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Disentangling from Sterling: Malaysia and the end of the Bretton Woods system 1965-72[1]

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A decade after independence, the Malaysian government and central bank were faced with a series of challenges that forced them to develop an independent policy, leading to the end of the historic role of sterling in their international monetary regime. Like some economies today that are faced with accumulated reserves largely comprised of a depreciating currency (now the US$), Malaysia had to disentangle itself from sterling at a time when there were no clear alternatives since gold was scarce, the US$ was weak and Germany, Switzerland and Japan resisted the use of their currencies as national reserves. This paper uses new archival evidence to show that external obstacles as well as some misjudgement meant that this was only achieved in June 1972, 15 years after Merdeka. This process also reveals new evidence about the post-colonial relations between Malaysia and Britain and sheds new light on the neo-colonial interpretation of the first decade of independence.

The first decade of Malaya's constitutional independence has sometimes been interpreted as conforming to a neo-colonial paradigm, partly exhibited by the creation of the Federation of Malaysia and the subsequent Confrontation with Indonesia, and also exercised through the collaboration of the Malay and Chinese elites with foreign capital until the political upheaval of 1969 led to a more nationalist government from 1970.[2] Recently this view has been challenged by White's examination of the legacy of British companies in Malaya and their relations with the state during the 1960s, which suggests that archive-based research may offer greater insights into the post-colonial relations between Britain and Malaya.[3] While the legacy of British business interests has been well documented, less attention has been focussed on the continuation of monetary links between Malaya and Britain. Hinds and Krozewski have established that Malaya's monetary links to Britain were important in negotiating the process of decolonisation in the late 1950s because of the large sterling reserves held by the colony on the eve of independence.[4] This article extends this work by exploring the unravelling of these monetary links between Malaysia and Britain that lasted for 15 years after constitutional independence. Tan Siew Sin acted as Finance Minister from 1959-74, both before and after the 1969 watershed, and White has implicated him in the emergence of 'crony capitalism' in Malaysia during his time in power.[5] Tan, along with Ismail Ali, Governor of the central bank (like Tan, Cambridge educated and a supporter of Tunku Abdul Rahman from the 1940s[6]) led Malaysia's response to the collapse of the international monetary system and the gradual disentanglement from sterling. This analysis therefore promises fresh perspectives on the allegations of collaboration between Malayan elites and London by examining the often tense and difficult relations between London and Kuala Lumpur over reserves policy. In 1966 Tan's semi-official profile written in London to prepare for meetings with the Chancellor of the Exchequer described him as 'excitable and too easily led into controversy', 'obstinate and self-satisfied' and displaying 'very strong anti-British feelings'.[7] Clearly, there was scope for conflict.

The end of the formal colonial period for Malaya in 1957 did not mark the end of the close monetary relations that had developed among Britain, Malaya and Singapore. Both Malaysia and Singapore continued to maintain their pegged exchange rate to sterling until June 1973, and to hold the bulk of their reserves in sterling even after the devaluation of the pound in 1967. The link to sterling grew out of the 19th century colonial monetary system into the post-1945 sterling area system, which protected its members from British capital controls in return for those members holding reserves in sterling and pegging exchange rates to sterling. The sterling area countries were mainly commonwealth countries (except Canada), and some Middle Eastern states with historic links to the UK. Soon after Malayan constitutional independence the sterling area system began to unwind as the pound as an international currency faltered and the interests of developing sterling area economies diverged from those of Britain. At this time Britain began its campaign for closer links to Europe with its first application to join the EEC, and decided in 1966 to withdraw British troops from East of Suez (primarily from Singapore and Malaysia) to redefine its international role.[8]

Along with other developing economies, Malaysia was caught up in the turmoil of the collapse of the Bretton Woods system and the retirement of sterling as a major reserve asset. Although Malaysia's robust balance of payments and economic growth allowed it to weather these global storms, they did pose challenges for the national government and formed part of the transition to a truly independent international monetary policy, presaged by the introduction of a national currency in 1967 and then activated by the controlled floating of the Malaysian dollar from 1973. During this period, Malaysia also played a distinctive role in the determination of how the international monetary system evolved, because of the country's importance to the development of sterling policy in London. By June 1966 Malaysia was the world's fifth largest holder of overseas sterling balances (after Australia, Kuwait, Hong Kong, and Ireland) with over 17% of total overseas sterling area sterling reserves. Malaysia was also the second largest government holder of sterling assets in the world, exceeded only by Australia. This should have given Malaysia considerable bargaining power in London over the disposition of these assets, but in the end the sterling ties proved difficult to disengage.

Reserves Strategy before the Sterling Devaluation of 1967

As Schenk has argued, while Malaya was negotiating its independence in the mid-1950s, the potential for monetary independence had a symbolic importance as an emblem of state-hood.[9] Despite the relatively speedy transition to independence on the peninsula, the governments of Singapore and the UK fought hard during the run-up to Merdeka in 1957 to continue to have a common currency operate in the two territories. This reflected both economic imperatives (the close integration of production and trade facilities) and political hopes for the eventual union of the two states. In the end a compromise was reached whereby the Malayan central bank, Bank Negara Malaysia (hereafter BNM) began operations in 1959, but the joint currency board continued to issue currency for the two territories.

When the joint currency board with Singapore was being planned, the Malaysian side argued strongly for the statutes to include the option of investing in assets other than sterling, specifically dollar assets. The Bank of England was powerfully opposed to the diversification of the currency reserve. As long as the M$ was pegged to sterling, holding dollar securities would introduce an exchange risk – if the US$ devalued then the reserves cover would be reduced. The Malayans, however, reasonably argued that this was a risk worth taking since sterling was more likely to be devalued, and sterling securities were prone to loss of value.[10] Moreover, the Bank of England's argument assumed that the M$ would keep its peg to sterling rather than follow a US$ devaluation. While the Bank of England wanted this to be a breaking point in the negotiations for a joint currency board, the Treasury and Colonial Office believed that the political as well as economic consequences of not achieving an agreement were too great to risk.[11] In the end, partly in recognition that the right to diversify the currency reserve would be more de jure than de facto, the Malaysians suggested that any investment in non-sterling assets would require unanimous agreement among the constituent members (including the UK through its control of Sarawak). The theoretical ability to diversify reserves, however, was viewed in Kuala Lumpur (KL) as an important political symbol of independence even as they made clear to the UK negotiators that 'the unanimity rule will ensure that non-sterling investment will be strictly limited in practice'.[12]

With the political union of Malaya and Singapore in September 1963, responsibility for currency matters shifted to the Federation government, and at the end of 1964 the government announced its intention to terminate the currency board as of June 1966, and to give the BNM its issuing powers for the Federation as a whole. On 9 August 1965, however, Singapore was abruptly separated politically from Malaysia. Efforts to continue the currency union between the two states began almost immediately, but the talks finally foundered in August 1966 over the control that Singapore would have over its share of the foreign exchange backing of the currency.[13] Ultimately, the continuation of the currency link did not suit either the political or economic goals of the Malaysian government. Economically, Malaysia sought to reduce the integration of the two territories and thereby promote economic development in Malaysia by discouraging the use of Singapore for trade. Reflecting on the period when Singapore was part of the Federation, Lim observed that 'They [Malaysia] always think themselves as the bigger brother. You must take orders from them in almost everything'.[14] Political relations had disintegrated during the mid-1960s, which further undermined the prospects for integration. As Lim recalled the Malaysian Prime Minister Tunku Abdul Rahman observing prior to expelling Singapore, 'You know, when you have a sore, you better cut it off, have a surgical operation'.[15] The IMF mission to the two states in November 1965 delicately described 'a certain mutual disenchantment which followed the separation of Singapore from Malaysia does not help to create now the cordial atmosphere which is important for the negotiation of a treaty between Malaysia and Singapore for a future currency union.'[16] In August 1966 each territory set out to develop their own national currencies.

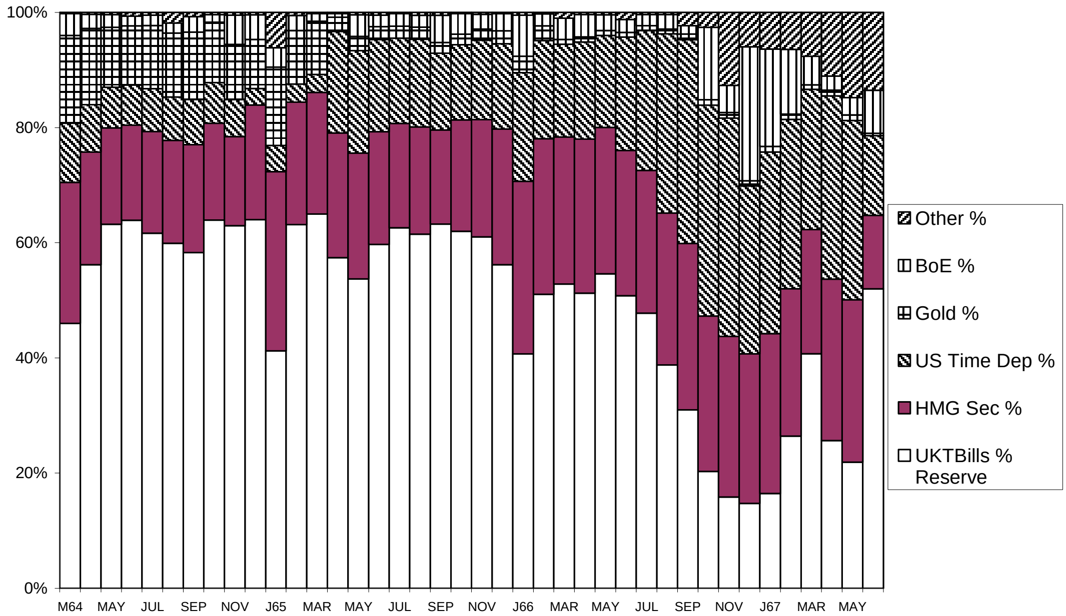
The problem of dividing the currency board's foreign exchange reserves among the constituent states was a prolonged source of dispute. In 1964 the currency board held M$1.56b or 47% of the two territories' foreign exchange so the distribution of these assets between Singapore and Malaysia was not a trivial issue. Although most of the assets were distributed after 1967, the final distribution was only resolved in March 1972. Singapore received 18.3% (£6.17m) of the assets of the currency board (its share of the distribution of profits) rather than the 35% it claimed (its share of the currency redemption). Malaysia got 74% (£24.95m).

On 12 June 1967 separate currencies were finally introduced but the principle of currency union was not completely abandoned. To retain the advantages of integration each currency circulated at par in the other territory with periodic clearing back to the country of issue. The external exchange rates were also fixed at parity in terms of gold with sterling as the intervention currency. Singapore continued with a currency board and Malaysia kept a high ratio of reserve backing, so they retained elements of the currency board system. The minimum foreign exchange reserve was formally set at 80.59% of currency issued but the central bank publicly expressed its intention to maintain reserves well in excess of this limit.[17] Their 1969 return noted that the policy of the government and the BNM was to keep at least 100% gold and foreign exchange cover for the currency in circulation at all times.[18] In addition, the BNM was required to hold foreign reserves equal to 35% of its deposit liabilities, although in practice that proportion had never fallen below 74% from 1964-1967. In June 1967 when it started to issue notes, external reserves totalled $463m, well in excess of the combined $290.5m combined statutory minimum required against currency issue and deposit liabilities.[19] By the end of 1969, BNM's foreign assets were still 159 per cent of the combined statutory minimum required and 175 per cent of the currency issue alone.[20] Despite the commitment to a high reserve ratio, an important consequence of the introduction of the Malaysian dollar was the decision finally to diversify currency reserves out of sterling and into other foreign currencies, which reflected the government's growing disenchantment with the link to sterling.

Malayan attitudes to sterling evolved through the repeated crises of the 1960s when the sterling exchange rate to the US$ was under repeated speculative pressure. The Malaysian Treasury formalised its position during the November 1964 sterling crisis, when the International Tin Council (ITC) considered diversifying their cash assets out of sterling. The government's position was that although Malaysia was a major holder of sterling, it would not diversify its assets in response to a possible devaluation.[21] They explained that this decision was taken to avoid putting further pressure on the exchange rate which would 'therefore tend to increase the possibility of bringing about a devaluation, which would be unwelcome to this government, as the Malayan dollar is linked with sterling'. Malaysia's large sterling assets were thus identified as a constraint on policy since diversification would threaten their value. Under the Malaya British Borneo Currency Agreement of 1960 the Malayan dollar was fixed at 2s4d so a devaluation of sterling would necessitate a devaluation of the M$. The Treasury also noted that deposit interest rates in London were higher than elsewhere, so diversification would reduce the ITC's income. This argument would also hold for the government's reserves, which benefited from high returns in London.

Archive records of the Bank Negara show that, in line with government policy, they did not diversify during the November 1964 sterling crisis. Indeed by December 1964, holdings of UK Treasury bills, government securities and deposits at the Bank of England had increased while US time deposits had been halved from M$15m (US$4.9m) to M$7.4m compared with October 1964. Figure 1 shows the changing distribution of the external reserves of the Bank Negara based on archival data. By 1966, two thirds of Malaysia's gold and foreign exchange reserves were held directly at the BNM, with the rest in the government's direct control.[22]

Figure 1. Distribution of Bank Negara Malaysia Reserve Assets March 1964-June 1967



Source: 1985/0005800, 1985/0005802, 1985/0005806, 1985/0005809, ANM

A lasting break in reserves management strategy is only visible from the sterling crisis of June 1966. At this time the government reversed its position on diversification of the ITC buffer stock, recommending that diversification should be supported although 'the Malaysian delegate should not create the impression that Malaysia is deliberately seeking to weaken sterling even further by this move. The stand should be justified on the old adage of not putting all one's eggs in one basket'.[23] Tan asked London for an exchange guarantee for their sterling reserves at this time, but was refused. The Chancellor urged him not to increase pressure on the pound again in Washington in September 1966, just at the time when the UK was planning its withdrawal of troops from Southeast Asia, and again Tan agreed.

The unpublished monthly accounts of the Bank Negara certainly suggest an new and more active policy of switching out of UK Treasury Bills and into other assets including US$ accounts, but also sterling deposits at the Bank of England. Tan later recalled instructing Ismail to 'take our reserves out of sterling, a million pounds a week' during the sterling crisis in the summer of 1966, and in June the BNM records show a withdrawal of deposits at the Bank of England by M$1.1m and M$8m of sales of UK government securities (about £1m combined). The funds were shifted to an extra M$2m on deposit at the Federal Reserve Bank of New York and an extra M$10m in US$ term deposits.[24] In August, Eric Haslam of the Bank of England visited KL to persuade Ismail to resist adding pressure to the crisis, although the archive data show that Ismail continued to run down his holdings of UK Treasury Bills to the end of the year. The proceeds were split between increases in Bank of England deposits and US$ time deposits, so the operation did not completely involve a diversification out of sterling and would appear at the Bank of England to be a move back into sterling. In November 1966 Ismail also began new investments of M$25m (£3m) in UK fixed deposits, which accounts for the increase in 'other' in Figure 1.

In July 1967, with the prospect of the BNM acquiring substantial sterling assets from the former joint currency board, London expected renewed calls for diversification. The Treasury and Bank of England were persuaded that Malaysia could not be prevented from diversifying this time, but they hoped to achieve a gradual and agreed programme to lessen the immediate pressure on the sterling exchange rate arising from sales of Malaysian sterling assets.[25] There was some confusion or at least inconsistency between directly held government assets and those of the central bank, perhaps due to political sensitivities of the government during the withdrawal of British forces. During a visit to London in early July 1967 to discuss aid to compensate for the British military withdrawal, Tan reassured the Chancellor that he did not expect to engage in further diversification during 1967. In turn the Chancellor reassured Tan that 'there was no question of devaluation' of sterling.[26] A few weeks later, however, Ismail notified the Bank of England that his goal was to reduce the sterling proportion of the currency reserves to two-thirds over the next six months, converting sterling at a rate of £3m per month to a total of £20m.[27] In the end, the diversification did not proceed as quickly as planned and by the eve of the devaluation the sterling proportion of total reserves was only 5% lower than in June (falling from 87% to 82%). As a result, Malaysia was caught out with large sterling holdings and the devaluation of 19 November cost the reserves M$250m (US$81.5m).

The Devaluation of Sterling November 1967

The sense of betrayal felt in KL after the sterling devaluation was intensified by the way that it exposed the differences between Singapore and Malaysia in regard to their financial relations with Britain. Malaysia was revealed as having fallen far behind the more entrepreneurial and self-interested Singaporean policy of secretly diversifying reserves in the run-up to the devaluation. This was politically damaging for the Malaysian government and led them into a defensive position of trying to catch up with Singapore and to identify (and act on) Malaysia's own national interests rather than taking advice from London. On 20 November, just after the devaluation, Tan told the Straits Times that he had repeatedly met with the Chancellor of the Exchequer over the past few months and 'received the most specific assurances that devaluation of sterling was practically unthinkable.' Asked if he was shocked by events, Tan replied 'what would be your reaction if you were in my place'? A few days later the Prime Minister tried to put a better gloss on Malaysian policy, telling the papers that 'about a month back we had the feeling that the British Government would devaluate [sic] and so we made up our minds and decided slowly to withdraw from the sterling reserve, and bought gold and transferred some to the US. We were in a difficult position and we had to do it gradually. If we did not plan our move, much more would have been lost'.[28] Again, the size of the reserves mitigated against quick diversification. IMF data show that Malaysia began to buy gold in August 1967 and by November had accumulated US$24.15m or 5% of reserves compared with US$1.05m in July or 0.2% of reserves.[29]

Immediately after the devaluation, Singapore's Finance Minister Goh Keng Swee announced that he had reduced the sterling proportion of Singapore's reserves in the months running up to November. This took Malaysia, the Bank of England and the UK Treasury by surprise. In London, it had been assumed that about 80% of Singapore's foreign exchange reserves were held in sterling, but Goh revealed in The Straits Times that their reserves amounted to S$1251.6m of which only 50% was held in sterling, 41% in US dollars and the rest in DM, SwFr and Frfr. The diversification had been achieved by investing accruals to the reserves in non-sterling assets while leaving the bulk of sterling reserves in London untouched. Table 1 shows the position of Malaysia in comparison with its sterling neighbours. Diversification had begun in a small way by 1966 but was far behind Australia and Singapore.

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.

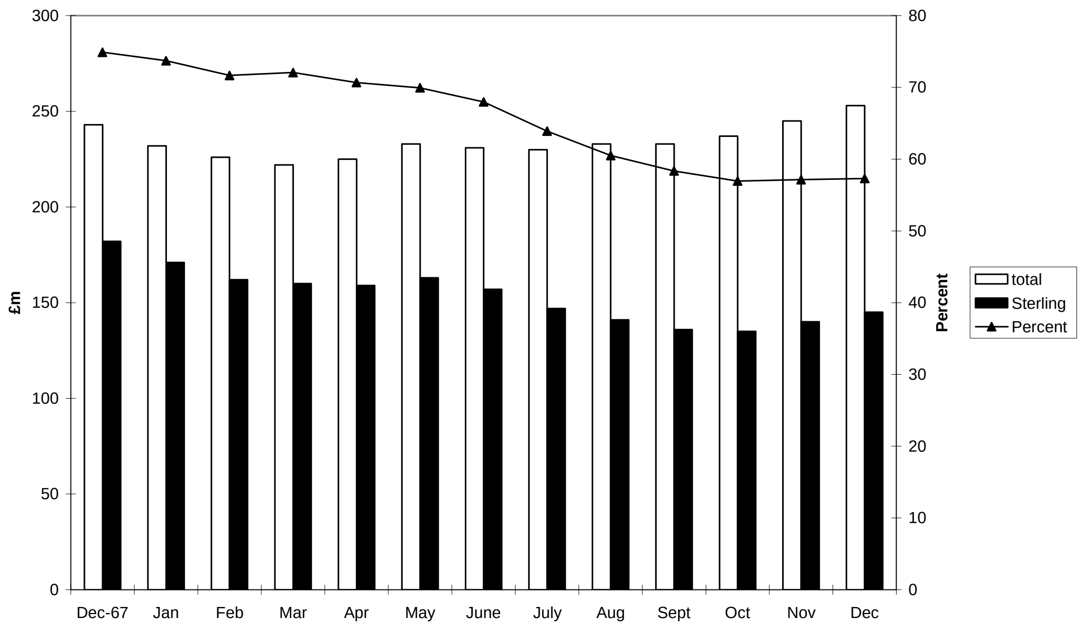
At the start of February 1968 Choi Siew Hong, Deputy Governor of BNM, met with officials at the Bank of England to set out new plans for the currency reserves.[30] The objective by the end of the year was a distribution of 40% each for sterling and US$ (compared with the 66% target in July 1967), with the remainder equally split between gold and other currencies. As Jeremy Morse of the Bank of England described, 'their losses on sterling devaluation have strengthened their determination not to be caught again. Their ministers are under attack in parliament on their past policies regarding sterling and the Singapore example and propaganda make things doubly difficult'. The Bank's counter-offer was a 50% ratio for sterling with the conversion of sterling assets spread evenly over the course of 1968 (£2m per month), a compromise subsequently accepted by Ismail. The programme was set to cost the UK reserves £22m (a saving of £12m over Choi's original proposal) and would bring the overall proportion of sterling in government and central bank reserves to 57%. The government's holdings of about £20m were considered more secure since sales they were mainly British securities trading well below their purchase value.[31] Meanwhile, however, by the summer of 1968 a comprehensive system to manage the diversification of sterling reserves globally was being prepared that would force all official holders of sterling to commit themselves to minimum shares of sterling in their reserves, and Malaysia would play a key role in this solution.

Re-negotiating the sterling link 1968-72

For countries holding substantial sterling reserves, the impact of the collapse of the international monetary system from 1968-73 was profoundly affected by the negotiation of a series of Sterling Agreements with London. From July-September 1968 representatives of the Bank of England and UK Treasury were sent to 34 countries holding sterling to agree the minimum proportion of sterling to be held in each country's reserves (known as the MSP) in return for an offer of an exchange guarantee of the US$ value of 90% of official sterling reserves. Holders would be compensated if the pound fell below US$2.38. Britain's ability to honour these 3-year agreements was underpinned by the Basle Agreement of September 1968 under which the central banks of the G10 promised US$2b in short term credit to cover diversification of global sterling reserves.

Figure 1 shows the accelerated diversification of Malaysia's reserves while the negotiations over the sterling agreement were underway from July to September 1968.

Figure 1: Malaysia's Reserves 1968



Source: TNA T312/2312

In May 1968, Ismail Ali toured Europe to canvas various central bankers' reactions to the possibility of Malaysia diversifying their reserves into European currencies.[32] At the end of May and the start of June, he made two deposits of SFr5m each at the Bank for International Settlements. By mid-August 1968, when the sterling agreement was being negotiated, he had deposited US$8m, DM5.1m and SFr15m, and by the end of September when the sterling agreement was signed these totals had risen to US$13.7m, DM41.75m, SFr15.12m, a total equivalent to about US$28m or £12m.[33] The increase in DM assets is particularly striking and related to the strength of the DM in international markets. In November 1968 Malaysia issued a DM25m bond and in February 1969, they issued a further DM40m bond. In July 1969 they also notified the bank of England that they would retain US$25m raised from a consortium of commercial banks in US$.[34] A further consortium package of US$50m was raised in February 1971, and Choi warned the Bank of England that this would reduce the proportion of sterling in the reserves.[35] Reserves diversification was thus accomplished partly through international borrowing that formed part of the Second Malaysia Plan. As well as currencies, Ismail also continued to buy gold until the end of 1969 by which time it comprised 10% of foreign reserves.

At first it seemed that London's negotiations over the sterling agreement with Malaysia would be quite straightforward, but in the end Malaysia was the last country to finalise their sterling agreement and the negotiations were bitter as well as prolonged. The initial optimism in London arose rather naively from the cooperative attitude of KL in the run-up to the devaluation of 1967. The negotiating brief noted that 'apart from some relatively small-scale diversification in 1966…Malaysia have been co-operative in their sterling policy. Since 1966, although wishing to reduce their high sterling percentage of overall reserves, they have consulted us in advance over proposed diversification'.[36] In July 1968, on the eve of the negotiations, Prime Minister Tunku Abdul Rahman visited London and was reluctantly favourable to the proposed agreements, remarking to the Australian High Commissioner that he had accepted the general proposals because 'we had to, we could not afford another devaluation, we lost so much the first time'.[37] This initial acquiescence was quickly reversed by Tan as the negotiations began in KL.

The British goal at the outset was to commit Malaysia to hold a minimum sterling proportion (MSP) in their official reserves of 73%, and also to get them to deposit 40-50% of their total non-sterling currency reserves with the BIS, where it would be available for the UK to borrow.[38] The MSP was much higher than the 57% agreed in February 1968, and was also higher than the proposed settlement with Singapore, but London believed that their offer of an exchange guarantee for sterling reserves should be rewarded by Malaysia holding more sterling. The London negotiating brief noted that 'Malaysia may wish to continue with their agreed diversification programme…if they ask… we could not refuse to honour our earlier agreement. Nevertheless, we should seek to deter them from further diversification by pointing to the fact that the guarantee would be its equivalent and indeed would be more far-reaching and that…sterling investments would be likely to produce a better yield than those in other currencies'.[39] In August 1968, Ismail was earning 6% on 12 month US$ deposits at the BIS and only 4% on other currencies, while the Bank Rate in London was 7.5% and the TBill rate was 6.95%.

The British negotiator was the highly experienced Christopher Fogarty, Treasury representative in Southeast Asia, who was joined by Eric Haslam of the Bank of England, who often visited Malaysia. At first, on 11 July Tan appeared favourable to the Basle agreement, noting publicly that 'This facility [Basle Facility] is a great step forward as it goes well beyond anything which has been agreed before, both in magnitude and in length of term… It should give much greater confidence to holders of this currency'.[40] When the private negotiations began in earnest, however, he quickly showed his true colours. In common with other countries he refused to accept an obligation to pay interest for the guarantee, and this was finally abandoned in all negotiations at the beginning of September. More fundamentally, he cast doubt on the whole international monetary system, and predicted a US$ devaluation in the near future. He scolded the leading economies in the world, claiming that 'In Britain in particular and also in other developed countries, there had been a major failure of Governments resulting in labour indiscipline, continuous inflation, and general lack of confidence, which was now painfully justified, in any paper currencies.' On the Basle Agreement, 'The US$2b was quite inadequate and could easily be frittered away in a couple of years on maintaining the UK standard of living'. These serious criticisms of British policy were supported by Ismail, who was also present. Tan concluded that 'the scheme was not attractive to Malaysia and he would rather take a risk in diversifying further out of the sterling - and indeed perhaps also out of dollars, it might be better to hold reserves in tin or rubber equities than in any of the traditional reserve media including gold'.[41] Given the volatility of primary product prices, this would have been foolhardy indeed, but this opening gambit was evidence of Tan's intention to use the negotiations to harden his position vis a vis London. It was very clear that Malaysia's position compared to other sterling countries was a prime consideration for Tan. Thus, Tan hoped to prolong the negotiations until his rivals in Singapore and Australia had concluded theirs to ensure that Malaysia was not treated worse by the British. Meanwhile, as we have seen above, diversification out of sterling and into other currencies accelerated.

In their telegrams back to London, Haslam and Fogarty both stressed the sensitivity in KL to the terms of any agreement concluded with Singapore. Nevertheless, they agreed that Tan should not be promised terms as favourable as those agreed with Singapore. Goh and his colleagues in Singapore were also negotiating fiercely, and by mid-August it was still not clear that any agreement with Singapore would be reached by the deadline of the Basle meetings on 7-9 September. Moreover, Singapore's total sterling holdings were much smaller than Malaysia, so London could afford greater concessions to them which would prove impossible to replicate for Malaysia. Talks were resumed in KL on 21 August when Fogarty announced concessions on the charge (dropped), duration (3 years instead of 7), unguaranteed proportion of sterling reserves (10%) and MSP (50% for government reserves plus provision for the currency board reserves to bring the total to 56%). Tan accepted these concessions except for the MSP, and countered with an offer of a firm public commitment to 30% overall, but a private agreement to maintain a working target of 50%. London could not accept such a low public MSP, which would set a precedent for other negotiations as well as potentially cost the reserves heavily, even if there was a private undertaking to maintain a higher proportion.

The Malaysian Cabinet considered the UK proposals on 4 September with the start of the Basle meeting looming three days later. The timing put the Malaysians in a strong position since if an agreement was to be signed by the deadline, London would have to accept the Cabinet's terms. By this time Malaysian ministers had learned of the terms of the agreement concluded with Australia under which Canberra had negotiated an MSP of 40% with a private working target of 46%. Nevertheless, the Malaysian Cabinet sought to exercise the power accorded by the approaching deadline by insisting on an MSP of 35% with a target practical working level of 45%, and also that the whole agreement should remain unpublished. This last proviso emphasizes the important political concerns of the Malaysian government and their sensitivity to public opinion about their ability to protect Malaysia's national interest.[42] Moreover, the Cabinet insisted that the remaining assets of the currency board should be excluded from the agreement. London responded by advising that despite the looming deadline 'we see no possibility of reaching an agreement with Malaysia on the basis of the terms which their Cabinet has proposed'.[43] The Sterling Negotiations Group in London deemed the failure to get agreement before 7 September 'unfortunate but not disastrous', and advised the team in KL to call Tan's bluff and suspend discussions for the time being.[44] Meanwhile, agreement with Singapore on a 40% MSP was concluded on 8 September (just in time to be reported at the Basle meeting) after Goh had learned of the terms agreed by Australia, which convinced him that no better deal was likely to be forthcoming.[45] Singapore did not have to give any private indication of working target since their actual sterling balances were close to their MSP level already.

In London, Ministers were fed up with Tan's intransigence and sought to force Malaysia to sign a sterling agreement by threatening to cut the British aid promised as an offset to the defence withdrawal from the region. A total of £25m had been promised to Malaysia of which only £7.15m was already committed, the rest due by

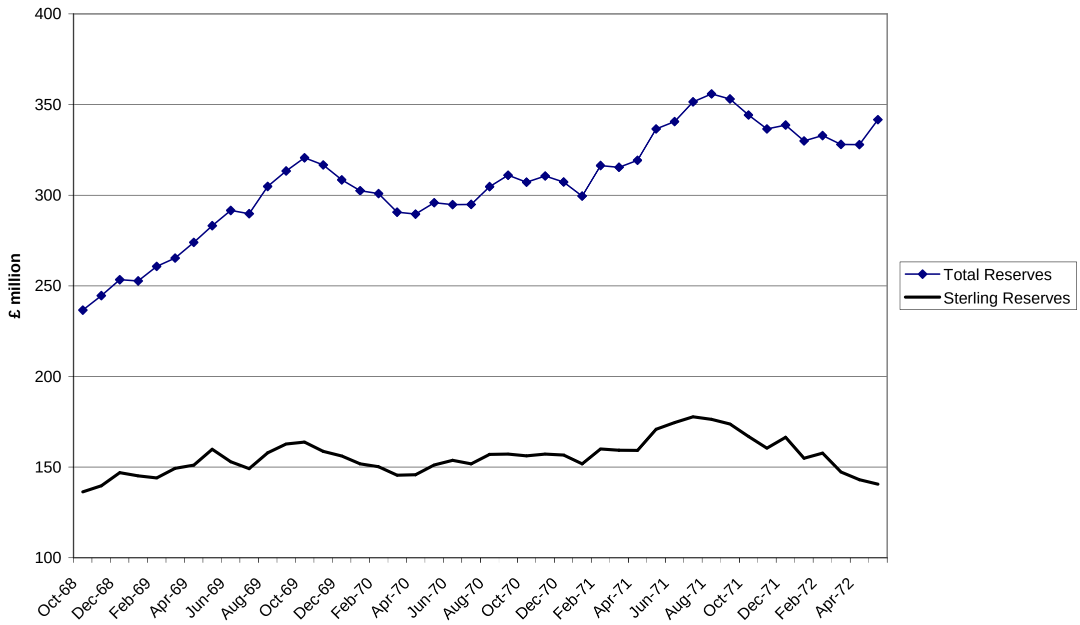
March 1973. The Commonwealth Office, however, argued strongly that such a move would provoke retaliation against British businesses, goods, and nationals. The advice concluded that 'they [Malaysian government] are capable of acting emotionally and irrationally and would be quite likely to do so in these circumstances'.[46] The link to aid was quickly, if reluctantly, dropped because of the dangers of pushing Tan too far. Aid was not a bargaining chip. The possibility that Malaysia maintained its assets in sterling in order to promote a good aid settlement is further undermined by the fact that Singapore had diversified unilaterally and with impunity in 1967.

By this time, the Bank's view was that 'We all feel very strongly that the Malaysians are outdoing the Australians in their intransigence'.[47] On 10 September, London offered an agreement equivalent to the one concluded with Australia with a 40% MSP and a private agreement to keep a higher proportion.[48] In Malaysia's case the private target was the status quo, 50% plus allowance for the currency board (i.e. 56%). The Malaysians agreed to the public MSP but wanted a lower private level and repeated that they would not agree to have such a side agreement written down, but only an oral commitment. The dispute dragged on until a meeting between Tan and the Chancellor on 23 September where Tan gave his verbal undertaking to consult London if Malaysia found it difficult to maintain sterling at 50% of reserves.

The final terms of the sterling agreement left Malaysia in practice very nearly where they had started in February 1968, when they agreed a programme of diversification down to 50% of total reserves, so it cannot be considered a victory for the Malaysian side. In addition, however, they now had an exchange guarantee for the US$ value of 90% of their official reserves, although the Malaysians persistently worried about a potential depreciation of the US$ (rather than of the £), which would erode this advantage. The victory for Malaysia was to get a deal at least as favourable as that offered to Singapore and Australia.

The operation of the agreement went ahead smoothly despite domestic political turmoil in 1969, although the BNM resisted reporting their sterling assets regularly. Figure 2 shows that during 1969 total reserves increased sharply as the price of rubber recovered and the value of total exports surged.

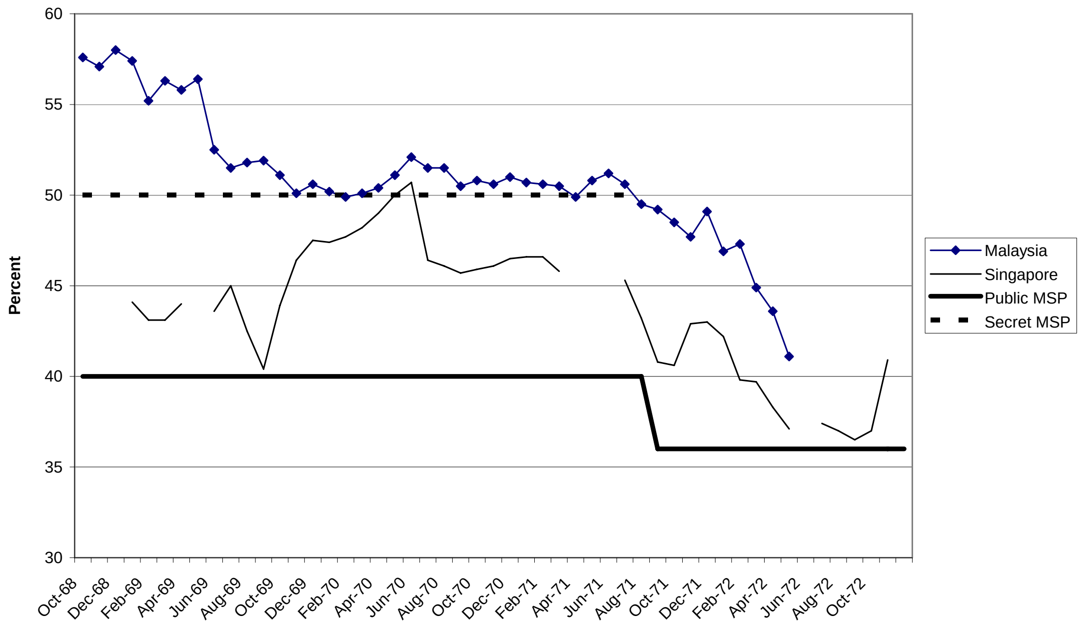
Figure 2: Malaysia's Reserves 1968-1972



Source: BE EID15/5-7

Figure 3 shows the differing patterns in the sterling holdings of Singapore and Malaysia under the agreements.

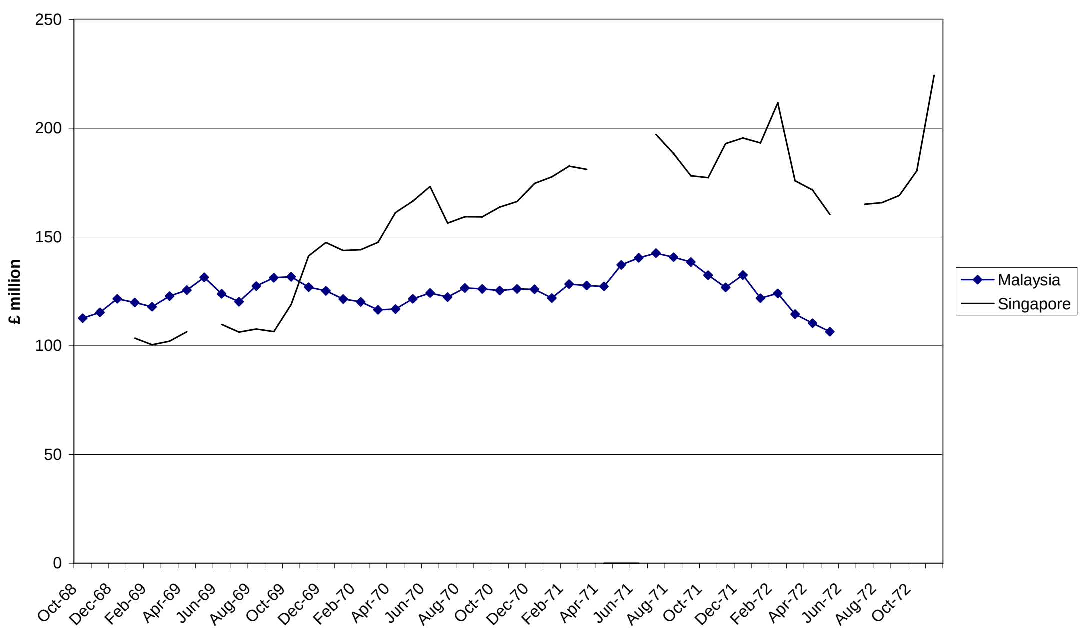
Figure 3: Share of Sterling in Reserves



Source: BE EID15/5-7, TNA T312/2649, 2650, 2966, T358/16

In terms of total reserves held in sterling, Malaysia retained the amount at a fairly constant level of between £150-160m, but the share in total reserves declined during the export booms of 1969 and again in 1972. The informal agreement of 50% was in fact binding for Malaysia after they diversified their reserves steadily during 1969. In the first quarter of 1970 Malaysia had to sell US$ and DM to a value of £16.2m to keep their sterling holdings above 50% of reserves.[49] Once the informal target was dropped in September 1971 and the MSP reduced to 36% Malaysia diversified quickly, although not as far as the new MSP. Conversely, the share of sterling in Singapore's reserve increased during the second half of 1969 to above 50% in June 1970. They then returned to about 46% from July 1970 to July 1971. After the Nixon shock of August 1971 and the subsequent depreciation of the US$ they reduced their sterling share closer to the new MSP of 36%. Figure 4 shows that the amount of sterling under guarantee increased for Singapore, but was quite stable for Malaysia. As we shall see, Malaysia allowed their agreement to lapse in June 1972 after sterling floated and thus were never able to take advantage of the exchange guarantee.

Figure 4: Amount of Sterling Guaranteed



Source: as for Figure 3

Leaving Sterling

Malaysia quickly became frustrated by the sterling agreement as the international monetary system crumbled. From early in its operation (and consistent with their criticism of the operation of the international monetary system generally) Malaysian officials in both the Treasury and the central bank began to worry about the implications of a depreciation of the US$, but their fears were repeatedly dismissed in London. During his meeting with the Chancellor in September 1968, Tan first raised the possibility of a US$ devaluation but the Bank of England arrogantly dismissed this as an 'economic conceit to imagine that Malaysia could appreciate against the US dollar'.[50] From early 1971 as the prospect for renewal of the sterling agreements approached, Ismail, Choi and Tan repeatedly complained about the weakness of the US$ and tried to press for an exchange guarantee in terms of gold. They also signalled early on that any renewal of the agreement would require the end of the oral commitment to a higher proportion than the formal MSP.[51] The proposed guarantee in terms of gold was abruptly dismissed when Jeremy Morse visited KL in March 1971 to canvas the possibility of a straight renewal of the agreements when they expired in September.[52] Tan asked for an interview with the Chancellor on the sterling agreements when he was in London, and they had a 40 minute discussion on the topic on 14 May. He again pressed for a gold guarantee given the turmoil in international currency markets in the spring of 1971 which had resulted in the revaluation of the DM.[53] The Chancellor 'made it clear that the UK could not move on this issue' because it would unpick the whole basis of the 34 sterling agreements and would add to uncertainty in international markets.[54] While most other sterling area countries were happy to acquiesce to the straight renewal, Malaysia tried to adapt the terms to their forecasted adjustments in the US$/gold rate.

At the end of July 1971 with two months left in the 1968 agreements, the Chancellor sent out invitations to all sterling countries to renew their agreements for a further two years with a unilateral and across the board reduction of 10% in all MSPs. London believed the agreements helped confidence in sterling, but they did not want to repeat the bitter bilateral negotiations of 1968. For Malaysia, the Chancellor proposed reducing the private working target to 45% from 50%. Tan replied on the day before the Nixon shock that he was ready to accept the 36% MSP but he refused to renew the working target.[55] Eventually the Chancellor of the Exchequer had to give way on this point. It was the easiest concession to make since it could be kept private, and thus not provide a precedent for other states to argue for concessions.[56]

On 23 August in the midst of the turmoil of the Nixon shock and while exchange markets were closed, Tan was taken into hospital suffering from pneumonia, which delayed the final agreement. This, in turn, prolonged the conclusion of agreements with Singapore and Australia who were waiting to confirm that there would be no further concessions to Malaysia. The draft letters were finally sent to Tan in hospital at the start of September and agreed just in time on 7 September 1971.[57] The formal text retained the reference to Malaysia's aim to hold 'appreciably more' of their reserves in sterling, but this was no longer privately specified. To outside observers, therefore, it was a straight renewal. Nevertheless, London had to release Australia from their private working target for fear that the Australians would learn of the concession to Malaysia. As noted in the Treasury 'we could not afford the loss of Australian goodwill which would result if they learnt (and we must expect they will) of a concession made to Malaysia but not generalized to them'.[58]

It is particularly curious given the sensitivity of Tan and Ismail to the value of the US$ that they concluded their second sterling agreement in September 1971 right after the Nixon Shock, but that the intervention rate for the guarantee was not a subject of discussion. In the event, because the $2.38 rate was explicitly referred to in the agreements rather than a par rate, the depreciation of the US$ against sterling from $2.40/£ to $2.60/£ under the Smithsonian agreements made the guarantee effectively inoperable. The sterling/US$ exchange rate could fall 8.5% before compensation would need to be paid. Tan wrote to the Chancellor to request a change in the trigger rate on 12 February 1972 in terms that suggest he expected the request to be uncontroversial.[59] Singapore went a step further and requested a formal review of the entire sterling agreement, with a view to abandoning it. For the British this posed considerable risk since if Singapore dropped the agreement, they would have to be ejected from the sterling area and exchange controls would need to be introduced between Singapore and Malaysia, which would be very difficult given the transferability of currencies. If, on the other hand, Malaysia followed Singapore in abrogating the agreement (which seemed likely) this would substantially reduce the proportion of total sterling covered by the agreements and thus mark 'the effective collapse of the structure of the Agreements'.[60]

The Malaysians assumed that the trigger rate for the guarantee would be automatically adjusted, but they were firmly rebuffed in a letter from the Chancellor delivered at the beginning of April 1972. Raymond Bell, Third Secretary of the UK Treasury visited KL on 12 April to discuss the issue with Malek Merican, Deputy Secretary of the Malaysian Treasury and Choi, Deputy Governor of the central bank, but there was no meeting of minds. The Malaysians could not understand how the UK could not agree to restore the spirit of the agreement. The British argued that Malaysia had benefited from the stability of sterling that the agreements promoted, and high yields in London. Their sterling assets continued to be guaranteed at the price they had been acquired. The Malaysian side acknowledged the longer term gain from the system, but argued that Tan's political position was exceptionally fragile if a further sterling devaluation was looming.[61] Bell argued that the prospects for sterling were good, but with memories of 1967 assurances in mind, the Malaysian side remained unconvinced.

The next day the British delegation met with Tan and Ismail. Tan brought along a dossier of clippings as evidence that there was a genuine risk that sterling would be devalued in the coming months.[62] Indeed, the Finance Ministry and the central bank (correctly) expected sterling to be devalued by the end of the year on the basis of these various accounts and Chancellor of the Exchequer Barber's most recent budget speech. Bell responded that Barbers' public comments about a more flexible exchange rate referred to his longer term proposals for the reform of the international monetary system, and reasserted that the UK government had no intention to devalue during the period of the sterling agreements. Tan argued that he could not afford politically to be caught out by another sterling devaluation, noting that 'even a donkey does not knock his head on the same rock twice'.[63] He had been assured there would be no devaluation in 1967 and also that the US would not raise the price of gold but both assurances had proved empty. Tan admitted that sterling reserves could not be diversified quickly given the weakness of the US$ and the unwillingness of other countries like Germany and Japan to have their currencies held as reserve assets. In March 1972 45% of Malaysia's reserves were still in sterling, amounting to £147m, which was well above the 36% MSP. Nevertheless, Tan advised Bell that unless an amendment was made to the trigger rate, Malaysia would allow the agreement to lapse by letting their sterling reserves to fall below the MSP. Bell confirmed that Malaysia would not then be eligible for the guarantee if sterling were subsequently devalued.

After these meetings, Tan wrote to Barber on 21 April 1972 to complain that 'I must admit that until I received your reply, I felt that the amendment proposed by us should present no difficulty to you...our recent talks with your Mr Bell confirmed our worst fears'.[64] He concluded that if the amendment was not forthcoming, Malaysia needed more latitude with its reserves policy and he reserved his position, warning that we 'may find it necessary to inform you that we have to re-consider our position in regard to the Agreement'. Barber responded rather equivocally on 12 May as speculative pressure was building against sterling. He asserted that 'Britain's external position is now stronger than for many years. There will naturally be fluctuations. Some things may go less well in the period ahead. Other things may go better'.[65]

The problems of the sterling agreement drew Malaysia and Singapore together in a united front against the UK. Just before Bell's visit, Lee Kwan Yew and Goh Keng Swee arrived in KL from Singapore to finalise the distribution of the currency board assets, resolve a long-running and bitter dispute over Malaysia-Singapore Airlines, and announce cooperation on international monetary affairs. The text of the press communiqué listed the following areas for consultation:

1. the sterling guarantee agreement
2. Malaysia and Singapore's future relationship with the Sterling Area when Britain joined the EEC on 1 January 1973
3. consultations on the views of the Malaysian Government for a greater voice for LDCs in the reform of the international monetary system, including SDRs and Tan's idea for a reserve asset backed by primary commodities or metals to replace existing holdings of reserve currencies.[66]

These two states also tried to bring the Australians with them in a joint request to change the intervention rate for the guarantee, but the latter had no sympathy for their cause.[67] Phillips, Governor of the Reserve Bank of Australia, professed to Bank of England officials that he was surprised by the approach from Singapore and Malaysia, and agreed to meet with them formally to discuss the issue (along with New Zealand), but reassured his London counterparts that 'so far as Singapore and Malaysia were concerned, he would continue to counsel moderation and patience on the lines he had done already.'[68] Bell's impression of opinion in Singapore, which convinced his masters in London, was that Goh was much more hostile to the sterling agreement *per se* than Tan, who wanted to continue the agreement but with the trigger rate adjusted.[69] The actual positions of Tan and Goh turned out to be the opposite once sterling floated.

A month after Barber's equivocal letter to Tan, sterling collapsed and had to be floated free of its fixed exchange rate on 23rd June. Malaysia's reaction was the most negative and vociferous of all the sterling countries as Tan accused the government of 'deliberate duplicity in having refused Malaysia's request for a new guarantee'.[70] In

Singapore, the chairman of the Monetary Authority, Wong, told the UK High Commissioner that they no longer felt bound by the sterling agreement, although they did continue with it until it expired, unlike Malaysia. Singapore announced that it had lost S$45m as a result of the float but Tan refused to reveal Malaysia's losses. On the basis of the amount of sterling in reserves in May 1972 the losses were probably of the order of US$21m or M$59m.

In Parliament, Tan boasted that

> 'the House can rest assured that we have done everything possible to safeguard the value of our external assets. We have not waited for events to happen before acting…indeed we do not think we are claiming too much when we say that we have anticipated events in this field more accurately and earlier than most other countries.'[71]

In order to maintain a pegged exchange rate both Malaysia and Singapore shifted their anchor from sterling to the US$, thus marking the end of their historic link to sterling. In fact, they were quite late in taking this step as Australia and New Zealand had shifted their peg to the US$ as part of the Smithsonian Agreement of December 1971.

During the first 5 months of 1972 (after the Smithsonian agreement and while the discussions over the trigger rate were underway) Malaysia reduced their sterling holdings by £26m, lowering the sterling proportion from 49% to 41%. After the float of sterling on 23 June, diversification to European currencies accelerated, and by 10 July 1972 the proportion of sterling was below the 36% MSP threshold. The Bank of England reported that £40m was transferred by Malaysia to deposit at European commercial banks, half in Germany and a further £15m in Switzerland.[72] The evidence is a bit ambiguous but hints from the BNM at the time suggest that, despite his claims in parliament, Tan did not move substantially out of sterling before the float.[73]

Despite the renewed sense of betrayal over the sterling float (or sink) so soon after re-assurances from London, the subsequent depreciation of sterling appears to have caused Tan to regret abandoning the right to compensation under the Sterling Agreement. He wrote to Barber in early July 1972 offering to restore Malaysia's sterling proportion to 36% if Barber agreed to amend the intervention rate to $2.60 with retrospective effect from December 1971, the date of the Smithsonian agreement.[74] This would mean effective compensation for the depreciation of sterling from $2.60 to $2.45 where it had stabilised by early July. Ex post compensation was not on the table, but officials from the Treasury and the Bank of England were sent out to KL to seek a new sterling agreement. UK Treasury officials and the BNM favoured a new agreement with a trigger rate of perhaps \$2.50, but Tan refused even to consider a new agreement without compensation for losses from the float and the talks were abandoned.[75] By this time Ismail was clear that the sterling agreement had been broken and he expressed his understanding to Bank of England officials that this made Malaysia ineligible for the guarantee in the future. When sterling was floated, the UK disbanded the sterling area and imposed exchange controls equally between sterling and non-sterling countries. Ismail told the Bank of England that one of the reasons for breaking the agreement was fear that Malaysia's sterling balances would ultimately be blocked by London.[76] This is evidence of a final collapse in the trust between KL and London and it is striking that Malaysia was the only sterling country to abrogate their sterling agreement in response to the float. Three months later, on 24 October 1972 sterling fell below the original trigger point of \$2.38 and the exchange guarantee was activated. Malaysia was no longer eligible for compensation but Singapore still held 41% of its reserves in sterling at this point and had £224.4m in guaranteed sterling assets, so they were paid £4.7m compensation.

Table 2 shows the declining share of Malaysia in official holdings of sterling reserves. By the time they abrogated the agreement, which was received with relative equanimity in London, they held less than 4% of overseas sterling reserves compared with over 17% in 1966. This was mainly due to accumulations elsewhere, in particular oil producing countries like Kuwait and Nigeria at the end of the 1960s. London's attention had by this time moved beyond Malaysia and the abrogation of the sterling agreement did not disrupt relations with London.

Table 2. Malaysia's Share of Sterling Area Sterling Reserves

	Percent of Sterling Area Sterling Reserves
June 1966	17.2
October 1968	7.8
May 1972	3.8

Source: June 1966, Treasury Historical Memorandum, *The Sterling Balances since the War*. TNA T267/29. For 1968 and 1972, BE EID15/5 and EID15/7.

Summary and Conclusions

The collapse of the Bretton Woods system posed new challenges for the leaders of newly independent states like Malaysia. A decade after independence, the Malaysian government and central bank were faced with a series of challenges that forced them to develop an independent policy, leading to the end of the historic role of sterling in their international monetary regime. Like some economies today that are faced with accumulated reserves largely comprised of a depreciating currency (now the US$), Malaysia had to disentangle itself from sterling at a time when there were no clear alternatives since gold was scarce, the US$ was weak and Germany, Switzerland and Japan resisted the use of their currencies as national reserves. External obstacles as well as some misjudgement meant that this was only achieved in June 1972, 15 years after Merdeka.

The archive evidence shows that Tan and Ismail correctly predicted shocks to the system (change in the gold price and depreciation of sterling) and sought to adapt their Sterling Agreement to protect themselves but they failed, partly because of intransigence in London and the lack of concerted cooperation from other sterling holders. On the one hand Tan appears to have repeatedly trusted reassurances from London and relied on his personal relationship with the Chancellor of the Exchequer, but on the other hand he railed against the dominance of British influence and sought to identify a policy that better reflected Malaysia's national interest.

The large value of sterling assets held by Malaysia as a legacy of the colonial monetary system turned out to be a mixed blessing. On the one hand it made London take Malaysia's claims seriously and they expended a great deal of time in the negotiations. On the other hand, London could not afford to make significant concessions to Malaysia, partly because of the intrinsic cost given the size of the assets, and partly because of the precedent this would set for other countries. We have also seen that the large value of sterling assets constrained Malaysia's ability to diversify since they could not sell off a significant proportion of their sterling assets without undermining international confidence in the exchange rate of the pound, thereby precipitating the devaluation of their remaining sterling assets. A further consideration was the low market price of longer term British government securities, which meant that rapid sales would incur capital losses. Beyond these external limitations on policy-making, the process of disengaging from sterling was prolonged by traditional relationships with London that persisted despite repeated betrayals of Malaysia's interests.

Malaysia was slower to react to the new realities of their loosened relations with London than Singapore was, and ministers were acutely aware that they did not benefit from the comparison with the more forward looking and independent policy of Singapore in 1967. Drawing on this experience, and the betrayal by advisers in London, Tan tried to drive a hard bargain over the freedom to determine the currency composition of their reserves in 1968. In this, he successfully achieved a deal equivalent to that of Australia and Singapore, which was much more than London initially offered, but it was not much better than the status quo ante. Malaysia faced a further disappointment in August 1971 when the guarantee trigger was not revised to take account of the US$ devaluation. Nevertheless, they continued to adhere to their sterling agreement and to peg to sterling despite the fact that the UK accounted for only 10% percent of their total trade and that other countries like Australia and New Zealand chose this moment to shift their exchange rate anchor to the US$. It took the float of the pound in June 1972 in the context of local inflationary pressure to push Tan to abandon sterling, but by this time it was arguably too late. The postcolonial experience of Malaysia was clearly complex and determined by both political and economic events beyond local control as well as by the legacy of colonial relationships.

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