Rs. 100 millions, beyond which the payments were to be effected through transfers of blocked sterling balances. In so far as the use of blocked sterling for current purchases of goods and services was concerned, it amounted to a grant of an interest free loan⁴⁶. It was, therefore, in the interest of either country to run large payments deficits with the other. This helped the debtor country in two ways: firstly, by diverting her own export of goods and services to hard currency area she could earn foreign exchange while her imports could be financed through the use of blocked sterling; secondly, she could liquidify her own reserves of 'frozen' sterling for current use, while freezing the current purchasing power of the other country in the process.

(46) Except to the extent sterling balances are entitled to interest, which is nominal, as the sterling balances themselves are mostly in the form of treasury bills and (see chapter I for a detailed discussion).

As it happened the value of Pakistani exports were far in excess of her imports from India. "Thus Pakistan had to receive blocked sterling in large quantities in lieu of this balance which she could not use for financing her imports until released by the United Kingdom in due course of time"⁴⁷. For Pakistan deferred payments meant postponing her own development expenditures until these balances were available for use. Moreover, as it happened, the sterling devaluation in 1949 reduced the value of sterling assets in terms of hard currencies, the loss occurring thereby was assumed by Pakistan to the extent Pakistan accumulated balances hitherto belonging to India.

The pattern of the balance of payments with India has gradually undergone a complete transformation. India reduced her dependence on Pakistan for the import of raw jute, and completely eliminated any need for the import of raw cotton by increasing domestic production. Pakistan on the other hand 'dieselized' her railways, the largest consumer of Indian Coal. Moreover the growth of cotton and jute textile industry made Pakistan self-sufficient in her requirements of cotton piece goods and jute manufactures, which she hitherto imported from India. As the two economies grew more independent of each other, the surpluses with India declined. In 1952 Pakistan had a deficit of Rs. 68.9 million for the first time. With the restoration of the exchange rate parity the surplus re-appeared for a short time, only to be followed by further deficits in the following three years. As a result of greatly increased production of consumer goods within the country, there was again an improvement and the surpluses re-emerged; the surpluses for the year 1962-63, the latest available, being Rs. 51.9 million.

(47) S.M. Akhtar, Economics of Pakistan, p. 130.

TABLE XI

GEOGRAPHICAL DISTRIBUTION OF PAYMENTS
SELECTED CURRENCY AREAS AND COUNTRIES

	1948-49	49-50	50-51	51-52	52-53	53-54	54-55	55-56	56-57	57-58	58-59	59-60	60-61	61-62	62-63
U.S.A.	-	-	-63.4	-227.2	-35.5	-46.4	+4.7	+57.8	-93.6	-101.0	+79.7	+13.2	-48.8	-48.8	-116.2
CANADA	-	-	-17.4	-33.3	-81.5	-2.1	-1.3	+3.4	-3.9	-13.6	-9.5	-2.5	-10.0	-4.8	+2.2
O.A.A.A.	-	-	+0.1	+2.1	+7.5	+3.5	+7.7	+16.5	+10.6	+11.9	+17.3	-	-	-	-
DOLLAR AREA	-113.7	-89.8	-80.7	-268.6	-101.4	-29.1	-0.9	+72.5	-86.9	-103.7	+89.9	+10.7	-59.2	-53.7	-166.2
U.K.	-	-	-287.8	-572.8	-497.4	-426.5	-292.9	-478.1	-573.2	-659.1	-539.7	-466.4	-145.5	+30.0	-503.6
INDIA	-	-	+158.0	+2.4	-68.9	+4.6	-8.1	+48.9	-49.5	-16.4	-31.8	+16.6	+5.8	+53.6	+51.9
O.S.A.	-	-	+34.2	-47.3	+10.0	+59.1	+123.6	+233.7	+73.5	+106.4	+225.4	+359.5	+245.6	+188.9	+284.1
STERLING	-460.3	-354.5	-95.7	-548.6	-556.3	-362.5	-209.1	-195.5	-549.2	-569	-345.5	-90.6	+105.9	+272.6	-167.5
O.E.G.C.	-	-	+423.8	+219.8	+116.8	+152.8	+140.5	+274.3	+162.9	+185.0	+119	+47.8	-194.5	-246.3	+32.6
R.O.W.	-	-	+190.2	+370.0	+62.3	+111.5	+36.7	+130.5	+54.2	+44.7	+43	+120.6	+199.5	-19.4	+21.97
JAPAN	-	-	+139.2	+246.0	+179.8	+79.4	+25.8	+176.0	+137.0	+37.8	+97.5	+12.2	-43.1	-110.7	-5.9
NON-DOLLAR	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
NON-STERLING	+118.6	+94.6	+753.4	+343.2	+258.9	+363.7	+213.6	+480.8	+354.1	+267.5	+290.6	+206.0	-137.6	-320.2	+246.4

The figures pertain to U.S. and O.A.A.A. together

© Only for three quarters of the year.

NOTE: The figures are generally not re-concillable, with the summary of balance of payments, because of the effect of (1) foreign aid (2) general errors and omissions are excluded from classifications (3) because of rounding off.

Based on: Monthly Bulletin, State Bank of Pakistan, Govt. of Pakistan, Planning Board, First Five Year Plan, Table 9, p. 198 ANDRUS AND MOHAMMAD The Economy of Pakistan, Table XLIV.

NON STERLING WORLD

The increasing dependence on foreign aid and credits brought important changes in the sources of supply for imports, while the major exports of the country had to find new markets as the easing of the dollar shortage in the world made North America less discriminated against and, therefore, a more efficient competitor in European markets, specially in the export of raw cotton from Pakistan. Because of the general convertibility of sterling and the linking of American aid and loans to trade as a result of what is generally known as the 'Buy America Policy' the United Kingdom (and, therefore, the sterling area) ceased to be the largest exporter to Pakistan. The economic re-construction of Japan and continental Europe shifted the demand for Pakistani exports from a traditional customer - the sterling area - to other parts of the world. The relative importance of the sterling area has been falling as a trading partner for Pakistan, specially as the economy of Pakistan is becoming more diversified.

The Dollar Countries:

Pakistan's record with the dollar area has been one of deficits both on trade account and payments. The only years with balance of payments surpluses with the dollar area have been 1955-56 and 1958-59, the former being the year of devaluation and the latter when all import licences were suspended for a temporary period. In both cases the change was reflected in a decline in the volume of imports. On trade account Pakistan's trade with the dollar area (mainly U.S.A.) increased about 8 fold over a decade (1951-61) while imports increased 9 times over the same period. This was possible through a large flow of capital in the form of machinery and equipment brought into the country

as well as cash invested, while loans and grants were also tied to imports from the United States of America.

The development needs of the country would have necessitated much larger deficits with the dollar area had it not been for the discriminatory policy pursued against dollar purchases. Pakistan undertook in 1952, as a member of the sterling area, to reduce her payments to the dollar area by 25 per cent relative to 1948 as a base year. As the dollar discrimination ended with the restoration of non-resident sterling convertibility deficits with the dollar area mounted reaching as high as Rs. 166.2 million in 1962-63 the highest ever attained since the Korean boom. The balance of payments with the dollar area does not truly reflect the flow of goods and services as American imports into Pakistan are largely loan financed and do not involve current spendings of foreign exchange.

Like overseas sterling area, Pakistan has enjoyed consistent favourable balance of payments with overseas American Account Area⁴⁸ (O.A.A.A.), but the volume of trade has not been insignificant.

Non-dollar non-sterling countries on the whole have been the best customers for Pakistan. With these countries Pakistan had large and consistent balance of payments. Japan in the far east and continental O.E.E.C. countries have been the more important. Recently, however, while imports from these countries have been rising, exports thereto have shown a declining trend with the result that the surplus on balance of payments with these countries has been on the decline. In 1961-62 Pakistan in fact incurred a deficit of Rs. 246.3

(48) O.A.A.A. includes all dollar countries except U.S.A. and Canada.

TABLE XII

PAKISTAN'S FOREIGN TRADE

EXPORTS AND IMPORTS BY CURRENCY AREAS AND COUNTRIES

	DOLLAR AREA				STERLING AREA			
	U. S. A.	CANADA	OVERALL	U. K.	INDIA	OVERALL		
	EXPORT, IMPORT	EXPORT, IMPORT	EXPORT, IMPORT	EXPORT, IMPORT	EXPORT, IMPORT	EXPORT, IMPORT	EXPORT, IMPORT	EXPORT, IMPORT
1951	10.4 : 9.2	.4 : .5	11.1 : 9.8	31.6 : 32.7	58.7 : 20.0	110.7 : 68.9		
1952	7.3 : 12.0	.4 : .3	8.0 : 13.4	22.5 : 40.9	19.4 : 28.1	50.1 : 82.6		
1953	9.6 : 5.5	.2 : .1	10.5 : 15.6	27.9 : 19.0	10.8 : 13.5	49.0 : 28.7		
1954	7.8 : 6.9	.1 : 1.3	8.5 : 8.3	23.0 : 30.6	10.8 : 4.0	44.4 : 41.7		
1955	11.6 : 12.7	.3 : .8	13.2 : 13.5	22.8 : 26.4	20.0 : 3.6	59.3 : 39.0		
1956	14.8 : 12.3	.6 : .3	16.5 : 12.7	25.8 : 27.5	17.4 : 4.4	61.8 : 39.3		
1957	18.1 : 57.2	.1 : .6	19.4 : 65.5	25.5 : 40.0	11.6 : 8.7	57.6 : 71.6		
1958	14.9 : 51.4	.3 : .7	16.3 : 59.0	28.0 : 33.4	4.7 : 8.8	47.4 : 56.0		
1959	15.8 : 39.8	.6 : .9	19.4 : 49.1	28.0 : 29.6	4.8 : 6.8	68.8 : 48.6		
1960	16.3 : 77.4	.7 : .6	19.6 : 84.1	32.5 : 54.7	12.9 : 10.6	86.7 : 87.9		
1961	18.8 : 75.5	1.3 : 5.8	23.9 : 82.8	27.1 : 60.8	11.8 : 12.0	77.3 : 14.2		
1962-63	17.3 : 154.8	.9 : 7.3	20.7 : 163.0	29.5 : 59.1	19.4 : 10.2	91.0 : 91.9		

TABLE XII (Cont.)

(Rs. Crores)											
NON-DOLLAR NON-STERLING AREA											
		JAPAN		O.E.E.C.		EAST EUROPE U.S.S.R.		REST OF WORLD			
		EXPORT	IMPORT	EXPORT	IMPORT	EXPORT	IMPORT	EXPORT	IMPORT		
1951	25.4	35.8	67.8	23.7	9.1	2.4	28.1	16.0			
1952	29.1	36.9	41.7	28.1	11.8	1.9	34.0	10.1			
1953	28.3	5.9	39.6	14.6	4.1	4	8.8	7.4			
1954	10.3	11.5	32.6	21.2	2.5	4	13.4	7.3			
1955	17.0	14.4	39.8	19.9	1.8	2	18.0	8.1			
1956	20.2	9.8	4.6	28.5	2.1	6	14.8	7.2			
1957	20.8	7.6	43.9	41.3	5.0	1.6	13.3	22.3			
1958	14.2	10.6	44.3	39.2	6.5	2.7	12.7	21.0			
1959	12.6	9.7	34.4	38.5	8.1	1.7	12.2	20.3			
1960	13.5	26.3	37.3	73.9	8.0	5.8	18.6	32.3			
1961	11.8	24.9	44.7	67.9	9.4	4.2	20.4	24.2			
1962-63	16.2	25.0	44.2	68.9	6.3	5.9	21.0	25.8			

Based On: Monthly Bulletin, State Bank of Pakistan, (Karachi: Nov. 1963).

million with the O.E.E.C. countries and Rs. 110.7⁴⁹ with Japan compared to for instance an overall favourable balance of Rs. 458 million in 1951. The situation in 1962-63 (the last year for which figures are available) improved considerably as a result of which a surplus of Rs. 32.6 million re-appeared with continental O.E.E.C. Countries, while the deficit with Japan was considerably reduced and stood at Rs. 5.9 million.

The other important countries include Russia, China, and countries of Eastern Europe commonly classified under "the rest of the world". The balance of payments with these countries has been consistently favourable but trade carried on has been only in small amounts.

The deficits in the balance of payments were met in the early years of independence by making a call on the accumulations of internal sterling assets and later on, when the sterling balances were already heavily drawn, through the use of foreign loans and credits and through instalment buying from countries like U.K., Germany, and Japan.

Table XIII shows the movements of Pakistan's gold and foreign exchange assets. Between 1948-50 the value of these assets dropped by Rs. 412 million. The change is mainly reflected in India notes. This is both because of the depreciation of Indian notes in terms of Pakistani rupee and their redemption to India which covered up the loss in sterling securities.

While Pakistan's sterling balances held in Account No. 2 continued to fall, there was a general upward movement brought about by a large surplus in the balance of payments in 1951. The fall in the balances in 1952, however, was both much larger and abrupt. Following devaluation gold and foreign exchange reserves were written up in terms of the Pakistani rupee but the

(49) For the first three quarters of the year only.

increase of Rs. 593 million in 1955 partly also reflects a perceptible easing of the balance of payments position.

The deficit in the balance of payments during the first few years of independence depended to some extent on the level of sterling securities released from the blocked accounts. Pakistan made full use of all releases granted by the United Kingdom, and the blocked assets were all used up quickly". In effect, therefore, while Pakistan's deficits in the earlier years were to some extent limited by the magnitude of releases from Account No. 2, by July 1951, when the deficits had re-appeared, virtually no limitations remained and the total foreign exchange assets whether currently earned or inherited at partition were available for free utilization"⁵⁰. As a matter of fact, Pakistan overdraw on the reserves in order to meet her dollar payments which exceeded the level allowed by the Gentlemen's agreement reached with Britain in 1949.

As the deficits mounted in later years, the strains on reserves were eased by foreign loans and commodity aid. In 1953-54, the United Kingdom agreed to grant a loan of £10 million for the purchase of equipment. In Pakistan addition/^{Pakistan}signed an agreement with the U.K., Japan, and Germany for instalment purchases of textile machinery the payments for which were spread over many years. In 1954-55 as the foreign exchange position became tight, the United States agreed to provide Pakistan with special commodity assistance for the import of industrial requirements and essential consumer goods worth \$111.07 million.

(50) Andrus and Mohammad, The Economy of Pakistan, p. 29.

TABLE XIII

PAKISTAN'S GOLD AND FOREIGN EXCHANGE ASSETS

YEAR	GOLD	STERLING * SECURITIES	GOVT. OF INDIA SECURITIES	INDIA NOTES	TOTAL	BALANCE OF PAYMENTS ON CURRENT CURRENT
1948	2.0	56.6	15.5	81.4	155.7	-
1949	4.2	57.5	31.6	43.1	136.5	-503
1950	4.2	67.1	13.2	29.9	114.5	-315
1951	4.2	112.2	11.9	29.9	158.4	+576
1952	7.9	39.2	11.8	29.9	89.0	-464
1953	7.9	39.4	11.8	29.9	89.2	-408
1954	7.9	70.2	21.4	29.9	99.5	- 28
1955	11.1	78.0	26.5	43.1	158.8	+ 37
1956	11.3	82.0	23.6	43.0	16.0	+363
1957	11.3	66.5	43.0	120.9	-282	
1958	23.0	50.7	43.0	116.8	-466	
1959	23.7	68.3	43.0	135.0	+ 32	
1960	24.6	74.2	43.0	141.9	+128	
1961	24.9	65.0	43.0	132.9	- 82	
1962	25.0	62.9	43.0	131.4	-101	
1963	25.0	83.8	43.0	151.9	- 87	

* Amalgamated under the head "Approved foreign exchange" with effect from the week ended 26th April 1957 and their under the head "Foreign securities" with effect from the week ended 3rd July, 1959.

Note. Balance of payments figures related to the year - July-June and are strict by not comparable, except for indicating a general trend.

Based on: Monthly Bulletins, State Bank of Pakistan.

One of the important advantages of membership in the sterling area lies in the fact that trade within the sterling area countries as well as with the rest of the world is possible regardless of the country's balance of payments positions vis-a-vis individual countries. Pakistan, for instance, despite her consistent balance of payments deficit with the dollar area, was able to import dollar goods in much larger quantities than her reserves would have permitted. On the other hand Pakistan enjoyed continuous and large surpluses with non-dollars non-sterling countries, without involving any discriminatory treatment from these countries. This was possible since these countries could cover their deficit with Pakistan by their surpluses with the rest of the sterling area.

The working of the sterling system within sterling area is simple. Settlements with non-sterling countries are regulated by the payments agreements entered into by the United Kingdom on behalf of the whole sterling area with several countries and currency unions, like E.P.U. Independent agreements by Pakistan with each of the country outside the sterling area could be burdensome, apart from the many technical and policy operations involved that could throw the whole exchange control system in confusion.

Concluding Summary and Remarks:

Pakistan's balance of payments has been generally unfavourable to Pakistan, despite a policy of strict exchange controls and exchange rationing. The distribution of this balance, however, has been generally conducive to the strengthening of the financial position of the sterling area. Pakistan's payments surpluses have been a useful source of earnings in gold, dollar, and

convertible currencies, while her concentration of deficits largely within the sterling area work to ease the strains on the central pool.

Pakistan, on the other hand, has been enabled to trade in a relatively wider area and with greater ease. The pattern of Pakistan's balance of payments has undergone considerable transformation in the direction of enhanced importance of the non-sterling countries as sources of imports and outlets for exports; but on a multilateral basis, sterling as an international currency has greatly facilitated Pakistan's world wide trading relations.

CHAPTER III

THE RATIONALE OF PAKISTAN'S MEMBERSHIP IN THE STERLING AREA.

The object of this chapter is to investigate the factors that keep Pakistan in the sterling area. The plan is first, to establish the need for Pakistan to join a currency union and then to discuss the benefits accruing to her on account of her membership of the sterling area. The implications of Pakistan joining another currency area (the dollar area) are deferred until the next chapter.

There are two categories of advantages Pakistan derives out of her membership in the sterling area, the advantages that accrue and would accrue to her by joining any currency bloc, and the advantages that flow from her membership in the sterling area. The first category of advantages are of a general nature and are enjoyed by all members of a currency union including members of the sterling area. The latter category of advantages are, however, derived because of the special relationship existing between the United Kingdom and the members of the overseas sterling area.

Advantages from joining a Currency Union.

"A payments union which is a mutual accounting organization and has no other purpose gives clear advantage to those member countries who do not take responsibilities of the Centre. These members can make payments easily to any other country in the world simply by using the banking facilities of the Centre country".⁵¹

(51) A.C.L. Day, The Future of Sterling (Oxford: the Clarendon Press, 1954), P.59

Membership in the clearing union is of particular benefit to those countries which have rudimentary banking systems and relatively under developed markets.⁵² These countries for one thing, cannot afford to maintain working balances in many countries and centres of the currency areas; for another it is very doubtful whether other countries in the world would be willing to accept a relatively unknown currency in the settlement of their claims.

In the events leading up to and following independence Pakistan was bereft of all banking facilities on account of suspension of business and the migration of a large number of banking personnel to India.⁵³ "The number of banking offices declined from 631 just before independence to 213 immediately thereafter."⁵⁴ The dislocation in the banks dealing in foreign trade of the country was even larger. In the event Pakistan had to depend largely on international banking - especially the British banks and their branches in Pakistan - for the conducts of her international trade.

Pakistani rupee is a relatively unknown currency in the world. The invoicing of foreign trade in sterling inspires confidence in Pakistan's ability to meet her international obligations. Besides, implicitly the whole sterling area is backing Pakistan with its total reserves - a factor that greatly facilitates the conduct of foreign trade.⁵⁵

"One of the economic justifications for the existence of the sterling area or any other currency union is that it offers an alternative to rigid bilateralism, when conditions are such that a smoothly working and unified

(52) A.C.L. Day, op.cit., P.59

(53) State Bank of Pakistan, Twelve Years of Banking in Pakistan (Karachi: Feroze Sons), P.1.

(54) Ibid.

(55) David. B.Noursi, Jordan and the Sterling Area (Beirut: M.A.Thesis; Dept. of Economic, A.U.B.), P.

payments system cannot operate.⁵⁶" The aim of the creation of a central clearing union for European payments (E.P.U.) was the settlement of intra union claims on a completely multilateral basis, whereby each country would be left the debtor or creditor of the union as a whole. The union thereby provided a mechanism, like the sterling area, whereby deficits in one country could be settled through a surplus with another.

In a way the above argument could also mean that the sterling area is a symptom of the transition to better functioning world wide payments system in the future. The builders of the European payments system, for instance, clearly anticipated the dissolution of the European payments Union, once fundamental balance in world trading structure was achieved.⁵⁷ The sterling system, however, is much more than a clearing system and though it may reduce in importance, the justification for its existence would persist even under a fundamental balance in international economy. Moreover, until a better and world wide system of payments is devised, the sterling area represents a large area of free trading bloc, and Pakistan as a member of the system stands to gain all the advantages of free trade and payments and of free convertibility ensured through the sterling area system.

As one may see from the discussion of the last chapter, the membership of the sterling area system has made it possible for Pakistan, for instance, to run into consistent balance of payments deficits with the United Kingdom and a Consistent (until very lately) favourable balance of payments with the Continental O.E.E.C. countries. No attempt will be made

(56) A.C.L. Day, op.cit., P.58

(57) W.M. Scammel, International Monetary Policy (London: Macmillan & Co.Ltd, 1961) IIInd. Ed., P.

here to go over the classical advantages of free trade, as this would carry the discussion too far afield; but the scope of multilateralism offered within the sterling area is undeniably to the mutual benefit of the sterling area countries including Pakistan.

An alternative to the membership in a currency union is to manage matters regarding currency and international payments independently. Pakistan's balance of payments position has been unfavourable to her in trade with almost all of her trading partners of any consequence. Pakistan's total deficit during the year 1962-63 was approximately Rs.87 million. On a geographical distribution, the deficit came to about Rs.166.2 million with dollar countries, Rs.167.5 million with the sterling area and Rs.5.9 million with Japan, while Pakistan's traditional surplus with the O.E.E.C. countries was a small figure of Rs.32.6 million after a deficit amounting to Rs 246.3 million during the year 1961-62. The pattern of balance of payments has two very important implication. Firstly, if it were not for Pakistan's membership in the sterling area, she would require much tighter exchange controls to correct her over all payments position, since she can no longer depend on the mutual line of credit. Besides the rigid bilaterism would necessitate the construction of a comprehensive system to maintain a balance in payments with individual trade partners.

Secondly, Pakistan's attempts to manage her currency independently would almost certainly land her into a position where she would have to declare her currency inconvertible in terms of almost every other currency in the world. The readiness of a monetary system to maintain convertibility for current transactions at stable rates can be estimated through the indication of the relationship between claims (money supply) and availabilities (production and reserves).⁵⁸ The money supply in Pakistan increased from Rs.2634 million in December 1948 to Rs.6192 million in October, 1962.

As against this, there was an actual decline in Pakistan's gold and foreign exchange reserves (including sterling assets), which were recorded at Rs.1285 millions in October, 1962 as against Rs.2634 million in December 1948.⁵⁹ The agricultural production in the country has been more or less static, while there has been a tremendous rise in population. The industrial production increased considerably, but in the absence of accurate data, the figures are not dependable. Roughly, the indication is that the ability on the part of Pakistan to maintain convertibility has actually deteriorated. The membership in the sterling area ensures the Convertibility of Pakistani Rupee (subject to the exchange regulations of the Govt. of Pakistan) to the extent the sterling itself is convertible.

Another argument which expresses the convenience of the currency area system concerns the stable exchange rates aspect of the currency areas.⁶⁰ Members of a currency union may fix their exchange rates in terms of a neutral currency or they might fix their exchange rates in terms of the most important currency in the union. The European Payments Union Unit of account is an apt example of the former, while sterling is pertinent to the latter. Rigid exchange rates are by no means a necessary corollary of stability though in the absence of an international balance, pegging the exchange is an effective way to ensure stability of exchange rates.

Pakistan is mainly a primary producing country. The exportable commodities from Pakistan have relatively inelastic supply in the short run and are subject to sharp price fluctuation. It is certainly in the interests of the country to maintain stable exchange rates in terms of the currencies

(59) State Bank of Pakistan, Monthly Bulletins.

(60) Day, The Future of Sterling, P.70

of the countries she trades with, to eliminate at least one source of fluctuations in the real value of her export proceeds. Moreover, in so far as stable exchange rates generate stability into the economy, Pakistan as a developing nation stands to gain, since her heavy outlay on development can be fairly predicted and planned in terms of costs.

Advantages from joining the Sterling Area:

Pakistan's financial ties with the sterling area are very flexible. Pakistan has its own central bank, its own money market, its own tariffs and customs and an independent monetary system. Pakistan's protective duties are in general high enough to deter foreign products both from within the sterling area and outside, from competing with certain protected domestic products. Pakistan, moreover, maintains some of her gold and foreign exchange reserves separate from the central reserves of the Sterling Area.

Pakistan's membership in the sterling area was the outcome of the Financial Agreement of 1947, signed between the United Kingdom and Pakistan on the eve of independence. Pakistan, however, decided to adhere to the sterling area because of strong economic arguments. ^{61/} The problem of the 'sterling balances' was one big factor exercising great influence on the decisions; but again had the sterling area membership been detrimental to the interest of the country, there was nothing to deter Pakistan from terminating this relationship. Iraq had actually done so on 1959, and Egypt did so much earlier, in 1954. It would, however, be wrong to exclude non-economic factors as irrelevant to a decision for or against the sterling area membership. In fact long years of association and the established patterns of trading, together with membership in the Commonwealth were also a great deal responsible in her choice to continue the established links

(61) Andrus and Mohammad, The Economy of Pakistan, P.301

with the sterling area. Relations between countries are not static and the economic reasons always supercede the temporary political expediencies. X
In the final analysis, therefore, only the economic benefits that Pakistan derives from the membership of the sterling area justify her membership in it.

The economic arguments commonly cited in favour of Pakistan's membership in the sterling area are;

The Economies of the dollar Pool.

The genesis of the reserve pool is this: All countries in the sterling area do not need all their reserve. In the short run there are countries that are earning more than their current needs, and there are others who might need these excess reserves since they are spending more than their current earnings. "Each country in the system can allow itself more latitude in its actions with given reserves; or, what amounts to the same thing, it can allow itself the same degree of latitude with less reserves"⁶². To the extent the need and the surplus of such reserves arises in a complementary order, the members of the sterling area afford each other a mutual line of credit.

Monetary reserves have generally three functions. "In a purely domestic sense these reserves may be a prerequisite for an increase in the volume of domestic money-currency and bank deposits. In the international sense, they may be used to finance savings in the balance of payments"⁶³ Monetary reserves, moreover, are claims over real resources from the point of view of the countries holding them and the holding of reserves is only one of the possible uses competing for the limited amount of resources at the disposal of each country. Pakistan, then is a developing country where

(62) Day, The Future of Sterling, P.78

(63) International Monetary Fund, International Reserves and Liquidity, (Washington, D.C., 1958), P.

every bit of resources have to be spent under strictly determined priorities. The membership in the sterling area indirectly helps Pakistan re-channel her resources to more useful purposes of development and enables Pakistan to 'buy security' with lesser reserves. India is another example of a country who has drawn heavily on her resources to finance her development expenditures. India's reserves to imports ratio fell from 146 percent in 1952 to a mere 43 percent in 1957. Were it not for the membership of the sterling area, she would have been far too reluctant to bring her reserves that low.

Another advantage that flows from the membership of the sterling area is that Pakistan can finance larger dollar imports than her dollar earnings permit. Pakistan is traditionally a net deficit country in her international transactions with the dollar countries, and has frequently drawn on the central reserves mostly to buy dollars to settle her balance of payments deficit with the dollar world.

"Reserves have to be higher in an unstable economic and political environment than in a world enjoying a great degree of economic and political stability. Higher reserves are also needed by underdeveloped countries with more volatile levels of exports proceeds and capital imports, than by richer and more diversified economies of the industrial countries."⁶⁴

Pakistan being a developing country needs to keep larger international reserves than does ~~fm~~ a fully developed nation. In the first place the factors that work to create instability like fluctuations in export proceeds are markedly more acute in the case of Pakistan. Pakistan's export proceeds have been characterized by sharp fluctuations because of both fluctuations in volume and of shifts in the terms of trade. Secondly; the priorities

(64) Robert Triffin, Gold and Dollar Crisis (New Haven: Yale University Press. 1961) P.

given to the economic development over almost all other national objectives, and the necessity of meeting targets fixed in these development plans, necessitates the maintenance of larger foreign reserves to compensate for any instabilities in export earning with a view to fulfilling such targets. Moreover, such predominant concern with economic development objective is almost certain to lead to a heavy pressure on foreign exchange receipts and international monetary holdings for two reasons. On the one hand, there is the direct increase in demand for foreign exchange to pay for the foreign currency costs of development projects. These are not expected to be negligible in Pakistan where a good deal of technical and physical know how has to be imported. On the other hand, there is the direct increase in demand for imports generated as an outcome of the possible development of inflationary forces concurrently with and as a result of heavy domestic development expenditures.⁶⁵

A third reason why Pakistan needs to maintain higher reserves is her vulnerability to cyclical pressures. The spiral of prices during the Korean boom, for instance, led to higher incomes and, therefore, higher purchasing power of the growers, which in turn led to a high inflation in the country. The following recession in 1952 was equally acute and resulted in great hardships, owing to strict austerity observed in expenditures, with a view to limit the deficit in the balance of payments. In addition, the huge development outlays themselves inject money into the economy, while 'economic products' of such investments are deferred until these development schemes actually materialize and go into production. Anti inflationary measure then need reserves to finance the import of foreign products to match the money supply generated in the economy.

(65) Elias S. Saba, "The Problems of Currency Convertibility in under developed countries", Middle East Economic Paper (1959), P.82

It is really very hard to test the adequacy of the external reserves of a country. Each country must determine the level of reserves she considers appropriate for her needs. Pakistan's gold and foreign exchange reserves are meant to serve a double purpose; to meet a temporary disequilibrium in the balance of payments to avoid more radical corrective measures like exchange depreciation; they also form part of the currency reserves against the total note issue, which must be backed at least 30 per cent in gold and/or foreign exchange.

One of the tests usually applied to ascertain the adequacy of external reserves is the percentage of such reserves to imports. Pakistan's gold and foreign exchange assets as on 25th October 1963 amounted to Rs.1519 million. The volume of imports made during July-June 1962-63, however, amounted to Rs.3819 million. Applying the above tests, the reserves in 1962-63 came to about 40% of imports. This percentage is considerably low compared to 85 per cent in 1953, 95 percent in 1954, and 128 percent in 1955.

Table XIV compares Pakistan's ratio of reserves to imports to some of the industrially advanced countries of the world, and to India which is generally comparable to Pakistan.

Table XIV

	<u>Reserve To Imports Ratio</u>							
Germany	10	15	31	52	58	53	65	75
Switzerland	150	120	138	150	141	124	107	98
Australia	92	47	52	93	61	39	49	68
India	172	105	102	146	137	127	80	43
Pakistan	126	116	47	85	98	128	89	66

Source: International Monetary Fund, International Reserve and Liquidity,

Appendix Table I, P.101

Table XIV shows a fruitful contrast between Germany, Switzerland and Australia on the one hand, and India and Pakistan on the other. Germany has achieved a level of reserves, where she can allow much latitude in her monetary policies, since she possesses a large cushion of monetary reserves. Switzerland, for the same reasons, has been a high reserve country. Australia on the other hand has had relatively low percentage of reserves. Comparing these developed countries with Pakistan, one can say that Pakistan's level of external reserves are inadequate. Comparing India with Pakistan (whose ratio deteriorated to 29% as against Pakistan's 40% in 62-63) it seems more Pakistan still has some/latitude to draw on her reserves.

"International liquidity is a concept with many facets. In assessing liquidity from the point of view of any individual country, account has to be taken of the various ways in which it may be able to meet, without great embarrassment, a strain on its balance of payments. This will depend not only on the degree of strain and its available cash reserves, but also on the possibilities of mobilizing additional resources and on the effectiveness of the international credit system." 66

Pakistan's membership of the sterling area does not affect the total volume of reserves. The difference it makes is in the confidence of the world in the solvency of the Pakistani Rupee, which in turn enables the government to maintain her foreign assets at a level low enough to be considered 'dangerous' in the context of another country not member of the sterling area.

(66) International Monetary Fund, International Reserves and Liquidity, P.89

To the extent, then, that Pakistan can economize in her foreign reserves, she can divert part of these resources to finance some of her development expenditures.

Trade between Pakistan and the Sterling Area:

Another reason that keeps the sterling area together is the large amount of trade that goes on within the area. The sterling area in this respect occupies a very important position and as a currency area is the largest buyer of Pakistani goods, while a large portion of Pakistani imports also originate from various countries of the sterling area. In 1961, for instance, the sterling area exports to Pakistan amounted to Rs.1012 million which was 33% percent of Pakistan's total imports. Pakistan's exports to various sterling area countries amounted to Rs.773 million 41% percent of Pakistan's total exports during the year.

The facilities available in the city of London for the conduct of foreign trade, namely in the negotiation and financing of documentary bills, is specially important. It was observed by the Committee on the working of Monetary System in Great Britain that the members of the sterling area regarded the money market in London as comparatively more efficient than one, for instance, in New York or Paris. To what extent this is because of habit and long association cannot be determined; but wherever possible, traders in the sterling area tend to prefer the facilities in London rather than New York in the conduct of their foreign trade.

The more important advantage of trade between Pakistan and the rest of the sterling area is the protective shield of discrimination provided by the sterling area system. When the dollar problem was acute, the sterling area discrimination covered both quantitative restrictions and protective duties. The imperial preferences, though not strictly a part of the sterling

✓ area system entitle Pakistan (as to all others signatories to Ottawa agreement) to preferential treatment in respect of import duties levied on certain Pakistani exports. Pakistan, for instance, could successfully compete with the dollar area raw cotton in the sterling area as well as in certain continental markets where there is preference to buy in a soft currency area - like the sterling - in order to effect economy in the use of dollar reserves.

The complementarity of the economies of the sterling area - the United Kingdom and the overseas sterling area - has been an important factor in the continued existence of the sterling area. The complementarity has continued even in the face of a continued change in the economies of both the U.K. as well as the overseas sterling area. As the overseas members of the sterling area have achieved 'light industrialization', the United Kingdom economy has switched to more sophisticated production of the so-called 'science-based products'. Britain, for example, is now an important importer of Pakistani cotton manufactures - cotton yarn and coarse cloth. Only a decade back she used to export them to Pakistan.

Flow of Capital Funds into Pakistan:

The relatively free flow movement of capital funds is another factor making for the cohesion of the sterling area. The supply of capital is an important factor for Pakistan in view of the inadequate domestic capital formation, which can be ascribed to the rudimentary nature of her capital market and low level of per capita incomes.

Foreign private investments generally has not been readily forthcoming in the case of Pakistan. The United Kingdom has been and continues to be the most important source of private foreign investments in Pakistan and accounted for nearly 68% of the total private investments in Pakistan during 1960. The share of the United States, which came next was only 9%.

Table XV shows the British private investments in Pakistan during the period 1957-60.

TABLE XV
BRITISH PRIVATE INVESTMENTS IN PAKISTAN
1957-60

	Total Investments 1	British Investments 2	Percent
1957	18.8	12.4	66
1958	14.1	7.8	55
1959	14.4	18.1	79
1960	10.1	16.1	68

Source: Interim Report Series; Second Five Year Plan: 1960-1965
(Washington, 1963) Vol. III No.1

The British investments before independence were largely concentrated in the parts of the subcontinent now comprising India. The Bank of England estimated the yield on investments in Pakistan during 1947 to be less than ^{67%} one tenth of the figure recorded for India.

The post-war British investment in Pakistan (in the private sector) was made in the main by the Commonwealth Development Finance Co.' and Burmah Oil Co.Ltd, the latter mainly in the share capital of Sui Gas transmission project. The total amount of foreign capital sanctioned for investment in industrial and commercial concerns between 1947 and 1956 amounted to Rs.530 million of which one third was for the oil industry.

As is apparent from Table XV, the British investments in Pakistan have been lately volatile in size. The prospects for the inflow of British

(67) A.R. Conan, Capital Imports into Sterling Countries, P.31

capital in the same amounts are rather uncertain, as Britain has directed her interests to the former British colonies in Africa.

The more important source for the supply of capital funds to Pakistan has been the International Bank for Re-Construction and Development and various aid and credit granting agencies of the United States. The I.B.R.D. granted loans totaling \$ 126 million during the year 1952-58, while the United States credits granted to Pakistan by the end of 1957 amounted to \$ 103 million. This is besides a large amounts of grants made available to Pakistan in the form of technical and commodity aid. The United States grants to Pakistan have been greatly stepped up.

There has been some criticism against Pakistan's continued membership in the sterling area. Some of the arguments used have been of a political nature and thus fall beyond to the scope of this present study. Some of the more pertinent arguments are:⁶⁸

- 1) To attain sufficient freedom of action in the financial aspect of its international economic relations it is very important for Pakistan to build up independent reserves in more than one currency.
- 11) Despite large contributions by some of the overseas sterling area countries towards the central dollar and convertible currency reserves, the mechanism of control rests with the United Kingdom. Again, while the exchange rate of the sterling is important for all the members of the currency area, the authority to regulate it is entirely with the United Kingdom.
- 111) Some of the countries outside the sterling area might discriminate against Pakistan, simply because they have a deficit balance with the sterling area as a whole.⁶⁹

Starting with the first argument, it can be argued that the practice of the sterling area system has changed in that many of the independent members of the overseas sterling areas, including Pakistan, do have independent reserve of gold and foreign exchange; and that the only restrictions on the use of the central reserves have been with regard to dollar countries with whom Pakistan has had consistent unfavourable balance of payments, and that Pakistan, therefore, has always drawn on the Central reserves to meet her dollar requirements.

As for the arguments of trade discrimination, this can work both ways: "indeed, the greatest advantage of the sterling area membership lies precisely in the ability to have trade with countries irrespective of the individual balance of payments relationship with them".⁷⁰ Moreover, the mere fact that in the seventeen years of association with the sterling area no discriminatory measures has ever been directed against Pakistan, serves to dismiss this argument.

The argument of 'the government of the area' has two important facets: Firstly the members of the sterling area realise that the sterling is the currency of the United Kingdom and the overseas members of the sterling area align their currencies with the sterling area simply because they themselves choose to do so.⁷¹ Secondly, the fact that the exchange rate has important bearing on the economy of all the members of the sterling area

(68) For example the Unilateral decision of the U.K., after the outbreak of oil dispute, to deprive Iran of Transferable Account facilities, restricted the ability of members of the sterling area to make payments to Iran; this action has been regarded by some as unwarranted political use of an economic arrangement. Andrus and Mohammad, The Economy of Pakistan, P.299.

(69) Ibid. P.300

(70) Andrus and Mohammad, op.cit., P.300

(71) Ibid. P.301

and that any recurrence of the 1949 devaluation would force the members to have second thoughts on their continued membership in the sterling area. The system of consultations being evolved, however, goes at least partly to allay these fears, and it can be hoped that if there is at all a need for adjustment in the exchange rates of the sterling the step would be taken with prior consultation.

In the section on the evolution of the sterling area system it was pointed out that the sterling area was gradually doing away with its discrimination and evolving into a more flexible and loose association. Pakistan's trade and payments patterns, for instance have gradually shown a drift towards non-sterling countries. With the end of dollar discrimination and the restoration of sterling convertibility, the benefits of the reserve pooling are much less significant. Likewise, as said earlier, the supply of capital from the United Kingdom has been both volatile and less certain.

Concluding Summary and Remarks:

The sterling area in its role as a currency union renders useful services to Pakistan. Particularly, the facilities provided by the very efficient British banking system and the invaluable 'support of confidence lent to Pakistan greatly facilitate her foreign trade.

The sterling in its role as a reserve currency, moreover, makes for stability in the exchange rates and greatly reduces the level of foreign reserves Pakistan would otherwise need to maintain. After gaining a large measure of economic independence through the establishment of national monetary institutions (central bank, commercial banking system etc.) Pakistan's relations with the sterling area have gradually transformed to one more satisfactory to the financial integrity of Pakistan.

CHAPTER IV

PROBLEMS AND PROSPECTS

The object of this chapter is to examine some of the current problems facing the sterling area and to forecast, as far as it is possible, the future of the sterling area and the role, if any, that the sterling area is to play as a part of international monetary system. The latter part of the chapter discusses some problems related to Pakistan's relationship with the sterling area and the prospects of her continued membership.

Any discussion of the future of the sterling area would be incomplete unless viewed from a broader background of world developments. It would be well to recollect here that the sterling area has been essentially a defence mechanism built against the emergencies of the war and strengthened when the dollar problem assumed an aggravated form and the sterling area came under a great threat of complete disintegration. The gravitation of monetary resources towards the United States during and immediately after the war left the world insufficient international liquidity to meet the needs of trade and development. The uneven distribution of liquidity brought a crisis of world dollar shortage.

Some Current Problems of the Sterling Area:

The problem of international liquidity (or illiquidity) raises two very important problems; that of evolving a mechanism which will help preserve a general international balance in payments except for temporary frictional adjustments between countries and between currency unions, and that of the provision of liquidity of an adequate level and appropriate distribution to absorb these temporary imbalances without trade restrictions or other more

radical measures.

The importance of an adequate level of world monetary reserves can hardly be overemphasized. Monetary reserves and economic growth may not be linked in a cause - and effect relationship, but economic growth is liable to be arrested at some point if there is not a parallel, though not necessarily a proportionate growth in monetary liquidity.⁷² When the gold or silver standard were in vogue, the debasement of coinage was an easy outlet of escape from the difficulties of the shortage of liquidity. Paper money was one of the solutions whereby gold and silver could be spared for payments in settlement of international accounts.

The present monetary systems may, but do not necessarily, help in relieving a shortage of world monetary reserves. They do so only to the extent that the key currency countries are willing to let their net reserve position decline through increase in their short term monetary liabilities unmatched by corresponding increases in their own gross reserves.⁷³

The monetary reserves of Great Britain were greatly drained during the war, while she assumed large amount of new obligations in the nature of sterling balances, which formed part of the working balances of the overseas sterling area countries as well as many other countries on the continent. Before the war the ratio of British gold and foreign exchange reserves to her short term liabilities was 1:1, but the ratio deteriorated to approximately 1:3 as the war ended. The establishment of a satisfactory reserves-to-liabilities ratio has been one of the objective of the British monetary policy since the war.

(72) Robert Triffin, Gold and Dollar Crisis, p. 64.

(73) ibid., p. 67.

The reduction of liabilities depends largely on the decision of the holders of the sterling balances to maintain, increase, or reduce the level of their reserves and falls outside the scope of British monetary management, except through an outright repudiation of these liabilities. The other alternative is to increase the total level of monetary reserves. A target figure of £450 million as annual surplus in the British balance of payments has been fixed to build up such reserves, to pay for the reduction of liabilities, and to cover the outflow of capital which goes to finance external investments in the sterling area countries⁷⁴. The target seems unattainable in the near future. The surpluses in the British balance of payments during 1958 and 1959 amounted only to £219 million and £51 million, while in 1960 an actual deficit of £344 million was recorded. The national objective of high incomes and employment and the British obligations towards the sterling area pose rather awkward questions of policy⁷⁵. Considerations of a banking solvency would render a surplus in the balance of payments essential while the objectives of full employment can be pursued only if the external balance is subordinated to the former.

Little reliance could be placed on the prospects of the growth of a sterling liquidity, since the British reserves as compared to short term liabilities are exceedingly low and a constant pressure on reserves has kept London always on nerves against any flight of 'hot money'. There would be, therefore, a strong inducement on the part of Britain to match her liabilities with reserves, so that there would be practically no expansion in the level of monetary liquidity.

(74) Great Britain, Committee on the Working of Monetary System, p. 232

(75) W.M. Scammel, International Monetary Policy (London: Macmillan and Co. Ltd., 1961) IIInd Ed., p. 267.

Another problem which is largely a derivative of the former is the irritant of speculative flights of capital to which sterling has been subject in the past. A satisfactory level of reserves, again, is necessary to build international confidence in the solvency of the sterling area which alone can stem such outflow of capital. The declaration of de jure non-resident convertibility of sterling, along with the softening of the U.S. dollar consequent upon the United States balance of payments difficulties, has greatly increased this confidence in sterling. There has been a marked reduction in the inducement of a switch from sterling to dollar. "Sterling, formerly subject to speculative raids at the slightest tremor of the United Kingdom ~~favorable~~ balance of payments drew foreign funds to London steadily during 1960 whilst simultaneously running an actual trade deficit."⁷⁶ There are, however, no firm grounds to believe that this strength would become permanent. On the contrary the balance of payments of the United States has shown considerable signs of improvement. The United Kingdom brought another interest rate change in 1964, increasing the rate to 5% in 1964. The sterling vulnerability is very likely to persist until a more satisfactory level of monetary reserves has been attained.

A third source of difficulty lies in the availability of capital, which many of the members of the sterling area consider very important in any rationalization of their relationship with the sterling area. The balance of payments situation and the demands on any surplus that the United Kingdom might earn make it very unlikely that the United Kingdom can possibly make available amounts of any considerable extent for the development of the rest

(76.) W.M. Scammel, Op.Cit., p. 398.

of the sterling area. "It is highly likely that the deficiencies of the sterling area become more pronounced because of higher living standards and devotion within the area to welfare state will slow down the rate of savings while the demands of the members of the sterling area for capital for development are likely to expand"⁷⁷. The members of the sterling area are, therefore, pulled in two different directions. On the one hand they would like to insulate their economies from a competitive world under the protective shield of the sterling area, through the imperial preferences, bulk purchase agreements^{and} their existing trade patterns. On the other hand they would want to explore every possible avenue for the availability of capital for development. Such is the dilemma that confronts many members of the sterling area. The sterling area does offer shelter against any immediate difficulties of the balance of payments and the existing distorted cost structure - the natural result of discrimination - but it does not offer a solution of the long term needs of the sterling area for expansion of markets and development of economic resources⁷⁸.

One way to augment the sterling area reserves to meet temporary shortages of liquidity would be to enlist the support of the International Monetary Fund through the grant of a guarantee in the form of a stand - by credit as an addition to the existing reserves to the sterling area.⁷⁹ It would indeed be quite proper for the International Monetary Fund to assist a

(77) Copland, Problems of the Sterling Area: with special reference to Australia, p. 6.

(78) Copland, Op.Cit. p. 24.

(79) W.M. Scammel, International Monetary Policy, 268.

a monetary system, which is carrying the burden of a large percentage of world trade, apart from the essentially identical objectives - of free trade and multilateralism - that the two institutions are committed to bring about in the future.

Mr. A. C. L. Day of the London school of economics, in evidence to the Committees on the working of Monetary system of Great Britain (Radcliffe Committee) suggested a complete or partial transfer of all sterling liabilities to the I.M.F., in the form of a loan to the United Kingdom payable to the I.M.F. over a number of years⁸⁰. Meanwhile, the sterling area countries could continue to use these balances as cover against their currency issues, or for the purposes of clearing payments for current transactions. To the extent these sterling balances would be fully convertible, there would be an equal increase in international monetary liquidity.

A third and a more sweeping solution would be to allow the sterling exchange rate a much wider range of variation. The dismantling of the sterling area exchange controls, which has recently taken place and the reversion of the area from a tightly knit bloc to a loose affiliation of sterling using countries makes a flexible rate^{of} exchange possible⁸¹. A flexible exchange rate, however, is possible under a generally balanced international economy, where a surplus or deficit is the result of short term factors that are self reversing. In so far as the maintenance of a relatively stable balance with the non-sterling world requires a further depreciation of sterling, the step would be highly embarrassing to the overseas members of the sterling

(80) Great Britain, Committee on the working of the Monetary System: Report, p. 241.

(81) Scammel, International Monetary Policy, p. 199.

area including Pakistan, since this would frustrate their investment and development schemes as the dollar or any other currency becomes more expensive. The rate of exchange between the pound sterling and the local currencies in the sterling area have necessarily to be fixed if uncertainties and inconveniences of intra sterling payments are to be avoided. Multilateral clearing of debits and credits would be extremely difficult if the rates of exchange and cross rates between currencies of all the members of the sterling area constantly keep in motion⁸². In addition, the flexible exchange rates within the sterling area would quickly overvalue sterling in terms of many of the currencies of the members of the sterling area and most certainly in terms of Pakistani rupee, which is apparently pegged at an overvalued rate of exchange with sterling as well as dollar. The unofficial rates of Pakistani rupee in free markets of the world is quoted at about 50 percent depreciation both against the sterling as well as the U.S. dollar.

An example of the support by the International Monetary Fund was the financial assistance received by the United Kingdom at the time of the Suez crisis; the drawing of \$561 million together with a stand by credit of \$739 million represented a considerable re-inforcement of the United Kingdom's reserves⁸³. A general stand-by credit could no doubt facilitate trade and payments by greatly strengthening the pound sterling, but would not meet the problem of a general shortage of liquidity and can, therefore, be considered as a measure of interim relief, until plans for a world wide system are chalked

(82) ibid., p. 305

(83) Great Britain, Committee on the working of Monetary System, Report, p. 246.

out on a grand scale and accepted universally. The Triffin plan discussed later in the chapter provides principles for a future international monetary system.

A transfer of sterling liabilities to the I.M.F. cannot be considered very realistic and though increasing liquidity to the extent of the amount of sterling balances falls far short of the world needs. The scheme would involve an internationalization of sterling reserves and supersession of the sterling system by a re-constituted International Monetary Fund. "An arrangement of this kind, requiring international agreement, would be extremely difficult to negotiate and does not appear likely to be of immediate and substantial assistance to sterling; it might, indeed, oblige the United Kingdom to discharge her external liabilities more quickly than would otherwise be necessary"⁸⁴.

Allowing the sterling a greater range of variation would similarly need an international agreement and the amendment of the Charter of the International Monetary Fund.

Problems and Prospects with reference to Pakistan:

The adequacy of Pakistan's foreign monetary reserves was discussed in chapter III. In short Pakistan's reserves to imports ratio declined from 103 percent during 1953-55 to only 40 percent in 1963. As the third five year development plan (1965-70) goes into operation, it can be safely assumed that part of the development expenditures would be met by drawing on these reserves. The inadequacy of monetary liquidity for Pakistan becomes all the more crucial. Pakistan's needs for international liquidity are twofold;

(84) ibid., p. 247..

firstly to meet the deficits in her balance of payments on current account, and secondly in order to finance huge development expenditures. While the sterling area provides some latitude towards the accommodation of Pakistan's current deficits, all the development needs cannot possibly be met within the sterling area and any future development of an institution for the provision of long term credit (like I.B.R.D.) would be highly welcome. Meanwhile, the makers of the sterling policy must try to operate a system which will permit a continuing development of the economies of both rich and poor members and that this development in turn will be translated into at least modest increases in the standards of living⁸⁵.

Another immediate problem facing Pakistan is the proposed entry of the United Kingdom into the European Common Market and its impact on the pattern of Pakistan's foreign trade. The United Kingdom and the European Common Market together accounted for about 36 per cent of Pakistan's total export trade during 1961-62, while the share of the above two groups in her total imports came to 38 per cent. The European Common Market alone accounted for about 20 per cent of Pakistan's total exports and 19 per cent of her total imports⁸⁶.

Under the imperial preferences a large number of Pakistani goods, namely; Cotton yarn, Cotton piece goods, woollen carpets and rugs, jute manufactures, leather and leather manufactures and surgical instruments all enter the U.K. market practically free of all customs duties. The acceptance of the Common E.C.M. tariff by the United Kingdom would be liable to affect Pakistani exports adversely.

(85) Copland, Problems of the Sterling Area; with special reference to Australia, p.

(86) Govt. of Pakistan: Department of Trade Promotion and Commercial Intelligence, Pakistan Trade (Karachi: 1962), Vol. XIII, p. 5.

The common tariffs of the E.C.M. are fixed under a formula taking a simple (unweighted) arithmetic average of the external tariffs of all the member countries. The United Kingdom is a low tariff country and if included under the formula of the common average is likely to keep these tariffs at a low level. It was further agreed between the United Kingdom and the E.C.M. (before the breakdown of the talks on the entry of the United Kingdom in the Common Market) that the United Kingdom would impose such tariffs gradually, to enable countries like Pakistan, India, and Ceylon to make suitable adjustments during the interregnum.

A high percentage of Pakistan's exports to the United Kingdom consists of raw jute, raw cotton, and hides and skins. Pakistan's position in respect of raw jute is one of near monopoly and the incident of an increase in the external tariffs of the United Kingdom is very likely to fall on the Consumers in the United Kingdom.

Heavy domestic demand for raw cotton in Pakistan has left little surplus for exports and the manufacturers should not normally find any difficulty in finding alternate markets because of the efficiency of modern machinery reflected in lower costs.

The manufacturers in Pakistan may face some competition from the associate countries of the European Common Market. Any way, there is little hope of the continuation of the imperial preferences in the future. In fact the United Kingdom at the international Conference on trade currently (May, 1964) holding its sessions in Geneva, has proposed the extension of these preferences to all developing countries.⁸⁷.

(87) "The Economist", (March 21, 1964), p. 1125.

The entry of the United Kingdom into the European Common Market would widen her market for exports with prospective improvements in her balance of payments. This would be welcome, since the United Kingdom would have more funds available for investments in the sterling area countries.

Pakistan's membership in the sterling area has been generally taken for granted as part of her overall political association with the United Kingdom. In view of the growing economic relations with the United States another alternative for Pakistan would be to associate her currency and monetary system with the U.S. dollar. The United States of America has been the largest supplier to Pakistan since 1959. Her exports to Pakistan during 1962-63 (July-June) amounted to Rs. 154.8 crores or about 40 percent of Pakistan's total imports during the year. There has been an 8 fold increase over a decade (1951-61) in trade with the dollar countries, while imports from the United States increased 17 times - in 1962-63 as compared to imports during 1951 - a year when imports into Pakistan were exceptionally high owing to her large export earnings during the Korean boom.

To clear views about 'the dollar area' it might be said at the outset that the term 'dollar area' cannot be used in the same sense as the term 'the sterling area' is applied. The sterling area, for one thing, is much more than a currency union in the sense of a centre for clearing mutual payments of the member countries. The members of the sterling area, in addition, have complementary economies and mutually beneficial trade patterns. The links between the U.S. dollar and the currencies of the other dollar countries, in contrast, are rather in the nature of "dollar exchange standard". It would, therefore, be incorrect to liken the membership in the sterling area to association with the U.S. dollar.

The United States dollar, moreover, is so strong that the currencies linked to it have to accept a de facto subservience to the monetary policies pursued by the United States of America. The monetary policies of the U.S. are guided by the objectives of internal stability of incomes at a high level of employment rather than considerations of external balance in payments.

The absence of a "central reserve pool" in the dollar area would deprive Pakistan of the benefits of the limited line of credit provided in the sterling area system to cover her temporary deficits - very important for a country like Pakistan, which experiences wide fluctuations in her export proceeds.

Finally, in case Pakistan quits the sterling area she would have to settle her deficits with the sterling area in gold or other convertible currencies, which would force her to restrict the relatively free trade, she can now conduct with countries in the sterling area as well as outside.

A proposal which evokes little interest now both in India and Pakistan was the establishment of a rupee area comprised of a customs union and a monetary clearing system - between the two countries. The proposal stemmed from the essentially 'integral economies' of the two countries, which were developed as one country before independence came. The principle behind the scheme was the maximum bilateral trade between India and Pakistan financed in Indian and Pakistani rupees to conserve the earnings of foreign exchange for development expenditures on the import of machinery and equipment.

The aim was to maintain a free flow of goods and capital movements between the two countries. Pakistan, however, could not possibly accept such a scheme which, she suspected, was essentially aimed at maintaining an economic status quo, whereby Pakistan would continue to produce cheap raw materials for Indian industries.

The bilateral payments agreements between the two countries, however, partially fulfill the purposes of a currency union. The bilateral payments agreement between India and Pakistan provides for bilateral settlement of accounts in rupees to a limited extent. Pakistan's payments balance with India has generally been favourable to Pakistan and the accumulations of rupee balances with India (which are inconvertible in a third currency) has been detrimental to the interests of Pakistan. India and Pakistan both have now developed parallel economies. The trade between the two countries has considerably declined and any extension of the payments arrangements into a more formal currency union is ruled out. Any such union moreover, does not help solve problems like the provision of international liquidity or the flow of capital for investments in Pakistan.

The Future of the Sterling Area:

A sterling area developed roughly on the lines of Keynes' international clearing union would be equally impracticable. The creation of liquidity based on the overdraft principle would not be workable as the overseas sterling area countries would quickly exhaust any such overdraft limit, in view of a consistent unfavourable balance of payments of the overseas sterling area with the United Kingdom, developed traditionally and off-set only on the triangular pattern of O.S.A. surplus with the non-sterling countries and the sales of gold production. True, it could alleviate any risks attendant upon any further exchange depreciation of the sterling but, as contemplated in the proposals for an international clearing union, if the United Kingdom was to transfer all her sterling liabilities into a neutral currency like 'bancor', not only would it be beyond her current resources but any such 'bancor' would

not serve an additional purpose⁸⁸ (e.g. provision of additional liquidity) which the sterling does not render at present.

Pakistan's membership of the sterling area has had positive benefits in many respects including mutually beneficial trade and payments arrangements and the economies in her external monetary reserves. The sterling area, however, has not proved a dependable source of capital for Pakistan. Pakistan's membership of the sterling area has not been detrimental to her interests in any way. It would, therefore, be only proper for Pakistan to stay in the sterling area, until a system more beneficial to the interests of the country has been evolved.

It seems likely that the sterling area itself would continue within the framework of its present system of qualified convertibility, much as it did between 1931 and 1939, the strength of its trading links and its payments connections being its main cohesive force⁸⁹. "The sterling area is by no means dead; it is not even moribund. But there is enough reason to believe that its justification is waning; wise policies will realize this, both by refusing to treat the area as a sacred cow which must come before all else by considering now whether better arrangements can be made to obtain its advantages without its costs⁹⁰".

These arrangements, broadly, should concentrate on two aspects of the international monetary system; firstly, finding ways to solving the problem of the general shortage of international liquidity, and secondly, a

(88) 'Bancor' was the name of the international unit of account, which John Maynard Keynes suggested in his proposals for an international clearing union at the Britton woods conference.

(89) Scammel, International Monetary Policy, p. 266.

(90) Day, The Future of the Sterling Area, p. 113.

mechanism to correct more fundamental disequilibrium in payments between the developing and the developed nations.

One possible approach to a long term solution of the problem of the scarcity of international liquidity would be in the internationalization of the foreign exchange components of the world's international reserves, protecting the world monetary system from the instability resulting from speculative shifts from one reserve currencies into another or into gold⁹¹.

The International Monetary Fund as presently constituted, does not possess adequate reserves to meet the world demand. Triffin estimated the monetary needs of the coming ten years (1958-67) to exceed the gold production by about \$5 billion to \$15 billion. The sterling area with its present inadequate reserves is in no position to 'create' any further liquidity. The dollar too has recently faced a consistent unfavourable balance in payments and it is hardly likely that the United States will be willing to further disturb her reserves to liabilities ratio.

~~The fund has also failed to provide any real basis for the correction~~ The fund has also failed to provide any real basis for the correction of disequilibrium in a world committed to objectives of full employment. There are only three ways a balance of payments can be corrected. These are depreciation of currency, deflation of domestic costs, incomes, and prices and direct control of the balance of payments. The fund objectives exclude the third and qualify the first in such a way as to make depreciation unworkable.⁹² At the

(91) Triffin, Gold and Dollar Crisis, p. 71.

(92) An exchange rate depreciation is permitted only when the fund is satisfied of a 'fundamental disequilibrium' in the economy of the country proposing it. Apart from the practical difficulty of diagnosing and distinguishing a 'fundamental disequilibrium' from a temporary disequilibrium, the tedious process of consultation and 'secrecy risks' make the decision a very difficult task.

same time full employment cannot go with a deflationary policy of incomes, costs and prices.

A re-organization of the I.M.F. has been suggested along several lines by many; the more radical among them is one advocated by Triffin. The principles of the Triffin plan in brief are;

- i) Monetary reserves should be held on an international basis and international accounts should be settled on a fully multilateral basis.
- ii) Lending facilities should be based on overdraft principles, i.e., as the reserves increase the lending to deficit countries would also increase thus maintaining the balance in the union.
- iii) Lending should not be without limit. Countries should not likewise, be allowed to accumulate surpluses without limit.
- iv) Fund balances should be stable in purchasing power, fully convertible, and free from any risks of depreciation.
- v) All countries should be obliged to accept the Fund's unit of account in all settlements.
- vi) Ultimately all reserves except working balances should be held with the I.M.F.⁹³.

Triffins proposals to increase the supply of international liquidity to meet the problem of inbalance in payments through an expansion of the I.M.F. deposit liabilities, though sufficient in many cases for a short term adjustment does not solve the problem of a persistent inbalance due to a variety of reasons including inflation, inability to maintain costs of exports and cost of import substitutes in domestic products⁹⁴. It is not suggested that the I.M.F. should actually assume the functions of long term lending,

(93) James W. Angell, "Re-organization of International Monetary System: an alternative proposal". The Economic Journal (London: Macmillan and Co. Ltd., 1961) Vol. LXXI, p. 693.

(94) Scammel, International Monetary Policy, p. 410.

but the need for the development of an institution with adequate funds (and probably active financial support from the I.M.F. together with control in matters of general policy) to look after the more fundamental disequilibrium arising out of under development is clearly indicated.

Whenever an international monetary system roughly on the above lines has been created and to the extent it is successful Pakistan's membership in the sterling area might become less important.

Concluding Summary and Remarks:

The sterling has been a great source of international liquidity. The financial position of the sterling area greatly weakened as a result of huge liabilities assumed by the United Kingdom during the war which reduced the United Kingdom short term liabilities to reserves ratio from 1:1 to 1:3. Another problem that has haunted the British monetary management, as a result, has been the constant danger of any large scale flight of 'hot money' outside London.

The prospects of a monetary system based on the sterling or the dollar are not very bright as the U.S.A. has recently experienced an adverse balance of payments. The general consensus is that the I.M.F. would be the right institution for the provision of international liquidity. As a measure of interim relief to the sterling area many proposals have come for seeking help from the I.M.F. in one form or another. A more radical proposal, which does not rely on assistance from the I.M.F. has been to allow the sterling a wider range of fluctuations.

The problem of the provision of monetary liquidity for Pakistan has been only too acute. The sterling area as a source of supply of capital has not been very active in Pakistan. The problem of the proposed entry of the

United Kingdom in the European Common Market, would necessitate some adjustments in Pakistan's patterns of foreign trade.

Despite its many limitations, the membership of the monetary area has been of great value to Pakistan; in her patterns of trade, in the economy of her foreign exchange reserve requirements, in the facilities provided by the city of London and finally the valuable co-operation attained in the management of Pakistan's financial affairs. Pakistan, then, is expected to continue to be a member of the sterling area in the foreseeable future.

C O N C L U S I O N

Pakistan's relations with other sterling area countries have been remarkably flexible. Before independence Pakistan (or the territories now forming part of Pakistan) were earmarked to produce raw materials for the United Kingdom. There were few industries. Business was dominated by foreign firms whose interests lay in buying cheaply for Britain. Money market was almost non-existent. The banking system was in a rudimentary shape.

On independence Pakistan decided to continue to be a member of the sterling area. Broadly this decision was the outcome of the following considerations.

- i) The dislocation in the economy caused at the time of independence in fact made Pakistan highly dependent on the British banking system, since many of the banks in Pakistan were closed and their head offices transferred to what was now the Indian Republic.
- ii) A high degree of concentration of Pakistan's trade in the United Kingdom made it imperative for Pakistan to continue old established trade and payments arrangements.
- iii) The sterling area in 1947 (at the time of independence) was a discriminating bloc of complementary economies and the membership therein was highly beneficial. Pakistan could successfully compete within the sterling area against non-sterling countries owing to quantitative restrictions imposed on dollar imports, and also owing to the system of imperial preferences.
- iv) It was realized that the best course to utilize the large amounts of sterling balances accumulated during the war was through remaining within the sterling area.

Many of these justifications have been waning; some of them do not exist anymore. The huge accumulation of sterling balances has been used up by and large; whatever remains is in the form of working balances. The dollar discrimination ended with the easing of the dollar shortage and the non-resident convertibility of sterling in Dec. 1958 along with other European currencies

brought the hopes expressed at the Bretton Woods Conference very near to fulfilment. Pakistan's foreign trade is gradually drifting towards non-sterling world - trade with the U.S.A. being the most conspicuous example. Finally, Pakistan has developed some of the paraphernalia - an efficient banking system, a money market and a central bank - for the functioning of an independent monetary system.

Many of the justifications of the sterling area membership have taken on new arguments. One of the justifications for the membership, for instance, may be that there is no alternative course open to her which is equally beneficial. The share of the sterling area in Pakistan's foreign trade may be declining but the sterling area still is the largest importer of Pakistani goods. There are other intangible factors like the 'support of Confidence', the economy of the reserve pooling, the habit of long association, and finally the overall political associations of Pakistan in the Commonwealth.

The sterling area has failed to meet some of the problems facing Pakistan. Pakistan, for instance, has never attracted substantial amounts of foreign funds for investments in Pakistan, but again a large percentage of whatever funds have been forthcoming from private investors have been of the U.K. origin.

The international status of the sterling as the world's reserve currency was wrested by the U.S. dollar as the second world war came to a close. Britain came out from the war as a debtor country owing large obligations to the United States and the overseas sterling area, having lost her traditional status of a creditor country. Most of her overseas investments were washed out

in the process of war finance. The post war monetary problem for Britain had two aspects that were closely related. Firstly, there was ~~the~~ problem of swift switch over from war - time production to production of peace time requirements. This involved rehabilitation and modernization of plants to increase production capacity. Secondly, there was the problem of surplus in her balance of payments to reinforce British gold and foreign exchange reserves to match her huge liabilities consisting in the main of sterling balances. As it turned out, the achievement of these twin objectives proved to be an impossible task. The balance of payments situation brought the devaluation of sterling in 1949. The problem of maintaining a satisfactory level of reserves to liabilities ratio has likewise defied a satisfactory solution so far.

The problem of the provision of an adequate level and appropriate distribution of monetary reserves has been an important factor hindering the growth of multilateralism in world trade. The Bretton Woods schemes failed to produce a satisfactory answer to the challenge. In the immediate post-war period, the United States assumed the responsibility of the provision of
× international liquidity under the Marshall plan. ×

Since 1955 new factors have emerged on the world scene that have brought radical changes in the sources of liquidity and their flow. The United States has consistently lost gold to the rest of the world owing to her persistent balance of payments deficits. All this has very important bearing on a future international monetary system. The sterling caught in its present difficulties of inadequate level of reserves is unlikely to allow an increase in world liquidity based on sterling (not that other countries would like it). The United States dollar, hitherto a significant source of liquidity to the free world in view of its payments difficulties, can hardly

be expected to continue to carry these burdens to the same extent as, for instance, she did in the immediate post-war period.

Despite its many limitations, the membership of the sterling area has been of great value to Pakistan; in her patterns of trade, in the economy of her foreign exchange reserve requirements, in the facilities provided by the city of London and finally the valuable co-operation attained in the management of Pakistan's financial affairs. Pakistan then can be expected to continue in the membership of the sterling area. A re-organization of the I.M.F., along with an institution like the I.B.R.D. for the provision of long term credit, would be highly welcome for the developing countries in the sterling area including Pakistan.

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