How Did They Become Reserve Currencies?

Everyone who has any acquaintance with the international monetary system knows that the pound sterling and the U.S. dollar have a special status as international or key currencies. In this brief history the author describes how they came to acquire this status.

Bo S. Karlstroem

One significant feature of the international monetary system is that most international payments are settled in either U.S. dollars or pounds sterling and that a large share of international reserves is denominated in either of these two currencies. But there is no necessary relationship between these two functions: Germany has a larger volume of trade than the United Kingdom, yet the deutsche mark is not a reserve currency. Nor do the two reserve currencies have much in common with one another. They have quite different origins in their reserve role, different histories, and today they have rather different characteristics. What has been said about the dollar holds true for both the reserve currencies, namely that they “became international currencies neither by Act of Congress (Parliament) nor by Act of God, but rather because they met various needs of foreign official institutions and foreign private parties more effectively than other financial assets could.”


What then were the historical factors which gave these two currencies a particular position? As these factors were quite different in the two cases it is probably wise to look at them separately for the moment.

Nineteenth Century Prosperity of the Pound

The pound as an international currency is the older of the two, having emerged as such in the nineteenth century. There were two major reasons for the predominance of the pound as an international currency in the latter part of the nineteenth century. First, and most important, there was the overwhelming predominance of Great Britain in world trade. This, of course, reflected the particular economic strength of Great Britain as the first country to reap the benefits of the industrial revolution. British industrial goods were in demand the world over, while Britain had a great appetite for raw materials and foodstuffs; it has been estimated that in 1860 the British market was absorbing over 30 per cent of the exports of all the other countries in the world. The
Finance and Development

The trading in goods was accompanied by a wide range of exports of services, such as shipping and insurance, from Great Britain. Intimately connected with these trading activities there was also a large export of British capital to the rest of the world, often with the objective of developing the export potential of Britain's suppliers of food and raw material. A continuous net export of capital between 1848 and 1913 brought up Britain's total net overseas assets to the fantastic amount of nearly £4,000 million by 1913.²

As a result of this great outpouring of sterling for trade and investment around the world, pounds were very widely available, and since many countries had substantial imports from Britain, it was convenient for them to conduct a considerable proportion of their external transactions in sterling. It was also convenient to hold sterling in London as working balances. So, by virtue of Britain's predominance as a trading country, and the consequent pervasive flow of pounds into every nook and cranny of world commerce, sterling acquired a ubiquitous function as a trading currency.

But sterling was held not only as a convenient means of conducting current transactions but also as a buffer against future needs, i.e., as a reserve. In this respect, the function of the pound came to parallel that of gold, which was the traditional main reserve asset. In one respect sterling was even superior to gold, in that sterling reserves could be invested in London and thus earn interest. In fact, in the nineteenth century and up to 1914, London, as the banking center of the world, could provide a much greater variety of savings outlets than any other financial center. In addition, the risks of holding sterling, although higher than the risks of holding gold, were still very small, and this was in time to be true of dollars. The gold standard, or the gold-sterling exchange standard, as some authors prefer to call it, had its heyday in the pre-1914 period. In this period, all major currencies were directly related to and convertible into gold; and the movements in a country's gold reserves influenced directly its internal volume of money and thus its economic activity: such, at


Bo S. Karlstroem, from Sweden, having worked in the British Commonwealth Division of the European Department of the Fund, has recently moved to the Western European Division of the same Department. Before joining the staff in 1964 he worked in Skandinaviska Banken, a Swedish commercial bank. He is a graduate of Stockholm University.

©International Monetary Fund. Not for Redistribution
least, was the ideal behavior under the gold standard. The economic distortions of World War I made it increasingly difficult to maintain the fixed relationships between individual currencies and gold; in addition, the war dealt sharp blows to the British economy, and the pound suffered badly.

The Rise of the Dollar as an International Currency

By contrast, the history of the dollar as an international currency goes back no further than World War I; it was indeed this war that played a key role in establishing the dollar as an internationally used currency. During most of the nineteenth century, the United States had imported capital from Europe. About the end of the century, the United States began to export capital, but only at about the same pace as the continued inflow. During World War I, however, the U.S. international investment position on private account turned completely around, and the United States became a substantial international creditor. In addition, the U.S. Government made credits available to its wartime allies. This swing to a creditor position was reflected in a rapid growth of liquid dollar holdings of foreign official institutions; some of this capital outflow from the United States—which went mainly to Europe—ended up as dollar reserves in the hands of foreign central banks, although most of it was spent again in the course of trade.

Moreover, many European countries introduced various kinds of controls on foreign exchange transactions during World War I, mainly in order to conserve their holdings of dollars; and European central banks stopped converting their currencies into gold on demand, thereby turning away from the gold standard. The United States, however, continued to follow its policy of convertibility. At the end of the war, there was a large pent-up demand from Europe for U.S. goods, and this demand was backed by rather substantial holdings of dollars. The United States was, of course, willing to supply these goods and it was also capable of doing so, not having suffered from the destruction of production facilities caused by the war as other countries had done.

The Interwar Period: Decline of Sterling and Rise of the Dollar

The 20 years between the two world wars
saw turmoil in international financial relations, culminating in the 1929 crisis and the following world-wide depression.³

Much of the financial history of the interwar period revolved around the gold standard and the efforts to restore and maintain convertibility of the individual currencies into gold. This was crucial to the development of the two reserve currencies.

When Great Britain's foreign reserves became exhausted early in 1919, the British ceased supporting sterling at its wartime level and allowed it to fluctuate in terms of gold; all other important European currencies followed the same policy. Only the dollar remained convertible into gold at a fixed price throughout the 1920's. The war destroyed the absolute dominance of the pound, and with the increasing strength of the dollar, New York was partially taking over the role of London.

Through a combination of circumstances, the position of the pound became increasingly precarious during the 1920's. A major reason was the decision in 1925 to re-establish the earlier connection between the pound and gold (i.e., to give the pound once again a fixed value in terms of gold) at the same value as it had had before the war. As a result, the pound became overvalued—i.e., imports became cheap and exports had difficulties in competing in world markets. Moreover, in the late

³ For a discussion of international financial developments in this period, see R. Nurkse, International Currency Experience (League of Nations, 1944).
1920’s, the remarkable strengthening of the French franc introduced Paris as an additional center of gravity in the payments system. Just as the pound, in being linked anew to gold, was overvalued, the new parity for the French franc was such that it made the French currency undervalued when it was linked anew to gold in 1926; the result was a rapid strengthening of the French balance of payments position. In addition, it was the French policy to operate with large gold reserves, and the conversion of French sterling balances into gold was a consequence of this traditional policy that hit the pound at a time when it was already weakening for other reasons. One author concludes that “the biggest failure of the 1920’s was the failure to realize how far-reaching were the changes since 1914 in the environment in which the international financial mechanism had to work. The single most outstanding feature of this environment was the relative rise in the position of America and the relative decline in that of Britain.”

The massive and world-wide depression that followed the financial collapse in 1929 is the subject of a vast literature and most of it is outside the scope of this article. For our purposes it may suffice to note that the depression dealt the final blow to the old gold standard. Great Britain abandoned it in August 1931; some other European countries clung to the fixed gold parity for another few years, but the system as it had existed was bound to die.

The Sterling Area

In the years between the trough of the depression and the outbreak of World War II, two features concern us particularly: the formation of the so-called sterling area and the increasing relative financial strength of the United States.

The origins of what came to be called the sterling area can be traced far back into history. As we have already seen, many banks and businesses abroad were used to keep their liquid balances in London; and the domestic monetary structures of most of what was then

---

the British Empire countries (except Canada) were linked to that of the United Kingdom, either rigidly through so-called Currency Boards or less rigidly through the commercial banking systems. Thus, most of the countries which came to form the sterling area had had close traditional connections and financial links with the United Kingdom for decades. In the financial tumult of the early 1930's there was a group of countries which decided in favor of stable exchange rates with sterling, i.e., a fixed relationship between their currencies and the pound. By 1933, this group comprised all the Commonwealth countries (except Canada), most of the Scandinavian and Baltic countries, plus a few others (mainly in the Middle East); it was at that time a loosely formed group of countries which as a matter of practical policy decided to retain relatively close financial links with Great Britain. The aim of the system was to permit a relatively free movement of goods, services, and capital between the member countries, with sterling as the key currency.

Seen in an historical perspective (i.e., against the background of the weakening of the pound and relative decline in importance of London as a financial center, as well as the deep-seated changes in the world economy which had been reducing Great Britain's economic strength relative to that of her rivals), the sterling area has often been regarded as an essentially defensive mechanism: "The whole period since 1931 is one in which Britain and a group of countries closely attached to her have made attempts to minimize the effects of the outside pressures of adverse economic forces." 5

It has to be remembered, however, that the formation of the sterling area occurred at a time when the world-wide trend was toward higher protection in the form of tariffs and quantitative restrictions on imports and controls of various kinds on capital movements. The sterling bloc in the 1930's was a relatively prosperous segment of a depressed world economy. Its share in total world trade increased, probably to a large extent reflecting the substantial exchange stability and reasonably free movements of goods and capital within the area.

The countries belonging to this loosely formed system (other than the United Kingdom itself and South Africa) held their official reserves almost entirely in the form of sterling (as opposed to gold), a practice which for most of them did not involve any considerable departure from long-standing custom.

The second function of a key currency—as a means of paying for current international transactions (the trading function)—remained important for the pound. Despite the weakening of the relative economic position of Great Britain, sterling remained throughout the world by far the most popular and convenient means of making international payments.

**Increasing Strength of the U.S. Economy**

The turning point for the dollar after the setback in the early 1930's came in 1934, when a new and higher value was adopted for gold in terms of dollars. The $35 per ounce gold parity—which is still unchanged—nearly doubled the value of U.S. gold holdings. After 1934, substantial amounts of speculative funds were shifted to the United States from the so-called gold bloc—France, Switzerland, the Netherlands, and Belgium—in anticipation that these countries would also alter their currencies in terms of gold. The growing threat of war in

---

5 Ibid., p. 36.
Reserve Currencies

Europe encouraged further large shifts of European funds to the United States. Its gold holding rose rapidly and reached $22 billion in 1940, thereby accounting for nearly three fourths of total world-wide official gold holdings. At the same time, the U.S. financial institutions were developed further and the financial markets were diversified. The growing strength of the external position of the United States was accompanied by a growing use of the dollar as a reserve and trade currency. As Table 1 shows, however, foreign holdings of liquid dollar assets, although substantially larger in 1940 than 10 years earlier, were still only about half the size of reserves held in sterling.

World War II had quite different impacts on the pound and the dollar. What happened in these years laid the ground for the international payments system of today. During the war years Great Britain's international financial position deteriorated sharply as it liquidated foreign investments and sold gold. In the post-war period, sterling liabilities to foreigners (i.e., foreign holdings of liquid sterling assets) have been three to four times as large as the British gold reserves. This massive short-term indebtedness, backed by relatively small official reserves, constitutes in essence the problem of sterling balances.

In contrast to that of the United Kingdom, the United States' financial position was little changed during World War II. Some sales of gold and an increase in foreign-owned liquid dollar assets were matched by an increase in U.S. long-term investment abroad. Table 1 shows that by the end of the war, U.S. gold holdings were about three times as large as the volume of foreign-owned liquid dollar assets.

From Dollar Shortage to Dollar Surplus

The United States, then, emerged from the war with a strong external financial position and a domestic economy undamaged, although of course changed, by the war. By contrast, the European economies had suffered greatly from the war; their foreign reserves were run down and their need for imports to rebuild their war-damaged industries was tremendous. Consequently, there was in Europe a strong and, for many years, unsatisfied demand for dollars—"the hard currency." In various ways—through the 1949 devaluations of most European currencies vis-à-vis the U.S. dollar, through successful U.S. programs of assistance, through exceptionally rapid expansion in Europe that attracted private U.S. capital, and through a rather sluggish growth in the United States—the imbalance between the two continents was gradually removed, and in the late 1950's the dollar shortage ceased to be a problem, i.e., official European holdings of liquid dollar reserves had reached a level which was regarded as reasonably satisfactory. Foreign-owned liquid dollar assets increased from $5 billion in 1947 (after having declined from about $7 billion in 1945) to $14.6 billion in 1958. The accumulation of dollar assets of foreign financial institutions—official as well as private—has continued at a rapid rate even after the dollar shortage had ceased to be a problem in the late 1950's. Indeed, the dollar shortage of the 1950's has been succeeded by a substantial dollar abundance—some would even say overabundance. These developments are dramatically illustrated by the fact that foreign liquid dollar assets, or the dollar balances, now exceed the gold reserves of the United States by approximately two thirds, whereas in 1945 gold holdings were about three times as high as the liquid dollar balances; moreover,
a large part of the gold stock is "tied" as backing for the domestic currency circulation. The rapid growth of foreign-owned liquid dollar assets has been the main factor in the postwar increase in total international reserves, or international liquidity as it is often called.

The United States has continued to keep the dollar fully convertible into gold at the price adopted in 1934, while other currencies have retained their formal independence of gold; these currencies' link to gold is, therefore, indirect and goes through the dollar; this system has been labeled a "gold exchange standard." The fact that the dollar has come to have an important place as an international reserve and trading currency reflects not only its direct connection with gold but also, and probably more important, the predominant position of the United States in the world economy. Its share of world commodity trade is approximately 15 per cent, twice that of any other country. U.S. exports of private capital account for over half of total international private capital exports, and the New York capital market is nearly as large as all other international capital markets combined.

The Sterling Area Today

As mentioned earlier, sterling emerged from the war with a large "over-hang" of sterling balances, i.e., official and private holdings of sterling mainly in the overseas sterling area countries, but also in some other countries, which were large in relation to the United Kingdom's own gold and dollar reserves. The benefits and drawbacks of these sterling balances have been intensely debated, particularly in the last few years. Some argue that a large

<table>
<thead>
<tr>
<th>Table 2. World Reserves: Growth, 1951-65</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td><strong>Reserves at End of</strong></td>
</tr>
<tr>
<td><strong>1951</strong></td>
</tr>
<tr>
<td><strong>(In billions of U.S. dollars)</strong></td>
</tr>
<tr>
<td>Gold</td>
</tr>
<tr>
<td>Reserve positions in IMF</td>
</tr>
<tr>
<td>Currencies of which</td>
</tr>
<tr>
<td>Claims on United States</td>
</tr>
<tr>
<td>Claims on United Kingdom</td>
</tr>
<tr>
<td>Other</td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
</tbody>
</table>


1 Covers short-term liquid liabilities to central banks and governments; foreign official holdings of U.S. Government marketable securities; and foreign official holdings of U.S. Government long-term nonmarketable securities for those countries that are believed to include such holdings in their reserves figures.

2 Covers liabilities to foreign central monetary authorities, including inter-central-bank assistance.

3 Excluding Soviet countries and Mainland China.
part of these short-term U.K. liabilities are highly volatile and have posed a threat (of being withdrawn) when confidence in the United Kingdom's external position and in sterling has weakened. Others emphasize the benefit that these sterling balances have given the United Kingdom in the form of common sterling area reserves and also as a basis for the sterling area as an economic unit. Although these short-term liabilities of the United Kingdom have been large in relation to its own reserves, they have not grown, on balance, over the post-war period; rather, there has been some tendency for the sterling balances to decrease over the years. In other words, the United Kingdom's short-term liabilities have not added to international liquidity in the last 20 years. This is in sharp contrast to the massive increase in the United States' liquid liabilities. (See Table 2.)

The problem of the sterling balances should also be seen against the background of slowly loosening ties between the sterling area countries. In terms of exchange control regulations, the sterling area has been a legally defined unit since 1940. But the economic basis of the area that was mentioned earlier in the context of the 1930's—its contribution to freer trade, economic prosperity, and stability both in Britain and in the overseas sterling area—has become less important since the early 1950's, with the gradual freeing of trade all around and the rapid expansion in all the industrial countries. Trading and other relationships among sterling countries have become looser; the share of their total overseas trade which these countries conduct with one another fell from over half in the early 1950's to about 35 per cent in the early 1960's. Overseas sterling area countries have also shown some tendency to accumulate reserves of gold and dollars in addition to sterling. The stock of international reserves denominated in sterling, although still substantial, is now less than half the size of that denominated in dollars (see Table 2). In sum, the role of the pound as a reserve currency and the importance of the sterling area have experienced relative declines in the post-war period.

Yet, while the dollar as a reserve currency is now more important than the pound, sterling remains a major currency in international trade. A large volume of international transactions is financed with credits from British banks and with sterling balances held by overseas residents. Although there are no figures available to demonstrate the quantitative role of sterling as a trading currency, a guess might be made that the share of world trade conducted in sterling is approximately the same as the share of world trade in which the sterling area participates, which is now slightly less than 30 per cent. This guess is based on the supposition that most, but not all, of the international trade of sterling countries continues to be conducted in sterling, and that some minor part of non-sterling area trade is also conducted in sterling. And although the New York financial market is now far bigger than that of London, it is still true that London remains an important financial center, which offers a very wide range of investment outlets and is far more diversified than other European financial markets.

In this brief historical sketch of the evolution of the pound and the dollar as reserve currencies no attempt is made to assess their role in the present international monetary system. The whole framework of international financial relations is being intensely debated, and major changes in the system are under consideration.