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New Zealand's Exchange Rate Regime, the Collapse of Bretton Woods, and the Twilight of the Sterling Area[1]

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Abstract

How did developing countries adapt to the collapse of the Bretton Woods system? Using new archival evidence, we argue that New Zealand offers an interesting case study of decision-making in a small economy dependent on primary production with close economic and political links to two larger partners – Britain and Australia – with divergent domestic policies. After some experimentation, New Zealand adopted an innovative intermediate solution for the exchange rate that aimed to generate stability for primary producers during a period when the direction of trade was diversifying and most currencies were floating. This imaginative policy was not accompanied by comparable changes in reserves management, and until 1975 New Zealand continued to hold the bulk of its reserves in sterling. The article explores the different priorities and institutional constraints affecting the choice of anchor currency and reserve currency in this context.

[1] We thank the RBNZ and Bank of England for access to archival material. Thanks are also due to Gary Hawke and Lyndon Moore for commenting on an earlier draft, and participants at the 2007 Asia Pacific Economic and Business History Conference, Sydney. The research is partly funded by the ESRC World Economy and Finance programme, RES-165-25-0004 and benefited from the research assistance of Niall McKenzie.

> New Zealand has played the sterling game at least as well as, and probably better than, many other countries. We should therefore gain some advantage from our past behaviour.
>
> N.R. Davis, Secretary to the New Zealand Treasury, July 1968.[2]

In the turbulence caused by the collapse of the Bretton Woods fixed exchange rate system in 1967-73, many developing countries were for the first time required to make independent decisions about their exchange rate and reserves management strategies. One such country was New Zealand. In addition to the failure of Bretton Woods, New Zealand had to cope with the prospect of British accession to the EEC, the unravelling of the sterling area mechanism, and the volatility of primary produce prices. With hindsight, these events also provided opportunities to re-shape New Zealand's position in the international economy.

From 1945, New Zealand was part of the sterling area group of countries that pegged to sterling, kept most of their reserves in sterling and enjoyed freer access to the London capital market.[3] Throughout the 1960s Britain sought to wind down the post-war sterling area arrangements, as the burdens of providing a reserve currency and preferred capital flows to the sterling area no longer accorded with Britain's orientation toward Europe.[4] Large external holdings of sterling in the form of reserve assets was popularly considered a threat to the value of the pound and so sterling was caught up in the conundrum of foreign exchange reserves denominated in national currencies that is still a feature the international economy. In this context, the crumbling of the international monetary system compelled New Zealand for the first time to formulate a genuinely independent exchange rate and reserves management policy. We argue that New Zealand offers an interesting case study of decision-making in a small economy dependent on primary production with close economic and political links to two larger partners – Britain and Australia – with divergent domestic policies. Ultimately, New Zealand adopted an innovative intermediate solution for the exchange rate that aimed to generate stability for primary producers during a period when the direction of trade was diversifying. This ambitious and imaginative policy was not accompanied by comparable changes in reserves management. For several years, New Zealand's reserves remained predominantly invested in sterling securities, despite the instability of sterling, the accumulation of non-sterling debt and the diversification of trade.

The optimum exchange rate regime for developing countries has been the subject of a large theoretical literature since the demise of Bretton Woods. During the 1990s, developing countries with weak institutional structures were often encouraged to adopt strong pegs to healthy and stable anchor currencies like the USD, even to the extreme case of adopting a currency board or dollarisation to impose policy discipline and enhance credibility. The opportunity cost of abandoning an independent monetary policy in an environment of globalised capital markets was deemed to be

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

[3] CR Schenk, *Britain and the Sterling Area*, Routledge, 1994. The sterling area included all members f the Commonwealth except Canada, and all British colonies.

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

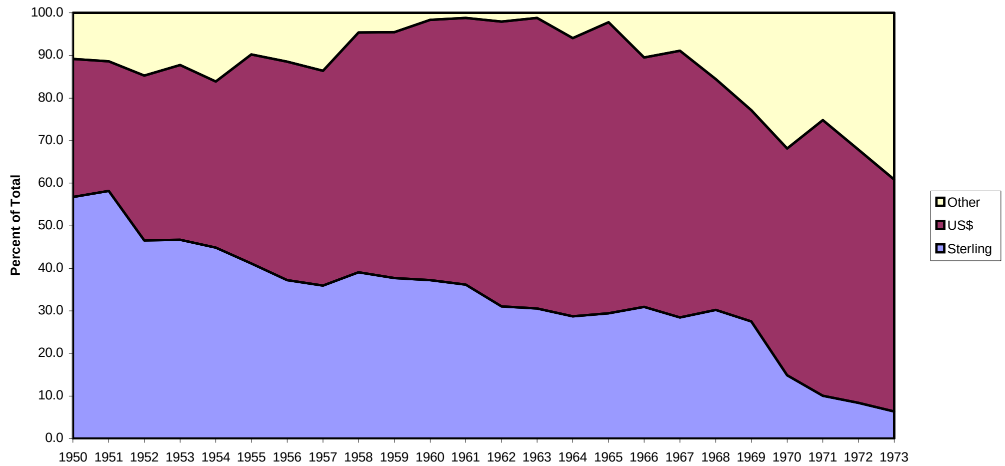
insubstantial. On the other hand, after spectacular crises in the late 1990s many emerging economies abandoned their pegged exchange rates, and adopted inflation targeting with floating (albeit dirty floating) exchange rates.[5]

In the late 1960s and early 1970s institutional conservatism led most developing countries to seek nominal exchange rate stability despite mounting inflationary pressure during the raw material boom of this era. Nevertheless, the collapse of Bretton Woods prompted many to reassess their allegiance to traditional anchor currencies. Anchor currencies share certain properties such as stability, liquidity, and the openness of the pegging country to the anchor country. The choice of reserve currency similarly depends on stability, liquidity and, with a view to avoiding exchange risk, the denomination of trade and debt. The primary roles of foreign exchange reserves in a fixed exchange rate regime are to cushion against fluctuations in the balance of payments and provide debt security. Movements in total reserves also signal to the market about the state's ability to defend the pegged rate. A further consideration in the choice of reserve currency is the real rate of return on assets. Traditionally, for smaller economies most official reserves were denominated in the anchor currency to avoid exchange risk. As we shall demonstrate, however, decisions over the anchor and reserve currencies were not coordinated in New Zealand, and the liquidity and rate of return on assets was an important determination of this divergence.

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

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

Fig 1: Denomination of World Foreign Exchange Reserves



In the 1950s exchange controls on current and capital account increased the network externalities of holding sterling reserves and pegging to sterling, but these receded with liberalisation of commercial payments in the 1960s. With regard to stability and liquidity, in the 1960s the credibility of the pound was repeatedly under threat and the market value of many British government securities sank well below face value. Moreover, as Britain's share of world trade declined and the capital market in the USD (and DM) expanded, the benefits of holding sterling reserves further receded. What is perhaps most surprising is that sterling was an anchor currency for so many countries (34 currencies in 1968) for so long. On the other hand, by the mid-1960s abandoning sterling was complicated by the weakness of the USD and the US balance of payments, which rendered it an unattractive alternative. While sterling declined as an international reserve asset throughout the post-war period, this process was uneven and the tipping point did not come until 1970.

Eichengreen explains the persistence of sterling reserves as 'a matter of loyalty by members of the Commonwealth and by British colonies with limited choice in the matter'.[6] This works best for the 1940s, since by 1961 most colonies had achieved independence, just when the pace of sterling's decline as a reserve currency slowed down. Eichengreen also cites the fear that by dumping sterling, the health of the British economy (on which many members of the sterling area depended) would be undermined. A more immediate practical issue was the threat to the value of remaining sterling assets if diversification pushed sterling off its peg.

New Zealand's policy-makers certainly invoked loyalty to sterling in their internal discussions and negotiations with the UK. As the quote at the start of this article suggests, they considered themselves a more 'loyal' participant in the sterling area than many other countries that diversified their reserves prior to the 1967 devaluation, and expected to be rewarded by the UK with an advantageous settlement over the extent of future reserves diversification. Nevertheless, historic ties with the UK had become strained from the beginning of the decade by the British commitment to join the EEC, which threatened the protected market for many of New Zealand's

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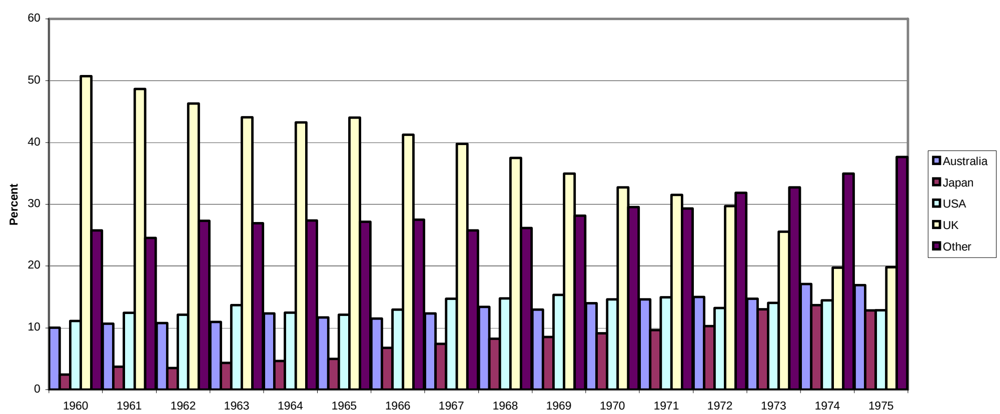
[6] B. Eichengreen, *Global Imbalances and the Lessons of Bretton Woods*, MIT Press, 2007. p. 134.

staple exports.[7] While Japan had overtook the UK as Australia's largest export market by 1965, New Zealand continued to be more reliant on the British market, although this dependence was decreasing inexorably from 1960, as is evident in Figure 2. The declining share of the UK in New Zealand's total trade (imports plus exports) was accompanied by diversification towards 'other' markets as well as towards the USA, Japan and Australia. The UK absorbed half of New Zealand's exports in 1965 but only about one third by 1971. New Zealand's links with sterling were further stretched by the deliberate increase in non-sterling national debt, particularly in DMs and USD dollars from 1965. From 1968, New Zealand imposed a ceiling of 8% payable on new foreign debt, and thus priced itself out of the London sterling market.[8]

Fig 2. Share of New Zealand's Total Trade



Source: www.stats.govt.nz

Figure 2 shows that Australia did not become New Zealand's second largest trading partner until the early 1970s, but the exchange rate between these two countries was already an important variable for New Zealand. Plans for structural diversification depended on the Australia market, which was the sole external outlet for New Zealand's manufacturers. That Australia competed in many third markets (e.g. for wool) also made the AUD/NZD exchange rate an important policy issue.

Exchange Rate Policy

The evolution of New Zealand's exchange rate policy reflects the essentially conservative nature of the governments during the 1960s and 1970s, and their emphasis on direct controls over the economy. This was also a period of consensus between the central bank and the Treasury, who shared responsibility for international monetary policy. By contrast, in Australia, the relationship between the central bank

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

[8] 'New Zealand borrowing on the London market', 8 July 1968. PRO T295/884. In 1966 and 1967 New Zealand borrowed the equivalent of USD286m in non-sterling debt from IBRD, IMF, BIS, RBA and the Eurobond market and USD75.6m in sterling.

and the Treasury was often less harmonious.[9] Faced with fluctuating primary product prices, Ministers sought to ensure stability for producers' incomes, partly through manipulation of the market price and partly through step-change exchange rate adjustments. Paradoxically, this approach led New Zealand to enter the era of floating exchange rates with an innovative solution to its particular challenges as a primary product producer endeavouring to diversify its economy, at the same time as facing a much larger rival – Australia – and a declining traditional outlet for its exports. An adjustable bilateral peg, first to sterling and then the USD, was tried, but ultimately failed to achieve the goals of domestic price and income stability given swings in the balance of payments and global instability. A fresh compromise system was introduced from early July 1973 that sought to achieve effective exchange rate stability for New Zealand producers at a time of global imbalances.

Initially, nominal exchange rate stability was the dominant priority. In November 1966, for example, the Reserve Bank of New Zealand (RBNZ) asserted in correspondence with the Federated Farmers that freeing the NZD would create uncertainty for traders, producers and overseas investors, and that the foreign exchange market was too shallow to support a more active policy. Floating the NZD would not resolve inflationary pressures and so tight direct controls on the economy would have to continue anyway.[10] These arguments against floating persisted until 1985.[11] As the balance of payments deteriorated in response to falling wool prices, however, the government made plans in mid-1967 to devalue against sterling, possibly by 20%, to restore farm incomes. Facing externally determined prices, the government sought to manipulate domestic currency incomes through exchange rate adjustments. These plans were pre-empted by the devaluation of sterling in November 1967, which provided New Zealand with the opportunity to join the general readjustments that followed. New Zealand devalued against the USD and AUD by just under 20%, and against sterling by just over 5%. At the time the RBNZ and Treasury thought that a further devaluation might be required soon, but they were reluctant to go further than the IMF was likely to accept without demanding a relaxation of import controls.[12] A turnaround in the balance of payments soon banished these fears.

In contrast with 1967, by the time of the next international monetary crisis in 1971, New Zealand was accumulating an inflationary surplus. In the meantime, the adjustable peg system had been threatened by repeated changes in parity in Europe (and a period of floating by the DM) and commentators had begun to advocate greater flexibility in terms of wider bands or crawling pegs. The New Zealand Treasury, however, remained a firm believer in the merits of the pegged exchange rate system, as was made clear to the IMF in July 1971 on the eve of the Nixon Shock: 'In our

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[9] John Singleton (2006). 'The Central Bank and Government Partnership in Australia and New Zealand since the 1930s', in Gordon Boyce, Stuart Mcintyre and Simon Ville, eds, *How Organisations Connect: Investing in Communication*, Melbourne, Melbourne University Press, pp. 100-22.

[10] RBNZ Box A0371, File 466. Memo by Governor RBNZ to General Secretary Federated Farmers of New Zealand, 3 November 1966.

[11] John Singleton with Arthur Grimes, Gary Hawke, and Frank Holmes (2006), *Innovation and Independence: The Reserve Bank of New Zealand, 1973-2002*, Auckland, Auckland University Press, pp. 82-7.

[12] RBNZ, Box A0371[?], Box of Miscellaneous papers: file on 1967 Devaluation, 19 November 1967,

view the need to provide stable exchange rate for trade purposes is paramount.'[13] On the other hand they did accept that smaller, more frequent changes in parity might avoid prolonged bouts of overvaluation (e.g. of sterling) and undervaluation (e.g. of DM). At the 1970 IMF meeting, the New Zealand representative indicated that a small widening of margins around parities could be tolerable, but that greater flexibility would need careful justification and floating should only ever be temporary. The Treasury concluded in mid-1971 that: 'Without being unduly rigid … it is suggested that we should continue to be cool (if not actually opposed) to even a limited (and general) widening of margins'.[14] Wider margins would have an exaggerated impact on New Zealand since the USD parity was maintained via sterling, so margins of as little as +/- 3% would mean fluctuations of up to 6% against the USD. The bilateral peg with sterling was thus beginning to be identified as a problem for New Zealand in these more uncertain times.

The RBNZ agreed with the Treasury's assessment of New Zealand's interests in the debate over more flexible exchange rates, in a memo written only four days before the Nixon Shock. The peg to sterling had served New Zealand well, but movements in the £/USD rate were reflected in New Zealand's exchange rates with the USD and other currencies, and 'under a system of more flexible exchange rates there would, of course, be scope for greater movement which could have the effect of producing an undesired deterrent to exports and a stimulus to imports, or vice versa. This would create internal economic management problems.' The RBNZ's view was more sympathetic to flexibility as they believed that while New Zealand's interests would be best served by a 'continuation of the par value system as it stands at present. If there is a consensus for a widening of margins by a further 1 to 2 per cent and/or a provision for temporary deviations from par for individual countries, we should support these proposals' but only because they would be unlikely to do much harm rather than because they would do any good. A regime of floating exchange rates was objectionable for the same reasons as greater flexibility, and was also unsuitable for New Zealand because of large seasonal fluctuations and the weakness of local institutions, in particular the shallow market for NZD:

> From New Zealand's own point of view it would be administratively difficult (but not impossible) to operate a system of flexible exchange rates. Rates might be fixed daily but daily transactions are so erratic that it would be difficult to establish a rational basis.[15]

The policy environment changed abruptly shortly after this position was developed, when the USA suspended convertibility on 14 August 1971. At this juncture, New Zealand was one of many countries hoping for a speedy decision on the future of the international monetary system. Like other small members of the IMF, it was

[13] RBNZ Archives, Box A0371, File 466, Cable: Wellington (Tsy) to Washington (for L.G. Brand – IMF Exec Director), 19 July 1971.
[14] RBNZ Archives, Box A0371, File 466, Draft notes for discussion: International Monetary System, drafted by D. Stacey [Tsy], 29 June 1971, p. 3.
[15] RBNZ Archives, Box A0068, File 50, Memorandum for the Directors: Exchange rate adjustment, 11 Aug 1971.

concerned 'to see the major decisions … being made without their participation.'[16] In the end, an interim global resolution did not emerge for another four months, but at least this period of uncertainty allowed the RBNZ and Treasury more time to review New Zealand's position.

An RBNZ memo set out the prospects for the international system and the implications for New Zealand. It was still unclear whether the world was moving towards a regime of floating exchange rates, or whether Bretton Woods would be patched up. However, the Bank felt that the government should consider five main factors when formulating its exchange rate strategy:

- The relative weighting of the major countries in total exchange transactions. They calculated that 42% of New Zealand's total exchange transactions were with the UK, 16% with Australia, and 18% with the US and Canada.
- 'The traditional relationship with sterling which has on the whole served us so well in the past.'
- 'Special need of our non-traditional exports on which we rely for so much growth in total export receipts.'
- Implications for agriculture.
- Effects on cost of living.[17]

The first two considerations pointed toward a continued close relationship with sterling, while the last two re-asserted the importance of the exchange rate for export prices and incomes. The third point emphasized the diversification of the economy, which depended on the Australian market and the competitiveness of exports in other markets, and this proved decisive in New Zealand's response to the Smithsonian Agreement.

Maintaining an unchanged peg against the devalued USD was not considered, as this would have implied a significant inflationary devaluation against other currencies. Floating freely was still off the table. The choice was between following sterling or the AUD. The RBNZ expected sterling to be revalued against the USD by more than the AUD. Thus, if the NZD stuck with sterling, it would experience a small effective revaluation against the rest of the world. If New Zealand went with the AUD, however, it could expect a small depreciation against the rest of the world. The report concluded that, 'there is not much in it either way, but it is presumably better to have a small devaluation than the opposite', implying that the NZD should follow the AUD despite the slight inflationary dangers.[18] In the end, the AUD and sterling appreciated equally against the USD, so this was not a deciding factor, but the discussion does reveal the growing importance of the AUD in the Bank's planning.

After months of negotiation among the G10, on 18 December 1971 there was a major currency realignment (the Smithsonian Agreement), prolonging the death throes of the Bretton Woods system. The IMF agreed that rates could fluctuate on either side of the new par (or central) rates by up to 2¼% (as opposed to 1%).

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[16] RBNZ Archives, Box A0068, File 50, The Confusion in International Finance (Report on IMF Annual Meeting, September 1971) [undated, for 14 Oct RBNZ Board meeting].
[17] RBNZ Archives, Box A0068, File 50, Memo for the Directors: The future of gold and par values [undated, Sept or Oct 1971], Appendix.
[18] Ibid.

Countries who wished to peg to sterling or another third currency could do so within narrower bands of 1%, leaving a combined maximum margin against the USD of 5½%. New Zealand, Australia, and Britain all chose to retain their existing gold parities, and thus revalued equally against the USD. This continuity masked a fundamental change, however, since the NZD ceased to be pegged to sterling and adopted the USD as its intervention currency.

As presaged by the Treasury in correspondence with the IMF in July, New Zealand could not tolerate the peg to sterling in the context of wider margins for gold parities. This was made certain when Australia declared the USD (not sterling) as its intervention currency. With effect from 23 December, Australia began its peg at the bottom of its margin against the USD, which allowed maximum room for appreciation and New Zealand followed. The choice of intervention currency for New Zealand was thus determined by the new wider margins rather than as a result of a general loss of confidence in sterling or greater confidence in American economic performance. This is confirmed by the continuation of sterling as the main reserve asset. If New Zealand had chosen to retain sterling as its intervention currency, the cross-rate between the NZD and AUD could have fluctuated by up to 5½%. Instead, ministers accepted the advice of the RBNZ and followed Australia's lead, using the USD as its intervention currency to maintain an indirect peg to the AUD, and moved to the bottom of the permissible margin against the USD.[19] The RBNZ justified the new policy publicly as follows:

> In view of the developing trade in manufactured exports [with Australia] a fluctuation of this magnitude [i.e. up to 5 ½%], which could not be controlled by New Zealand, was clearly undesirable. Accordingly it was decided to follow the same policy as had Australia, in order to maintain a fixed relationship with that country.[20]

Even though one third of New Zealand's trade and 42% of its total exchange transactions were still with the UK, the combination of Australian and US trade together comprised almost one third of transactions. Moreover, the Australian market was vital to the programme of structural diversification. Pegging to the AUD directly was not a viable option because of the shallow and illiquid market in AUD assets to intervene in the exchange market. At the end of these months of uncertainty, the RBNZ concluded that 'The estimated overall effect of the changes in exchange rates over the period from pre-August 17th to the present time (after weighting by the volume of current account transactions with each country) is negligible.'[21] One new outcome, however, was that the effective exchange rate became a more important indicator through the deliberations of autumn 1971.

The next shock to the system arose when sterling was floated in June 1972. Given the preference for exchange rate stability with the AUD, the British float seemed to vindicate New Zealand's decision to link to the USD. Figure 3 shows that,

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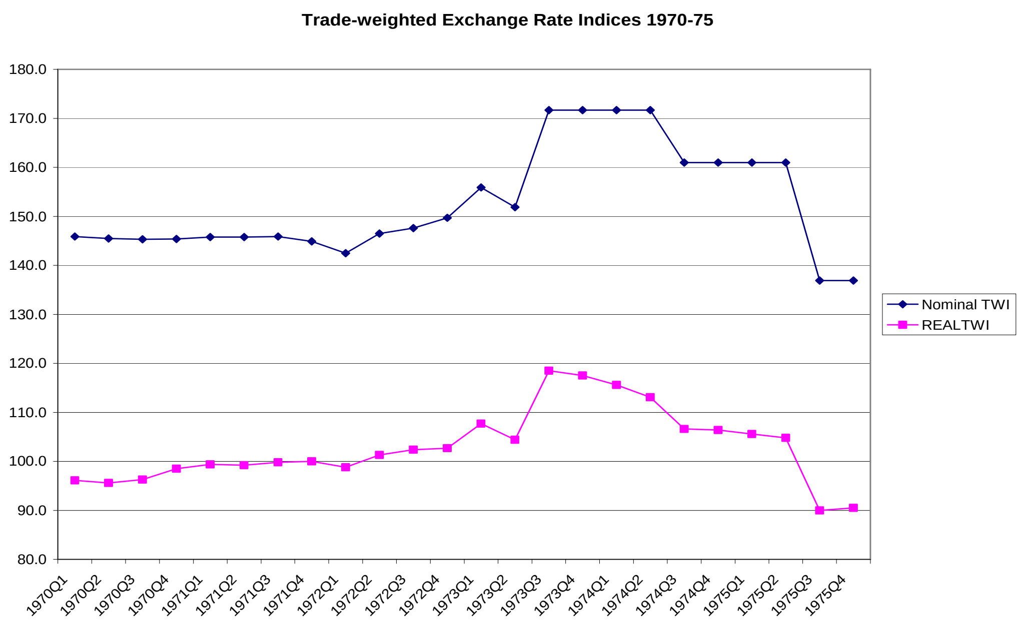
[19] Roderick S. Deane, Peter W.E. Nicholl, and M.J. Walsh,, eds (1981), *External Economic Structure and Policy: An Analysis of New Zealand's Balance of Payments*, Wellington: RBNZ, pp. 142-3.

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

[21] Memorandum for the Directors: Currency Realignment, 5 Jan. 1972. RBNZ Box A0068.

while the nominal bilateral rate to the AUD and USD remained fixed, the trade-weighted NZD exchange rate began to appreciate as sterling depreciated. Figure 3 also indicates that an alternative strategy of pegging earlier to a nominal trade-weighted exchange rate, would have had similar results to the actual policy of pegging to the USD, at least until June 1972, although in real terms there was a slight appreciation. After sterling began to float, however, the bilateral peg to the USD allowed an appreciation of the trade-weighted index without changing the parity. Pegging to a trade-weighted basket after June 1972 would have led to a gradual depreciation, in view of sterling's downward float, which would have enhanced the inflationary pressures that plagued the economy.

Figure 3: Trade-weighted Exchange Rate Index 1971-75



Source: RBNZ, indices based to a long run average = 100

In December 1972, in response to a robust trade surplus and large speculative capital inflows, Australia revalued by 4.85% against the US dollar (and effectively by 7.05% against the NZD). New Zealand too enjoyed a strong current account performance during the commodity boom of the early 1970s, and its own reserves approached record levels. Though tight capital controls restrained the speculative element for New Zealand, the government was still faced with the decision of whether or not to follow the Australians. On the one hand, a revaluation would help to dampen inflationary pressure. But, on the other hand, the NZD had already appreciated by about 4% since sterling had begun to float, and it was not clear that a further revaluation was warranted, especially in view of the impending shock to the farming sector from Britain's entry into the EEC in January 1973. The RBNZ counselled the government to take no action, and thus gain a short-term trade advantage over Australia. In contradiction of the advice offered at the end of 1971, the central bank now argued that, as Australia was not yet a dominant trade partner, retaining the fixed parity with the AUD was not a matter of general principle. Ministers accepted this advice.[22]

In the wake of these developments, the Reserve Bank Governor, Alan Low, met with Minister of Finance, Bill Rowling in early January 1973. Low expressed sympathy for a policy, not of floating, but of more frequent small changes in the exchange rate (a crawling peg). The minister, however, was unconvinced. He asserted that 'exchange rate changes were bound to hurt someone, and they were not worth making if they were only small – he thought about 7 per cent would be the minimum change worth making'.[23] The central bank was thus toying with a more actively managed and interventionist exchange rate regime after the sterling float and the break with the AUD, but it would take repeated shocks to the USD to convince Ministers that a more dynamic and independent approach was warranted.

The next shock came when the US devalued unilaterally by 10% in February 1973, marking the end of the Smithsonian Agreement. This time New Zealand and Australia stuck to their existing gold parities and appreciated against the USD to a new pegged rate. The following month most countries in Europe and Japan abandoned their fixed exchange rates against the USD and in the second quarter of 1973 the trade weighted NZD exchange rate appreciated. Given New Zealand's persistent external surplus and domestic inflationary pressure, officials began to argue that the NZD should no longer be tied to a weak currency, such as the USD. The combination of the boom in primary product prices and the slide of the USD exposed the dangers of pegging in the new environment of generalised floating. The repeated USD shocks and mounting current account surplus finally convinced Ministers of the merits of the RBNZ's preference for a more managed approach to the exchange rate, although there was still no support for a freely floating rate.

Within the RBNZ, thinking on exchange rate strategy evolved considerably during the early months of 1973. The NZD was now in effect floating against all currencies except the USD and those currencies fixed to USD. This was an uncomfortable position to be in, considering the authorities' aversion to floating, and given that it entailed depreciation at a time of persistent balance of payments surplus. Also, it was certainly easier to make a change in the regime when in surplus rather than being forced off a peg by a deficit. The priorities expressed by the RBNZ emphasized their desire for a more independent policy, although Australia remained a consideration. They were to:

- 'Make our own decisions
- Don't depreciate when we should if anything be appreciating
- Reasonable certainty for traders
- Coordination with Australia'[24]

To restore stability required a more flexible relationship with the USD either by fixing the rate daily, aligning with sterling or another currency instead of the USD,

[22] RBNZ Archives, Box A0081, Draft memo: Revaluation of the Australian dollar, 8 Jan 1973; Box A0384, Press statement by Min of Finance (W.E. Rowling), 23 Dec 1972.
[23] RBNZ Archives, Box of Miscellaneous Papers: Interviews with Minister of Finance 1937-1979**,** File note: Interview with W.E. Rowling, 9 Jan 1973.
[24] Handwritten note, undated, RBNZ Box A0096.

or allowing the NZD to float freely with its value determined by the market.[25] The last option was rejected because of the shallowness of the market for NZDs against most other currencies. The RBNZ already intervened in the local market for USDs, sterling and Canadian dollars, but would have had to extend this intervention to a range of other currencies of which it did not have adequate liquid supplies. As for the second option, sterling was accepted as a logical currency to align with, since the UK was still New Zealand's largest trading partner; nevertheless, this option was not elaborated. The first option received more detailed attention. In order to set a daily USD rate, the RBNZ 'would have to take into account the effect of any movement on the rates of our other trading partners. This effectively means we would need to set the value of the N.Z. dollar in relation to sterling or Australia or some other currency and then work back to US/NZ.' This statement shows the beginning of a solution where cross rates would be used to set the USD/NZD rate. This quickly evolved into a recommendation to revalue and then 'make daily adjustments to US rate to stabilise (or alter as desired) the average value of $NZ – package'.[26] Meanwhile, at the end of June, an Australian paper outlining the benefits of pegging to a basket of currencies was made available to the RBNZ.[27] It is not clear whether this was before or after the RBNZ deliberations outlined above, but this shows that a basket was under consideration on both sides of the Tasman.

Finally, on 6 July 1973, the RBNZ set out its recommendations for ministers, and these were implemented three days later. The NZD was revalued by 3.25% against the USD (and the AUD), and the government announced that henceforth the NZD would be fixed in relation to a weighted basket of currencies instead of the USD alone. This marked a compromise between the desires for greater flexibility in the new environment of floating exchange rates, and for a stable rate to accommodate domestic producers. The records of the RBNZ suggest that this innovative decision was prompted by frustration at the difficulty of maintaining exchange rate stability against a range of currencies at the same time as the USD, given the dollar float. Using a basket allowed for a more dynamic and practical strategy that could moderate fluctuations in exporters' incomes and curb the depreciation arising from the peg to the USD. It also marked a return to sterling as an important part of exchange rate determination.

Although ten currencies were in the initial basket, four – sterling (40%), the USD (18%), the AUD (20%) and the yen (11%) – dominated the initial weighting.[28] These ratios reflected the share of total exchange transactions on current account with each country and were very close to the weights suggested in October 1971. Sterling's share in the basket was much higher than the proportion of trade with the UK (which was only 25.5% by 1973) which suggests that there was more to the weighting than merely wanting to stabilise primary producers' incomes. An increasing proportion of New Zealand's debt was denominated in USD and DM, but sterling still accounted for the bulk of external liabilities. A further merit of the

[25] Handwritten note, undated: 'Float of N.Z. dollar', RBNZ Box A0096.
[26] Handwritten note, undated, RBNZ Box A0096.
[27] Memo: Australia's exchange rate: breaking the rigid link with the U.S. dollar, 29 June 1973 (an Australian document, supplied by Bob Johnston), RBNZ Box A0384
[28] UK 40%; US 18%; Canada 2%; Australia 20%, Japan 11%; W. Germany 4%; France 2%; Netherlands 1%; Italy 1%; Switzerland 1%.

basket mechanism was its flexibility and obscurity, as the RBNZ advised the Ministry of Finance:

> The proposed procedure leaves all our options open. The “basket” formula can be modified at any time; the calculations can be “shaded” to allow for special situation [sic], and if a decision is later made to move our “anchor” up or down (devaluation or revaluation) we are as free as ever we were to act.[29]

Details of the components of the basket were kept secret to allow them to be changed without affecting market sentiment and to confound speculators. Weights were adjusted annually in response to changing patterns of transactions. Even IMF officials were rebuffed when they asked for details, although they welcomed New Zealand’s innovation as ‘appropriate… both from a domestic and an international point of view’.[30] Indeed, they praised the scheme as ‘both ingenious and appropriate, bearing in mind our overall economic situation at the time and the general state of exchange markets overseas.’[31] Obscurity and flexibility are attributes of a basket currency that still have great appeal, for example for China. Given that the rate was no longer fixed against any particular currency, the basket was considered a float from the perspective of the IMF. But (dirty) floating was in any case the norm by this time and New Zealand was one of several nations to begin pegging against a basket of currencies in 1973. The others were Cyprus, Finland, Malawi, Malta and Morocco. New Zealand was arguably the most important country to adopt this system, and its version of the basket mechanism was distinctive, involving daily adjustment to the exchange rate for the USD to compensate for changes in the value of the basket.[32] Initially the rate was managed to keep in line with the rates that prevailed on 15 February, immediately after the latest USD devaluation.

New Zealand’s new policy was attractive to Australia’s central bankers, but not to officials in the Australian Treasury, who believed that a peg to a single currency was more likely to encourage monetary discipline at a time when ministers appeared dangerously expansionist.[33] The adoption of the basket in New Zealand therefore reflected the close relations between the Treasury and the central bank in Wellington and their consensus on the continued need for direct controls, as well as the economy’s greater dependence on primary production. Australia maintained its unilateral link to the USD, but revalued by 5% in September 1973. New Zealand responded immediately with 10% revaluation against each currency in the basket (although the revaluation against the AUD was of course smaller). Figure 3 shows

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[29] RBNZ Archives, Box A0068, File 56, Memo for the Minister of Finance: Revaluation of New Zealand dollar: supplementary notes, 6 July 1973.
[30] IMF Memo: New Zealand – Exchange Rate System, prepared by European Department, July 10, 1973. RBNZ Box A0096.
[31] IMF Consultation 1973, Meeting re Exchange Rates, 7 Nov 1973, RBNZ Box A0096.
[32] IMF Annual Report on Exchange Rate Restrictions 1973. For details of New Zealand’s basket arrangement see Deane, Nicoll and Walsh, *External Economic Structure*, pp. 147-8.
[33] RBNZ Archives, Box A0384, RBA Memo: Australia’s exchange rate: breaking the rigid link with the U.S. dollar, 29 June 1973; Handwritten notes of visit to RBA, July 1973. C. B. Schedvin (1992), *In Reserve: Central Banking in Australia, 1945-75,* St. Leonards, NSW: Allen & Unwin, p. 493.

that, over the next 12 months, the real exchange rate depreciated, although the nominal trade weighted index was kept steady.

From the fourth quarter of 1973, the appreciation of the USD in response to the oil crisis, combined with the collapse of the non-oil commodity boom, weakened the external positions of both Australia and New Zealand, and ultimately prompted Canberra to accept that a basket was a more workable form of peg. In September 1974, the Australians devalued by 12%, and introduced the basket. New Zealand reacted defensively and devalued by 6.2% against its own currency basket.[34] The New Zealand authorities stated that their 'decision … was taken in view of the recent fall in farm incomes and the need to retain a competitive position for our manufacturers in the Australian market.'[35] Again, farm incomes and diversifying the economy were key factors in determining exchange rate policy.

Further alarming developments occurred in New Zealand's external accounts in the following year, and in August 1975 the NZD was devalued by a further 15%. In a press statement, Bob Tizard, the Minister of Finance, explained that, with the world in its worst post-war recession, he had to take action to stimulate the economy. Moreover:

> [I]n present world conditions of floating exchange rates, inflation and rapid changes in terms of trade, it was imperative for a small trade-dependent country such as New Zealand to review its exchange rate more frequently than had been the case in the past.[36]

In the late 1960s and early 1970s, New Zealand consistently sought an exchange rate regime that would contain inflation and stabilise farm incomes, but this became more difficult to achieve as the chosen nominal peg enhanced inflationary surpluses. The diversification of the economy became a third important policy consideration, leading the authorities to manipulate the nominal exchange rate so as to gain short term competitive advantages over Australia. Essentially, the problem was to identify an appropriate anchor to ensure discipline, internal stability and growth. The abandonment of sterling in favour of the USD in 1971 had more to do with wider margins and the priority of stability against the AUD than with the credibility of the USD versus the pound. In the early 1970s high export prices and balance of payments surpluses exerted inflationary pressure that prompted periodic revaluations supported by wage and price controls. The USD peg allowed the NZD to appreciate on a trade-weighted basis once sterling depreciated from June 1972, but, once the USD began to depreciate this peg exacerbated inflationary pressures. When the USD ceased to be managed, New Zealand tried to use exchange rate policy to stabilise producers' incomes by pegging to a basket currency with a large sterling element. The operation of this system was complicated by the disarray in exchange markets that followed the oil crisis prompting several step-changes in the peg to accommodate them. Weak local institutions, in particular the shallow foreign exchange market, and fears about

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[34] The devaluation was technically 9% against all currencies except AUD, against which there was a revaluation of 3% because of the 12% devaluation by Australia. Deane, Nicholl and Walsh, *External Economic Structure*, p. 149.

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

[36] RBNZ Archives, Box A0046, Press statement by Minister of Finance, 10 Aug 1975.

the impact of nominal fluctuations on incomes, meant that it took another decade to move to a float.

This analysis has shown that Australia's policy choices were an important, but not overriding, consideration for New Zealand. Following the AUD was critical in the move to adopt the USD as intervention currency at the end of 1971. A year later, however, the link with the AUD was not allowed to outweigh domestic interests. New Zealand then led the way to using a basket rather than a single reference currency in July 1973, and took advantage of changes in the AUD exchange rate to improve competitiveness. The case of reserve currency management discussed below shows that New Zealand's links to sterling were much stronger than those of Australia and indeed strengthened despite the changes in exchange rate policy.

With hindsight, it could have been a mistake to have followed Australia on to the USD peg in December 1971, especially at a 'low' rate. This exposed New Zealand to rising inflationary pressure, and to swings in cross rates vis-à-vis other important currencies, including sterling after the June 1972 sterling float. On the other hand, it is by no means clear what the best strategy might have been amidst such uncertainty, and the trade-weighted index did appreciate somewhat. The adoption of the basket in mid-1973 demonstrates a strong commitment to a stable nominal exchange rate at a time of increasingly generalised floating. Meanwhile, the real trade-weighted index depreciated almost immediately, punctuated by step-change nominal devaluations. What is perhaps most remarkable is the imaginative and ambitious nature of the policy that was adopted by the RBNZ and the New Zealand Treasury. Despite global uncertainty, their reaction was not merely to follow their larger neighbour, nor to copy their traditional leader, but to devise a new and innovative approach to exchange rate management to suit their domestic priorities. Reserves management was to prove equally challenging through this period of transition.

Reserve Currency Management

The post-war sterling area was defined as a group of countries that pegged their exchange rate to sterling and kept the bulk of their reserves in sterling in exchange for freer access to the London capital market. The previous section has shown how the first defining feature of New Zealand's membership was dropped without fanfare in December 1971 when the NZD was pegged to the USD, although the sterling area was only formally disbanded in June 1972 when sterling floated. Nevertheless, New Zealand returned to a system with sterling as the main component of the exchange rate in July 1973. The second defining feature of the sterling area, the denomination of reserves, was much more prolonged and is further evidence of the continued importance of sterling for New Zealand. Furthermore, unlike the choice of anchor currency, the UK had a large vested interest in the denomination of the foreign reserves of sterling area countries and they successfully managed to contain diversification.

Given its historical trade and financial links with Britain and the London capital market, New Zealand traditionally held the bulk of its official reserves in sterling. As late as October 1967, 85% of New Zealand's reserves were in sterling. Rather than declining after the November 1967 devaluation, the sterling proportion actually increased over the following five years, despite the collapse of sterling as a reserve currency globally. In the second half of the 1970s, however, diversification was swift, and by 1980 only 18% of the reserves were left in sterling.[37]

Other sterling area countries diversified their reserves before New Zealand. During the 1960s Australia accumulated non-sterling assets and reduced official sterling securities so that by 1967 only 60% of their reserves were in sterling. This reflected the diversification of Australia's trade and borrowing patterns and waning confidence in sterling's future. At the start of 1967, New Zealand's pattern of reserve holdings more closely resembled those of Malaysia and Singapore. New Zealand was left further behind when Singapore adopted an aggressive but secret diversification strategy in early 1967 (see Table 1).

Table 1: Proportion of sterling in official reserves

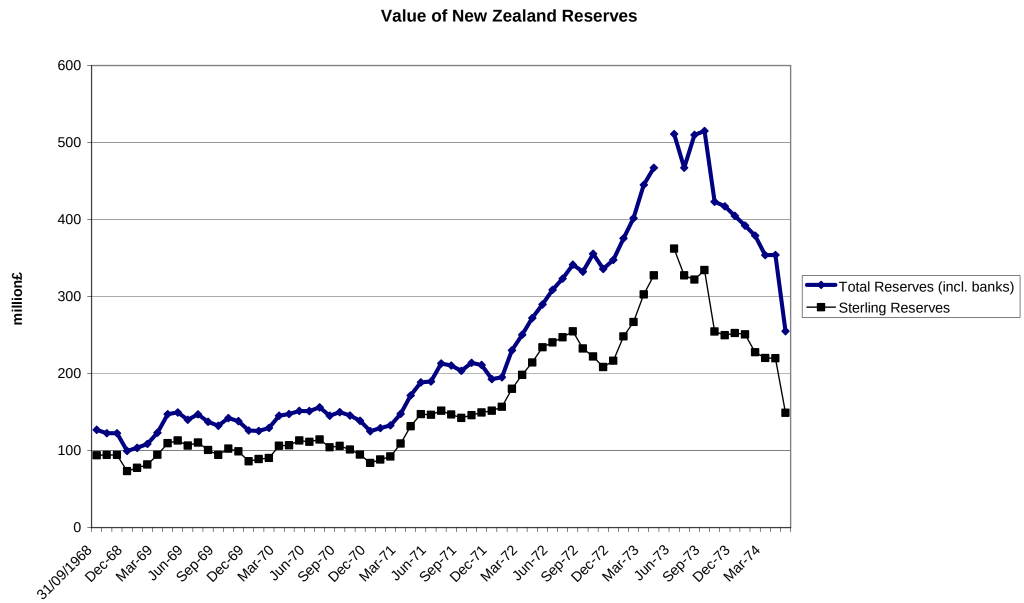
	Australia	New Zealand	Malaysia	Singapore
1964	79	98	96	100
1965	70	97	96	98
1966	69	97	90	93
Jun-67	64	80	87	74
Oct-67	60	85	82	50
Dec-68	46	76	58	44

Source: BE OV44/116. 1968 from T312/2811, T312/2804, T312/2649, T312/2312.

Between 1968 and 1974 New Zealand participated in a series of agreements between Britain and sterling area countries, which committed signatories to hold a minimum sterling proportion (MSP) of official reserves, in exchange for a guarantee in sterling of the USD value of 90 per cent of official sterling reserves. Overseas reserves of the trading banks were included in the definition of official reserves. Figures 4 and 5 show developments in New Zealand's official reserves. Figure 4 shows the dramatic accumulation of reserves from the end of 1970 as a result of the boom in earnings from primary exports. The data also show a substantial diversification of reserves out of sterling in the second half of 1972 that was then reversed during 1973.

[37] Deane, Nicholl and Walsh, *External Economic Structure*, p. 337.

Fig 4: Value of New Zealand's Official Reserves, 1968-74

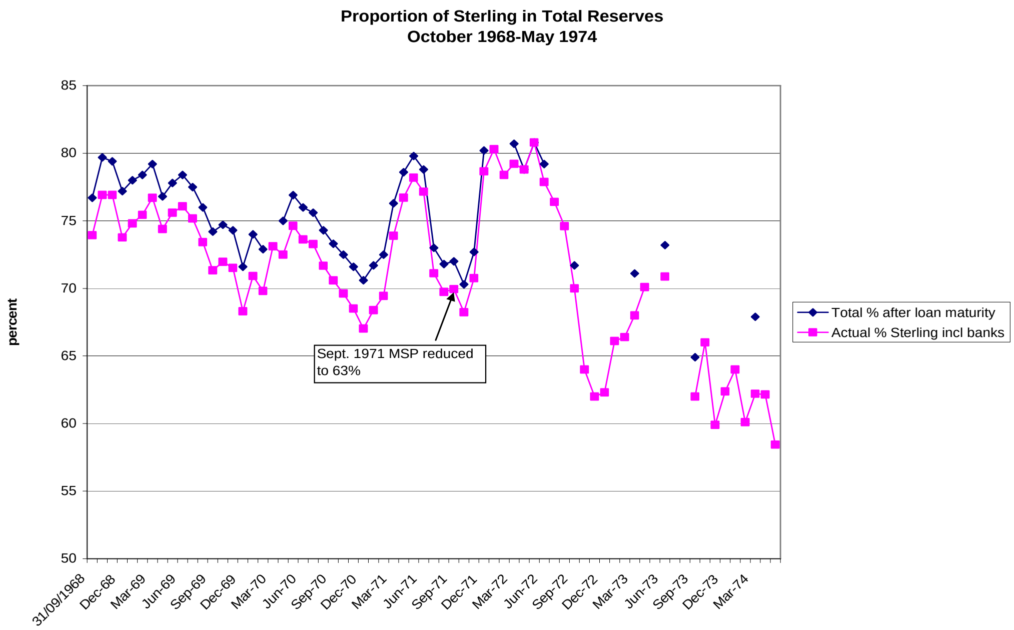


Source: Bank of England Archives EID15/5-7

Figure 5 illustrates the sterling proportion of overall reserves as calculated for monitoring the Sterling Agreements. It should be noted that the MSP system made special allowance for maturing sterling loans that were not refinanced. After New Zealand failed to renew a £15m loan in London in September 1968, an equal amount was added to the calculation of their sterling reserves. This kept the reported total above the statutory minimum 70% at the seasonal lows at the end of 1969 and 1970. The MSP was reduced to 63% in 1971, but the actual proportion of sterling climbed due to large current account surpluses. The MSP was reduced further to 56% in March 1974. By November 1974, just before the termination of the sterling agreements, 59% of New Zealand's official overseas assets were still in sterling.[38] Large seasonal fluctuations brought sterling reserves close to the statutory 70% threshold at the end of each year, but they were usually well above the minimum. These large seasonal fluctuations meant that New Zealand had to keep a larger precautionary proportion of reserves in sterling to ensure that they did not breach the MSP and thereby lose their entitlement to the guarantee. Diversification occurred through foreign currency earnings and the proceeds of foreign borrowing, which was mainly deposited into fixed term deposits at the BIS. The RBNZ and Treasury also built up reserves through periodic short term swap arrangements with the BIS. The first such arrangement with the BIS was a one year swap facility of NZD against gold up to a value of USD30m in February 1967. In September 1972, about half of the RBNZ's non-sterling reserves were on deposit at the BIS, a proportion that was increased subsequently.[39]

[38] RBNZ Archives, Box A0046, Memo for Directors: International Report December 1974, 7 Dec 1974.
[39] Report by DH MacDonald (BIS) of a meeting with RWR White Deputy Gov of RBNZ, 13 September 1972. BISA 2/319 Reserve Bank of New Zealand Wellington

Fig 5: The Proportion of Sterling in Total Reserves, 1968-74



The discussion below shows how the sterling agreements were negotiated. Although policy-makers in both the Treasury and the RBNZ assumed they would be rewarded for the loyalty they had shown to sterling and to the UK, these expectations were disappointed. In June 1968 the British introduced their proposals, which they claimed would bring greater stability to the Sterling Area. The MSP concept was devised by the Bank of England and their counterpart creditor central banks. In brief, the Bank of England approached central banks of the G10 through the BIS for support in case of the further diversification of sterling reserves. Having offered short term credit in the past, these banks were unwilling to cooperate further unless the UK obtained an undertaking from sterling area governments to restrict official reserves diversification. It soon became clear that the quid pro quo for such an undertaking would be the guarantee of the exchange value of a substantial part of these reserves. In June 1968, British officials visited all 34 sterling area members to negotiate agreements in time for the G10 central bankers' meeting in September.[40]

Rather against the spirit of British intentions, Low, the Governor of the RBNZ, viewed the MSP initiative as an opportunity to diversify the reserves. As explained above, New Zealand had been left behind when other countries were diversifying and had suffered correspondingly more from the sterling devaluation.

1954-1991; BISA Banking Policy of the BIS 'Points a signaler au President' 1/19M (1) 1960-74; Brief for RL Knight Deputy Chief Cashier's visit to Wellington 18 February -2 March 1974. BISA 2/319 Reserve Bank of New Zealand Wellington 1954-1991.

[40] Initially London hoped to offer an exchange guarantee for only 80% of sterling reserves and to charge 1% interest on these balances, but the interest had to be dropped because countries refused to pay it and the proportion guaranteed had to be raised to 90%.

Low hoped that the British would accept an arrangement that would permit New Zealand to catch up with such countries. Reserves diversification was thought to be desirable 'on general grounds and in the light of the large volume of non-sterling debt which will be falling due for payment over the next few years.'[41] When New Zealand borrowed currencies that might appreciate, like the USD or DM, it would be prudent to hold more reserves in those currencies. Low was optimistic that the British would be accommodating. As a rough guide, he felt that New Zealand should aim for the following distribution of official reserves: sterling (50-60%), USD (20-25%), European currencies (10%), gold (10-15%).[42] In fact, New Zealand did not achieve this level of diversification until after 1974.

Low did not favour a wholesale switch out of sterling, a currency which continued to offer 'significant advantages'. He indicated that any further sterling devaluation was likely to occur in the context of a general realignment, which would reduce its impact on New Zealand. London, he explained, continued to offer 'the best interest rates and the best facilities for the investment of funds'. Much of New Zealand's trade was still denominated in sterling. In short, New Zealand 'should continue to regard sterling as the basic component of its reserves' but reduce its dominance.[43]

N.R. (Cop) Davis, the Secretary to the Treasury, rejected Britain's opening proposal of an MSP of 80%,[44] believing that it 'would penalise New Zealand "for having played the game"' while other sterling area countries had diversified.[45] Davis even hoped to avoid any firm commitment on the MSP, and wanted strong assurances of continued access to the British capital market.[46] He shared Low's confidence that New Zealand could count on British good will, despite the wrangling over the UK's applications to the EEC. In the end, Britain and New Zealand settled on an MSP of 70% with a guarantee of the USD value (at the rate of £1 = USD2.40) of 90 per cent of New Zealand's sterling balances. Under a secret side agreement confirmed in April 1969, Wellington undertook to aim for an informal 80% sterling proportion. The MSP agreement was for three years, with provision for extension by mutual consent.[47]

The UK had achieved its main goal, and New Zealand's loyalty had not been rewarded with concessions. Indeed, New Zealand ended up with the highest MSP in the region except for Hong Kong. Australia, Malaysia and Singapore all negotiated an

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[41] RBNZ Archives, Box A0088, Memo for Minister of Finance: The Sterling Balances – A Proposed Scheme, 20 June 1968, pp. 3-4.
[42] Ibid., p. 7.
[43] Ibid, p. 6.
[44] ANZ, AALR 873, Acc. W3158/84, 61/4/2/1, pt 1, Memo from N.R. Davis [Sec to NZTsy] to Minister of Finance, 19 July 1968 , p. 1.
[45] Ibid, p. 3.
[46] Ibid., pp. 3-4.
[47] Treaty Series No. 118 (1968), *Exchanges of Notes and Letters Concerning the Guarantee by the U-K and the Maintenance of the Minimum Sterling Proportion by Certain Overseas Sterling Area Governments (The Sterling Area Agreements),* Cmnd. 3834, November 1968, pp. 67-70; ANZ, AALR 873, Acc. W3158/84, 61/4/2/1, pt 2, Roy Jenkins to Rob Muldoon, 24 Sept 1968; Roy Jenkins to Rob Muldoon, 1 October 1968; Sir Ian Maclennan to Rob Muldoon, 19 November 1968; National Archives, T312/2811, Correspondence in April 1969 between Lang and Sir Frank Figgures of HMT.

MSP of 40%. The absolute value of the sterling held by Malaysia and Singapore increased their bargaining power and their finance ministers adopted a tougher attitude towards the British.

Even more striking than the conclusion of the sterling agreements in 1968, was their renewal in 1971 and, in amended form, in 1973, despite the intervening upheavals in the international monetary system. Other countries that adopted the USD as their anchor in 1971 requested permission to diversify their reserves further, but New Zealand made no such request.[48] Even the access to the London capital market to refinance existing debt was of little practical use due to high London market rates. On the other hand, the inability to refinance these debts reduced the actual amount of sterling required as foreign exchange reserves while retaining the guarantee.

Australia and New Zealand renewed their sterling agreements because the terms were not unduly constraining, while the guarantee clauses offered security of the USD value of reserves. For the six months between the USD devaluation at the end of 1971 and the float of sterling the following June, however, the sterling agreement guarantee (set at pre-Smithsonian parities) was inoperative, undermining its value. But, when sterling floated below the threshold against the USD in November 1972, New Zealand became eligible for compensation. New Zealand was paid £3.7m for this episode (payment only arriving in March and May 1973),[49] and a further £6.937m after the threshold was breached again between September 1973 and March 1974.[50]

New Zealand, however, shared increasingly in the frustration of other sterling holders. In January 1973, Ray White, the Deputy Governor of the RBNZ, found BIS officials 'very pessimistic about the future of sterling … [and one] said quite bluntly that we should move out of sterling to the maximum extent possible'.[51] The following month, Governor Low found British morale shaky: UK officials 'would be very happy to get rid of the whole scheme. It had been politically difficult and embarrassingly complex.'[52]

The UK made a unilateral offer to sterling area countries in September 1973 to extend the existing agreements with minor modifications for six months.[53] Most

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[48] 'Sterling Agreements – End of Phase 1', BE EID15/2. This was Hong Kong, Bahamas, Bermuda. Malaysia ceased to adhere to their sterling agreement once sterling floated.

[49] 28/9/73 Chancellor's brief for meeting with Joseph [Bill?] Rowling, NZ minister of overseas trade, National Archives London, T358/19.

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

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

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

[53] The level of sterling balances to be covered by the USD guarantee would be the lower of the amount held on 24 September 1973 and 29 March 1974, and compensation would be paid if the average sterling/USD exchange rate fell below USD2.4213. RBNZ, Box A0068, File 57, Memo for the Directors: Sterling reserves agreement, 10 October 1973.

countries, including Australia and New Zealand, agreed to this stop gap measure.[54] As officials in Wellington pointed out, the alternative was a scramble to exit from sterling, leading to substantial losses on medium to long-term securities.[55] Some New Zealand officials became restive in the ensuing months. For example, Dick Wilks (RBNZ) argued against any further extension of the sterling agreements after March 1974: 'We have helped to prop up sterling for 5½ years. Isn't it about time they [the British] and we faced facts?'[56] New Zealand, he concluded, needed more 'freedom of action'. Nevertheless, the early months of 1974 saw new negotiations. The British, still worried about their financial imbalances, hoped to persuade the remaining significant sterling area countries, including Australia and New Zealand, to consent to private 'gentlemen's' agreements, limiting the speed at which they would diversify their reserve holdings, but they offered no further guarantee of the foreign currency value of sterling holdings. The British message was that all parties stood to lose from a sterling crisis. Bill Rowling, the Minister of Finance, prevaricated.[57] When Australia rejected a gentlemen's agreement, the British offered to continue the existing agreement for a further nine months, an offer accepted by New Zealand.[58] Compensation was now based on the effective exchange rate of sterling rather than the USD alone.[59] After the sterling agreements expired in December 1974, the RBNZ immediately began selling sterling for USD.[60] Thus the share of sterling in New Zealand's total official overseas assets fell to 29% in 1976, whereas the share of the USD rose to 35% and the share of the DM reached 30%.[61]

After a few teething troubles, New Zealand experienced few difficulties in complying with the terms of the MSP agreement, although there was increasing frustration in Wellington over the constraint on independent policy. Large seasonal fluctuations meant that amount of sterling held in reserves was probably larger than would have otherwise been the case because of the need to ensure that the MSP was not breached and that New Zealand remained entitled to the guarantee. Nevertheless, abandoning the MSP (and guarantee) and building up USD reserves might not have been a better strategy even after the adoption of the USD as anchor currency. Not only would it have been costly to liquidate the sterling portfolio, but the USD was no more stable or liquid than sterling and returns were high in London. Moreover, the

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

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

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

[57] ANZ, AALR 873, Acc. W3158/83, 61/4/1, Notes of meeting held in the British Embassy, Rome, on Wednesday, 16 January; Note for File: By N.V. Lough for Governor RBNZ, 30 Jan 1974; ANZ, AALR 873, Acc. W3158/84, 61/4/2/1 pt 4, Note on Sterling Reserves Agreement, undated 1974.

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

[59] RBNZ (1974), *Annual Report 1973/74*, p. 23.

[60] In mid-December RBNZ ordered USD60m for delivery in the first quarter of 1975. The Bank of England assumed this was to adjust to the end of the MSP. BE OV44/235.

[61] The shares in 1972 were 70% for sterling, 5% for the USD, and 6% for the DM. Deane, Nicholl and Walsh (1981: 337).

USD peg was in the event only an interim position pending introduction of the basket. After the basket was introduced and the MSP agreement was wound down, however, there was a large relative shift from sterling to USD and DM assets which suggests that the agreements did delay diversification. Although the weightings in New Zealand's reserves portfolio did not match those in the basket, both the reserves and exchange rate strategies were now based on the principle of diversification.

Conclusion

New Zealand was one of the main innovators of the basket peg in the early 1970s, and many developing countries followed their lead. This paper has explored how this decision was made and the implications for reserves management. The advantages of playing the 'sterling game' were diminishing for New Zealand even before the 1967 devaluation, but it was not in the government's interests to abandon it altogether. In the context of a continued commitment to pegged exchange rates, neither the USD nor the AUD were entirely satisfactory alternative anchor currencies. Similarly, while New Zealand wanted to diversify its foreign reserves, there was no obviously superior alternative to sterling. Confidence in the USD was almost as weak as in the pound in the late 1960s.

Eichengreen is right to say that loyalty played *some* part in the retention of sterling as a reserve currency. By 1968, however, New Zealand hoped that their past loyalty would allow them to hasten diversification rather than maintain their commitment to holding sterling. In the event, New Zealand failed to negotiate a sterling agreement that gave as much freedom to diversify as most other sterling area countries. Several factors contributed to this outcome. First, New Zealand had not shown much prior inclination to diversify and establish a lower base, and the total value of its sterling holdings was not large enough to offer much bargaining power. Secondly, New Zealand adopted a cooperative attitude because the 'guarantee' clause reduced the risk of holding sterling assets; because a flight from sterling reserves would have been costly; and because Britain's goodwill was required on other matters including trade policy. Thirdly the economic and financial link to the UK remained vital. In the early 1970s, the appreciation of sterling assets in terms of the USD under the Smithsonian Agreement coincided with large current account surpluses and the accumulation of reserves. Thus the share of sterling in New Zealand's reserves increased rather than decreased at the same time as the peg to sterling was abandoned. By the end of the 1960s, it was economic rather than political or historical motives that led New Zealand to maintain a large proportion of its reserves in sterling.

New Zealand's experience illustrates the dilemmas facing a small, export-dependent country when choosing a new exchange rate anchor and reserves strategy. In the early 1970s New Zealand was able to orchestrate a benign exit from Bretton Woods because of the coincidence of strong demand for exports, pressures for appreciation rather than depreciation, and rising reserves.[62] Since the USD peg was in practice a transitional rather than a permanent answer to the exchange rate question, the fact that New Zealand did not change its reserves strategy in 1971-72 was not a disadvantage from the point of view of maintaining the fixed exchange rate. As in the following decade, the RBNZ and the Treasury found innovative solutions to external and internal economic pressures, although the onset of the first oil crisis and the

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

downturn in non-oil commodity prices would undermine the stability of the new approach in the later 1970s.