Monetary Institutions in Malaysia & the Transition to Independence[1]

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As Europeans have been learning over the past 5 years, exchange rate policy has fundamental implications for the exercise of independent economic policy and therefore for national sovereignty. The famous Mundell-Fleming trilemma elegantly shows that with fixed exchange rates, an independent monetary policy can only be pursued with tight capital controls. At a time such as the 1960s and 1970s when capital flows were accelerating quickly beyond the control of national authorities, maintaining a pegged exchange rate required the loss of policy sovereignty. This was not controversial when the main anchor currencies were low inflation, fast growing economies, but as the British and American economies suffered from persistent balance of payments deficits and rising inflationary pressure, the opportunity cost of fixed exchange rates increased. For Malaysia, this situation was further complicated by the state's ambitious development plans and the geographical diversification of trade and payments. On the one hand, a fixed exchange rate makes it more difficult to implement development plans if they imply higher rates of inflation, but on the other hand a stable exchange rate may be needed to encourage the capital inflows on which industrialisation depended. This dilemma was faced by Malaysia in the early 1970s in a period of turmoil in international monetary markets and when policy orthodoxy was shifting from preference for fixed rates to floating. Examining Malaysia's exchange rate policy and the abandonment of the historic link to sterling, therefore, promises to offer fresh insights into the transition to independence.

The end of the colonial era did not mark the end of the close economic and financial relations that had developed among Britain, Malaysia 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. Along with other developing economies, Malaysia was caught up in the turmoil of the collapse of the Bretton Woods fixed exchange rate system and the retirement of sterling as a major reserve asset. Although Malaysia's robust balance of payments 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 Malaysia's importance to the development of sterling policy in London.

This paper uses new archival evidence to explore Malaysia's reserves management and exchange rate policy. Malaysia was faced for the first time with having to make an independent decision about the future of their exchange rate policy and to adjust their reserves management to the new era of currency instability. In terms of reserves management, the global re-distribution of sterling assets in the post-war period increased the importance of Malaysia to the operation of sterling as a reserve currency. By June 1966 Malaysia was the world's fifth largest holder of overseas sterling balances (after Australia, Kuwait, Hong Kong, and Ireland). Malaysia was also the second largest government holder of sterling assets in the world, exceeded only by Australia. This gave Malaysia considerable bargaining power in London over the disposition of these assets. Like many countries in this period (particularly in Europe), most developing economies sought to retain adjustable pegged exchange rates when the main currencies floated free in 1971-73, but they found this increasingly difficult to sustain in an environment of general floating. Their solution, in common with other trade-dependent countries such as New Zealand and Australia, was to maintain stability against a trade-weighted basket of currencies.

Reserves Strategy before the Sterling Devaluation of 1967

While Malaysia was negotiating its independence in the mid-1950s, the potential for monetary independence had a symbolic importance as an emblem of state-hood. On the other side, the governments of Singapore and the UK fought hard during the run-up to Merdeka to continue to have a common currency in the two territories.[2] 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 Malaysian central bank began operations in 1959, but the joint currency board continued to issue currency for the two territories under the Currency Agreement 1960. It could be argued that this constrained the monetary independence of Malaysia during the period of transition after constitutional adjustment, but the scope for independent policy under a pegged exchange rate and with no local money market was in any case limited. The system arguably served Malaysia well as the economy grew quickly and confidence in the currency system was retained. Malaysia did not take up the opportunity to invest up to one third of the assets of the currency board in local securities, which would allow the use of local reserves for development. Confidence in the currency was a key component in promoting international confidence in the stability and probity of the new regime, which in turn was vital to retain and promote foreign investment for development.

With the 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 Bank Negara Malaysia its issuing powers. After the abrupt political separation of Singapore from Malaysia in August 1965, Singapore continued to hope that the currency union could be prolonged and Lim Kim San, Finance Minister of Singapore wrote to Tan Siew Sin, his Malaysian counterpart, to propose the continuation of the currency board, or failing that preferred option, the two states should establish a joint central bank.[3] Ismail bin Mohamed Ali, Governor of the Bank Negara Malaysia, quickly met with Lim and presented him with a proposal for the issue of a joint currency by extending the Bank Negara Malaysia's jurisdiction to Singapore. He rejected outright the continuation of the currency board as an outdated and inflexible system. Having waited 6 years for full powers of a central bank, Ismail was not content to let the opportunity to seize these powers escape. More controversially for Singapore's sovereignty, his proposal would see his Bank supervise the Singapore banking system, operate Singapore's exchange control and be banker and financial adviser to the Singapore government.[4] For Singapore, the writing appeared to be on the wall for the end of the common currency and Tan moved quickly to try to secure a firm commitment on the distribution of the foreign currency assets of the currency board in the (now likely) event of its dissolution. In response to Ismail's criticism of the currency board, Lim pointed out that the automatic nature of the currency board had ensured the stability of the M$, and he questioned whether local money markets were yet developed enough to allow effective open market operations needed for monetary independence. Ismail acknowledged that this area was still underdeveloped, but asserted his goal of developing the local money market, as had begun with the establishment of Short Deposits (Malaysia) Limited. This exchange highlights the different attitudes of the two states to monetary policy, with Singapore more conservative and Malaysia wanting to take advantage of opportunities for a more expansionary policy in line with their development aspirations. These different priorities further undermined the prospects for a currency union.

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 by discouraging the use of Singapore for trade and taking over the marketing of their own production. Political relations between the two states also disintegrated during the mid-1960s. As the IMF mission to the two states in November 1965 delicately put it '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.'[5] The negotiations were finally abandoned in August 1966 and each territory set out to develop their own national currencies with the help and advice of IMF officials.

The problem of the disposition of the currency reserve rumbled on for a further 4 years. From 1960, the currency board moved from longer term securities (of maturity greater than two years) to the shorter end of maturities and Treasury bills. This process accelerated as the board began to liquidate assets and place the proceeds on deposit in banks in London from 1965-66, and the bulk of the reserves were distributed to the constituent states in 1967. In 1964 the currency board held S$1.56b or 47% of Malaysia's foreign exchange (including Singapore) so the distribution of these assets between Singapore and Malaysia was not a trivial issue and was, in the end, prolonged for a further five years after it ceased to issue notes, when the distribution was finally resolved in Malaysia's favour in 1972.[6]

Despite these outstanding quarrels, in June 1967 the separate currencies were finally introduced. To retain the advantages of integration, however, each currency was to circulate at par in the other territory with periodic clearing back to the country of issue. The external exchange rates were also fixed at parity against sterling. For the HSBC, the change required the switch of the West Malaysia branch's accounts from Singapore to Kuala Lumpur. Higher interest rates in Singapore (1/2% above prime) encouraged the bank's clients to shift their overdrafts to Malaysian branches. The bank also reported that 'firms in KL who previously paid for their imports in Singapore are jibbing at the increased rate of so-called inland exchange and are also transferring their facilities'. The separate currencies thus encouraged more banking activity in Malaysia, although HSBC continued to complain about the increase in regulations and request for statistics by the Bank Negara Malaysia.[7] Part of the Bank Negara Malaysia's policy was to discriminate against foreign banks in its efforts to encourage domestic banks. From 1959 only foreign banks already operating in Malaysia were allowed to increase the number of branches. From 1971, no new foreign banks were allowed to enter and no new branches were allowed.

An important consequence of the introduction of the Malaysian dollar on 12 June 1967 was the decision to diversify Malaysia's currency reserves out of sterling and into other foreign currencies. It was recognised, however, that the foreign reserve backing for the new currency would need to be no lower than under the currency board. The minimum was set at 80.59% but the central bank expressed publicly its policy to maintain reserves well in excess of this limit.[8] When the joint currency board had been established in 1959, the Malaysian side had argued strongly for the statues to include the option of investing in assets other than sterling, specifically dollar assets. The Bank of England was powerfully opposed. As long as the M$ was pegged to sterling, holding dollar securities would introduce an exchange risk – if the US$ devalued then the cover for the local currency would be reduced. The Malaysians, 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.[9] 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.[10] 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. The theoretical ability to diversify reserves, however, was viewed in 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'.[11]

The diversification of the currency reserve remained high on the central bank's agenda, particularly as the exchange rate of sterling came under threat in the mid-1960s. In July 1966, when sterling underwent a crisis of confidence, Ismail began to diversify the central bank's official holdings of sterling into dollars. The process was only halted by the visit of a Bank of England official to Kuala Lumpur who persuaded Ismail to resist adding pressure to the crisis. At this time, the Finance Minister Tan

Siew Sin, asked London for an exchange guarantee for their sterling reserves, but was refused. The Chancellor urged Tan to hold the line 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. A year later, in July 1967, with the prospect of 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.[12] There was some confusion or at least inconsistency between the government's disposition of their official reserve assets and those of the central bank. In 1966, two thirds of Malaysia's gold and foreign exchange reserves were held directly at the Bank Negara Malaysia, the rest being in the government's direct control.[13] At a meeting with the Chancellor in London in early July 1967, Tan reassured the Chancellor that he did not expect to engage in further diversification during 1967.[14] 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.[15] In the end, the diversification did not proceed as quickly as planned and by the eve of the sterling devaluation in October 1967 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 at the time of the devaluation with large sterling holdings and the devaluation cost the reserves M$250m. Tan had been reassured by the Chancellor in July 1967 that 'there was no question of devaluation', but this proved untrue when sterling was devalued 14% on 19 November.[16]

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, and in the degree of independence shown in their reaction to the collapse of the international monetary system more generally. Malaysia was revealed as having fallen far behind the more entrepreneurial and self-interested Singaporean policy of secretly diversifying their 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's progress and to identify more carefully (and act on) Malaysia's own national interests rather than taking advice from London.

After the devaluation of sterling in November 1967, Goh Keng Swee announced that he had run down the sterling proportion of Singapore's reserves in the months running up to November. This took 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 November that the actual proportion was closer to 50%. Domestically, Goh was able to show that his policy had saved the Singapore reserves from some of the damage of the sterling devaluation. For London, this announcement threatened the discipline of the sterling area system since it presented a new benchmark for the developing members' holdings of sterling. More fundamentally it was greeted as a signal of a loss of intimacy and trust between Singapore and London that stemmed also from the withdrawal of troops from East of Suez announced in the summer of 1967. In Singapore, this episode strengthened the political capital of Goh in his more hostile attitude to Britain as against Lee, who professed to want to maintain strong links with London.

In contrast to the foresighted policy of Goh, the Malaysian government was thrown into a rather unflattering light as having trusted Britain too much and not acted in their own interests soon enough. Malaysia still held 82% of their reserves in sterling by the end of October 1967 and, while they had negotiated with the Bank of England permission for a slight diversification, this was not to the 50% level of Singapore. Table 1 shows the position of Malaysia in comparison with its sterling neighbours. This more cooperative attitude on the part of the Malaysians did not reflect warm relations between London and KL. Finance Minister Tan was described in London as 'excitable and too easily led into controversy', 'obstinate and self-satisfied' and displaying 'very strong anti-British feelings' in 1966.[17] Nevertheless, Tan had left Malaysia behind Singapore, which made his domestic political position more vulnerable and enhanced his intransigence in future negotiations.

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.

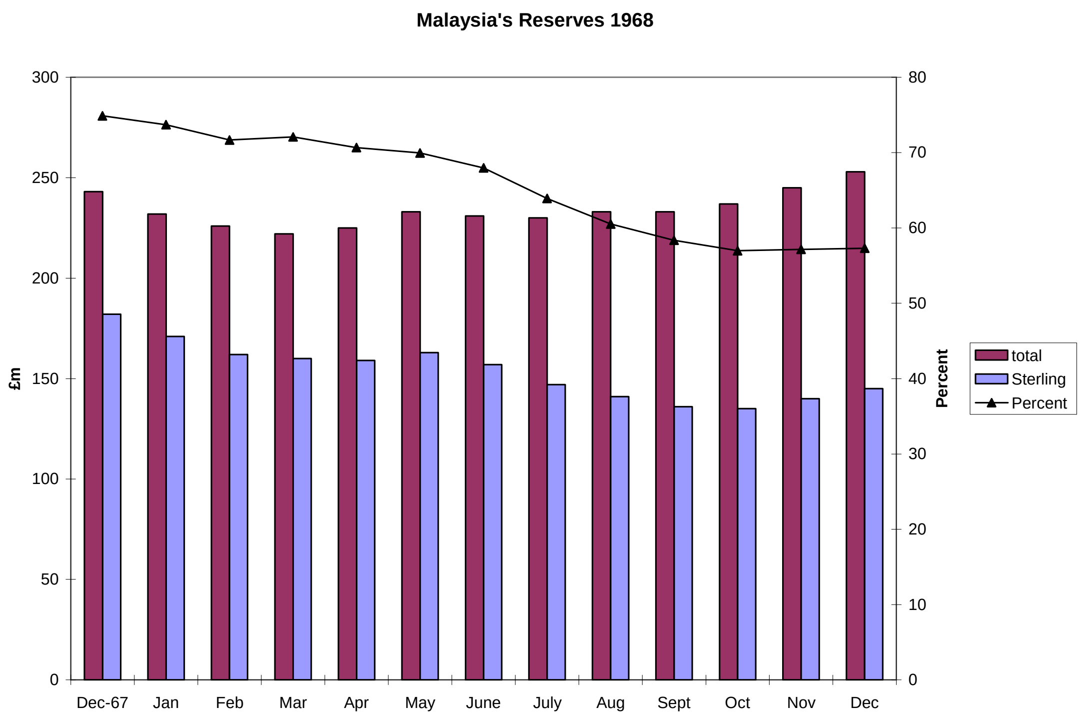
At the start of February 1968 Choi Siew Hong, Deputy Governor of the Bank Negara Malaysia, met with officials at the Bank of England to set out their diversification plans for the currency reserves.[18] The objective by the end of the year was a distribution of 40% each for sterling and US$ (compared with a 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 sales of sterling 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 of securities would incur significant losses.[19] 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

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. 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 $2b in short term credit to cover diversification of global sterling reserves.

Figure 1 shows the accelerated diversification while the negotiations over the sterling agreement were underway from July to September 1968.

Figure 1



In May 1968, Ismail toured Europe to canvas various central bankers' reactions to the possibility of Malaysia diversifying their reserves into European currencies.[20] At the end of May and the start of June, Ismail made two deposits of SFr5m each at the BIS. By the 12 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.[21] Figure 1 shows that Malaysia's sterling assets were run down by £27m between May and September while total reserves were almost constant. The increase in DM assets is particularly striking and related to the strength of the DM in international markets and the proceeds of DM borrowing. 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$25m raised from a consortium of commercial banks in US$.[22] 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.[23] Reserves diversification was thus accomplished partly through international borrowing that formed part of the Second Malaysia Plan. In the summer of 1969 most of the DM deposits were withdrawn to be invested in DM securities with higher yields. As well as currencies, Ismail also began to make gold deposits (loco London) with the BIS. Malaysia had begun to buy gold in September 1967 and by June 1971 the BIS held 29m tons of gold on Malaysia's account, when Ismail asked the gold to be transferred to loco Berne.[24]

At first it seemed that London's negotiations over the sterling agreement with Malaysia would be quite straightforward, particularly in comparison with Singapore. 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 for Malaysia 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'.[25] In July 1968, on the eve of the negotiations, Tunku Abdul Rahman visited London and was favourable to the proposed agreements, remarking to the Australian High Commissioner in London that he had agreed to the general proposals because 'we had to, we could not afford another devaluation, we lost so much the first time'.[26] 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.[27] The MSP was much higher than the 50% 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 for Malaysia 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'.[28] In August 1968, Ismail was earning 6% on 12 month dollar deposits at the BIS and 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 Haslam of the Bank of England. 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'.[29] 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 announced that he expected 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$2 billion 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'.[30] 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, the Malaysian side preferred to prolong the negotiations until the attitude of other sterling countries had been expressed, and indeed Tan pressed in vain for a collective sterling area conference on this topic. London (and sterling) could not afford the publicity that such a meeting would generate and so this proposal was quickly rejected. A further complication was that KL would be technically responsible for the sterling proportions of Sabah and Sarawak over whom they had little effective control. As the negotiations progressed, the Malaysian side grew particularly concerned about the possibility of accidental breaches in the MSP that would make them ineligible for the guarantee. 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 to the terms of any agreement concluded with Singapore, which was vital for public opinion. 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 actual 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), un-guaranteed proportion (10%) and MSP (50% for government reserves plus provision for the currency 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 gentleman's agreement to maintain a working target of 50%. London could not accept such a low 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 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.[31] 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'.[32] 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.[33] 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.[34] 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'.[35]

By this time, the Bank's view was that 'We all feel very strongly that the Malaysians are outdoing the Australians in their intransigence'.[36] On 10 September, London offered an agreement equivalent to the one concluded with Australia and Singapore with a 40% MSP and a private agreement to keep a higher proportion.[37] 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$, which would erode this advantage. In addition, Malaysia asked for and got the Australian concession on future access to the London market to refinance debt, although this was not in the end needed and so did not sweeten the deal for them in practice. The victory for Malaysia was to get a deal at least as favourable as that offered to Singapore and Australia.

The operations of the agreement went ahead smoothly despite domestic political turmoil in 1969, although the Bank Negara Malaysia resisted reporting their sterling assets regularly. Figure 2 shows that during 1969 the total reserves increased sharply as the price of rubber recovered and the value of total exports surged. This combination of a rise in reserves with low demand for advances because of the political uncertainties increased banks' liquidity and prompted the central bank to raise commercial banks' statutory reserve ratios for the first time in July 1969 (from 3.5% to 5% of deposits), marking the start of a more active phase of monetary policy.

Figure 2

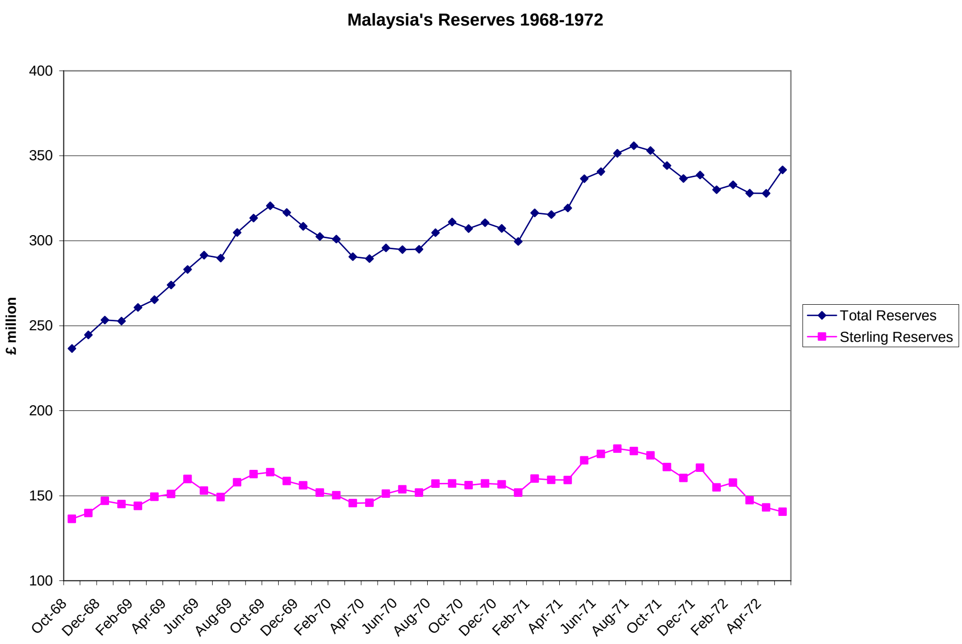
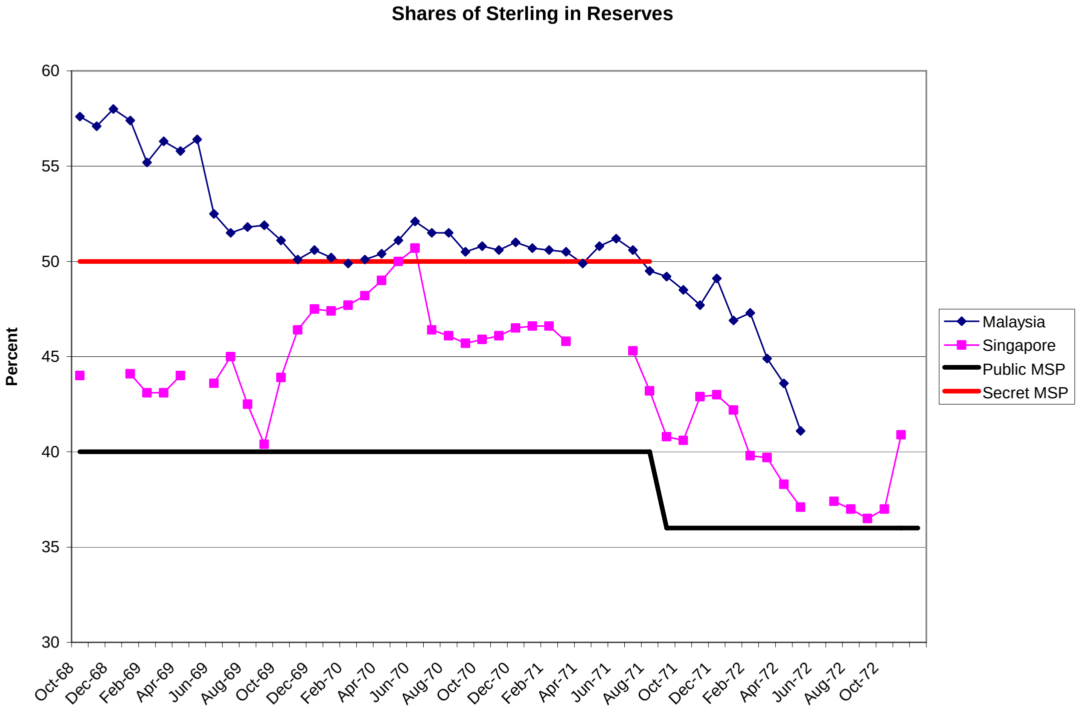


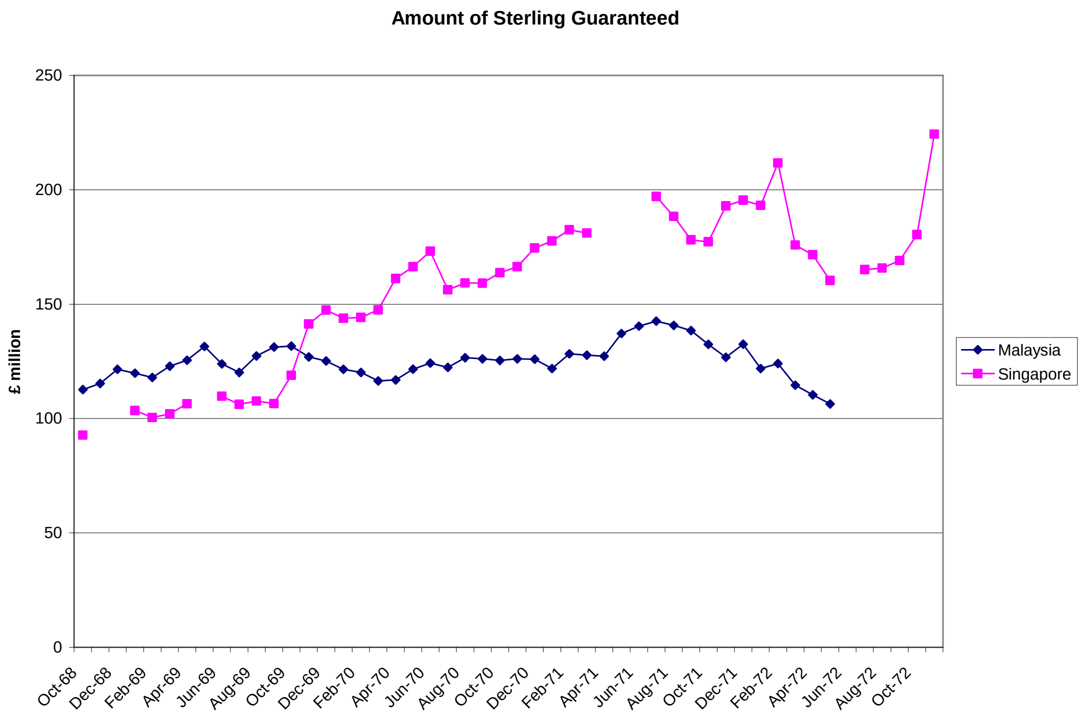
Figure 3 shows the differing patterns in the sterling holdings of Singapore and Malaysia under the agreements.

Figure 3



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%.[38] Once the informal target was dropped in September 1971 and the MSP reduced to 36% (and after the Nixon shock) Malaysia diversified their reserves 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 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



Malaysia quickly began to become 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$, but their fears were repeatedly dismissed in London. This is evidence of an increasingly independent stance by Malaysia, not connected directly with attitudes among its comparator countries. During his meeting with the Chancellor in September 1968, Tan first raised the possibility of a US$ devaluation but the Bank of England dismissed this rather arrogantly as an 'economic conceit to imagine that Malaysia could appreciate against the US dollar'.[39] From early 1971 as the prospect for renewal of the sterling agreements approached, both the Ismail and Choi of the Bank Negara Malaysia, 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.[40] 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.[41] 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.[42] The Chancellor 'made it clear that the UK could not move on this issue' because it would unpick the whole basis of the agreements. A complete renegotiation would add to uncertainty in international markets.[43] This shows that, 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. Tan also encouraged the Chancellor to consider a more formal programme of reducing sterling as a reserve currency by replacing the sterling agreements with a scheduled annual reduction in sterling reserves.

At the end of July 1971 with two months left in the sterling 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, partly as a result of pressure from the French to make progress in reducing sterling as a reserve currency in anticipation of accession to the EEC. London wanted to renew the agreements, which they believed had helped confidence in sterling, but did not want to renew 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, although he pointed out that this meant that the value of sterling reserves held by Malaysia would be about the same as the amount held in September 1968 because total reserves had increased.[44] He refused, however, to renew the working target. Eventually the Chancellor of the Exchequer had to give way on this point. This was the easiest concession to give up since it could be kept private, and thus not provide a precedent for other states to argue for concessions.[45]

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.[46] 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'.[47]

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 $2.40 rate was explicitly referred to in the agreements rather than a par rate, the depreciation of the US$ against sterling to $2.60 under the Smithsonian agreements made the guarantee effectively inoperable. Only Malaysia, Kuwait and Bahrein raised the issue of the guarantee level after the Smithsonian parities were re-set at the end of 1971. 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.[48] 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 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'.[49]

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. 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 Siew Hong, 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 to Malaysia from the system, but argued that Tan's political position was exceptionally fragile if a further sterling devaluation was looming. Without adjustment of the intervention rate, sterling could depreciate up to 8.5% against the US$ back without triggering the guarantee.[50] Bell argued that the prospects for sterling were good, but 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.[51] 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 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'.[52] 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 reserves. In March 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 allowing 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.

Tan wrote to Barber on 21 April 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'.[53] 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' but he did not urge Tan to take any particular path.[54]

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.[55]

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.[56] 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.'[57] 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. Goh was more concerned to be able to diversify out of sterling in advance of any SDR proposal that would replace sterling as a reserve asset, a prospect he found unappealing.[58] The actual positions of Tan and Goh turned out to be the opposite once sterling floated in June 1972.

A month after Barber's rather equivocal letter to Tan, sterling collapsed leading to the introduction of a floating 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'.[59] 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 $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.'[60]

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, reducing the sterling proportion from 49% to 41%. After the float of sterling on 23 June, diversification to European currencies was 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.[61] The evidence is a bit ambiguous but Bank of England evidence and hints from the Bank Negara Malaysia at the time suggest that, despite his claims in parliament, Tan did not move substantially out of sterling before the float.[62]

Despite the renewed sense of betrayal over the sterling float (or sink) so soon after assurances that the pound was strong, the depreciation of sterling renewed Tan's interest in the guarantee. 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.[63] 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 discuss the potential for a new sterling agreement. UK Treasury officials and the Bank Negara Malaysia 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 abaondoned.[64] 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.[65] This shows a particularly low level of trust. In the end, Malaysia was the only sterling country to abrogate their sterling agreement unilaterally in response to the float. Three months later, on 24 October 1972 sterling fell below the original trigger point of $2.40 and the 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. Tan's backtracking over the abrogation in July suggests that he may have regretted his hasty decision.

Throughout the tortuous management of the decline of sterling as a reserve currency, Malaysia struggled to identify and then deliver their national interest. With their trust in British ministers undermined in 1967 and again in 1971, they turned more resolutely than their neighbours toward an independent policy of reserves diversification from July 1972 and at the same time began to reconsider their exchange rate policy.

Exchange Rate Policy

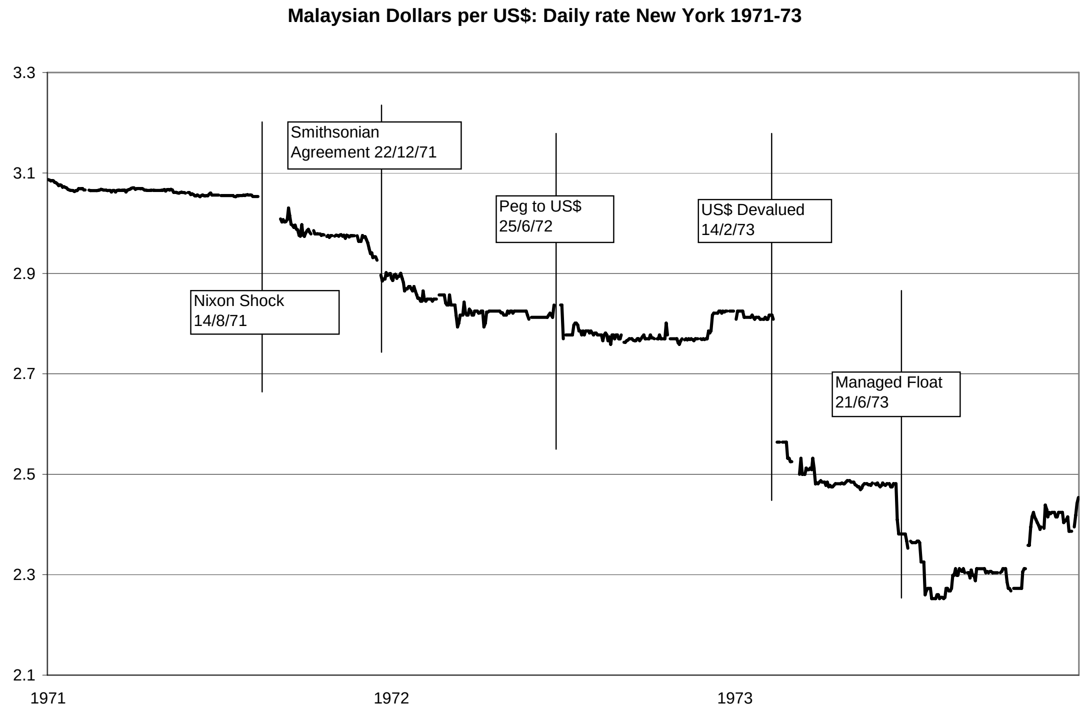
Related to the issue of reserves policy was the complicated problem of choosing an optimal exchange rate regime. Throughout the post-war period the dominant paradigm of pegged exchange rates enforced by the IMF under the Bretton Woods system appeared uncontroversial. Malaya as a colony and then as an independent state benefited from membership of the sterling area, with the exchange rate pegged to sterling rather than directly to the US$ or gold. In the 1950s this conferred advantages of free capital flows and trade preference in return for holding the bulk of exchange and currency reserves in sterling. Moreover, given the dollar shortage in the 1950s, it was preferable for many countries to have sterling as their intervention currency. By the 1960s, however, these advantages began to wane as sterling became less stable as an anchor due to inflationary pressure in the British economy and the fragility of the sterling exchange rate against the US$ and DM. At the same time, however, the US$ was increasingly under pressure which reduced its attractions as an alternative anchor. The strong European and Asian economies (such as Germany, Switzerland, Japan) operated capital controls in order to discourage overseas holdings of their national currencies so pegging to them was also not an option. As the fixed exchange rate system crumbled from 1967 with the devaluation of sterling, through the collapse of the gold pool in March 1968, the devaluation of the US$ in August 1971 and then the float of sterling in June 1972, many countries were faced with the need to either shift their peg from sterling to another currency or to float. Countries like Malaysia with a large exposure to international commodity markets sought exchange rate stability, but stability against which currency? And how was this to be achieved when the traditional anchor currencies were themselves unstable? These questions were even more difficult for Malaysia whose national currency was freely transferable with that of Singapore from 1967.

Tan's decision not to allow the new Malaysian dollar to follow the devaluation of sterling in 1967 appears to have been a hasty one. Tan telephoned his counterpart in Singapore, Goh Keng Swee within a few hours of the sterling devaluation to inform him that the new Malaysian dollar would not depreciate. Lee Kwan Yew thought the decision misguided, given that Malaysia was reliant on primary product exports like rubber and tin that were traded in sterling, since this made their exports less competitive.[66] Because Singapore was the commercial centre for Malaysia, however, they followed the M$. Meanwhile, the old Malayan dollar retained its statutory peg to sterling so that it depreciated against the new dollar. This effectively helped to speed up the transition from one currency to the other (there were still $600m of old currency in circulation) but at the cost of considerable social and political unrest. The decision was even more damaging since it was poorer and rural inhabitants that tended to hold the old currency and were thus disadvantaged. Riots broke out as the population felt betrayed by the government that had promised a 1:1 exchange of old to new currency.

PJ Drake argued strongly that the M$ should have been devalued in order to boost economic growth and the balance of payments.[67] Ceylon, an important rubber and tin producer devalued and thus gained a competitive edge. Lee argued along the lines of the official Bank Negara Malaysia position that the inflationary impact deriving from higher import prices of rice and other foodstuffs from neighbouring countries that did not devalue would have outweighed any positive impact of devaluation on exports.[68] Such inflation, of course, would also have had important political implications because of the effect on the cost of living. The supply of Malaysia's key exports (rubber and tin) were price inelastic so devaluation would not boost export earnings. Demand for key foodstuffs was also price inelastic so the balance of trade would have worsened. Lee also argued that the world prices for rubber and tin were determined by the US$ price and that the sterling price quickly rose to compensate for the devaluation, so restoring domestic currency producer incomes. The US$ price of rubber had been falling since mid-1966 and by November 1967 was at 16 cents per pound (a fall of almost 22% over a year earlier). During 1968 the price recovered and so did export earnings. The revaluation against sterling was accompanied by increased government spending in 1968 and 1969 that helped to offset the deflationary impact. Although export earnings fell slightly in 1967, this cannot be attributed to the exchange rate changes that happened in November of that year. In 1968, earnings recovered and then exports boomed in 1969. It is difficult in these circumstances to identify a negative outcome from the exchange rate policy chosen in 1967. The real effective exchange rate calculated by the BIS for Singapore shows very little impact from the nominal appreciation against sterling. The nominal effective exchange rate, in contrast shows a dramatic appreciation, which suggests that prices adapted quickly.

The next shock to the system came on 15 August 1971 when President Nixon suspended the convertibility of the US$ to gold and threatened import restrictions unless surplus countries responded by revaluing their currencies against the US$. With Tan in hospital on 23 August 1971, Fogarty asked the Deputy Financial Secretary whether the M$ would follow sterling when exchange markets re-opened and was told that this was likely, although it was still under consideration.[69] In the end, the decision was taken (in common with other sterling countries) to remain with the pound at M$7.3469/£ and the M$ floated up against the US$ for the rest of the year. In December 1971 the par value system was restored under the Smithsonian Agreement with wider margins of +/-2.25%. Malaysia, unlike Singapore, did not adopt these wider margins and instead availed itself of the arrangement under the Smithsonian Agreement by which countries could continue to peg to currencies other than the US$ within the narrow band of +/-1%. Malaysia's policy of sticking with sterling contrasted with that of Australia and New Zealand, who reacted to the wider Smithsonian margins by moving their peg to the US$ directly in order to reduce the range of fluctuation. With wider margins of +/-2.25% around gold parity combined with a margin of +/-1% with sterling, the M$ could fluctuate by as much as +/-6.5% against the US$. Figure 5 shows the bilateral nominal exchange rate with the US$.

Figure 5



The Smithsonian agreement proved a temporary resolution. In the first six months of 1972 the pound came under increasing pressure and on June 23 was floated, posing a further shock for Malaysia's policy-makers who chose this time to move their peg to the US$. The main reason was that domestic inflationary pressure was mounting and following sterling in a depreciation against the US$ would merely accelerate this pressure. This was a common reaction to the sterling float by many countries who had maintained the peg to sterling through the Smithsonian agreement. By shifting the peg to the US$, this outcome was averted and a sharp appreciation against sterling instead somewhat ameliorated the inflationary pressure. Nevertheless, in the second half of 1972 inflation accelerated even further due to government expenditure and external borrowing. Import prices also rose while export prices stagnated so that the value of the trade surplus for the year fell by almost half compared to 1971 and the current account went into deficit. Lee Hock Lock blames higher prices for rice and sugar for the rise in the consumer price index by 1.6% in 1971 and 3.2% in 1972.[70]

In common with other developing countries pegged to the US$ during the primary produce boom of the early 1970s, the bilateral peg to the US$ also soon proved inappropriate for Malaysia. In February 1973, in response to its own domestic pressures, the US$ was unilaterally devalued by 10%. Malaysia restored its peg at the new rate of US$2.50/M$ but a month later most major currencies were floating, leaving Malaysia pegged to a depreciating US$ for another four months despite persistent inflationary pressure. In June 1973, under pressure of inward speculative capital flows, the central bank abandoned its efforts to keep the M$ within its upper bound against the US$ and allowed the M$ to appreciate. The World Bank judged this an important element in the containment of inflationary pressure.[71] This was formally an abandonment of the par value but did not constitute a true floating rate since the central bank announced that it would continue to intervene to prevent 'sharp and erratic fluctuations' and that it would not let the M$ depreciate below the ex ante lower bound.[72] In the midst of the oil crisis in the first quarter of 1974, the M$ was allowed to depreciate slightly against the US$. The US$ remained the intervention currency and while relative stability was maintained against this currency, the rates against the Yen and sterling became more volatile and the effective exchange rate appreciated. As a result, in September 1975 the M$ was finally stabilised against a basket of currencies which allowed a depreciation.

Figure 6 shows how the bilateral exchange rates with its main trading partners became unstable from the Nixon Shock of August 1971, which complicated the management of the exchange rate system.

Figure 6

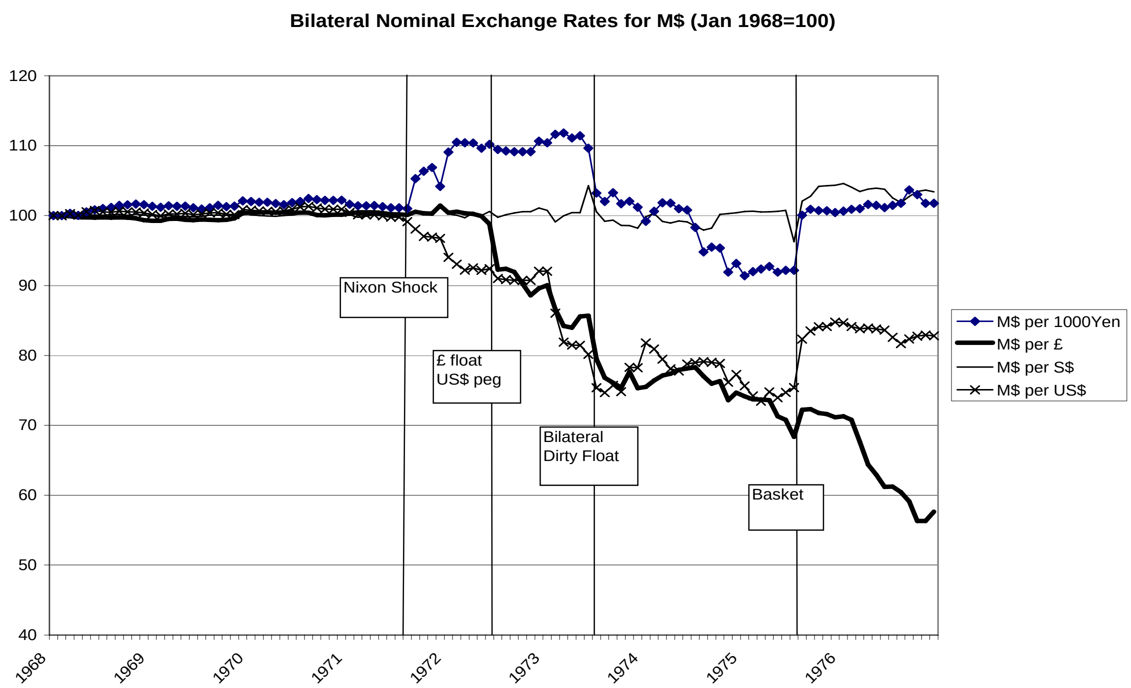
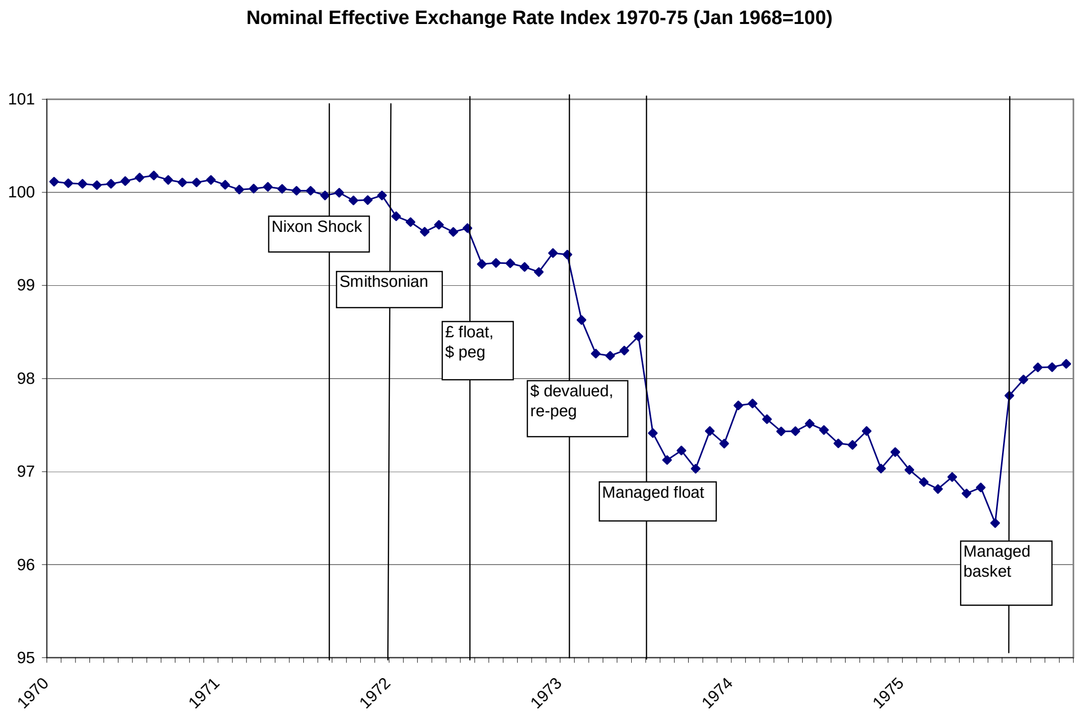


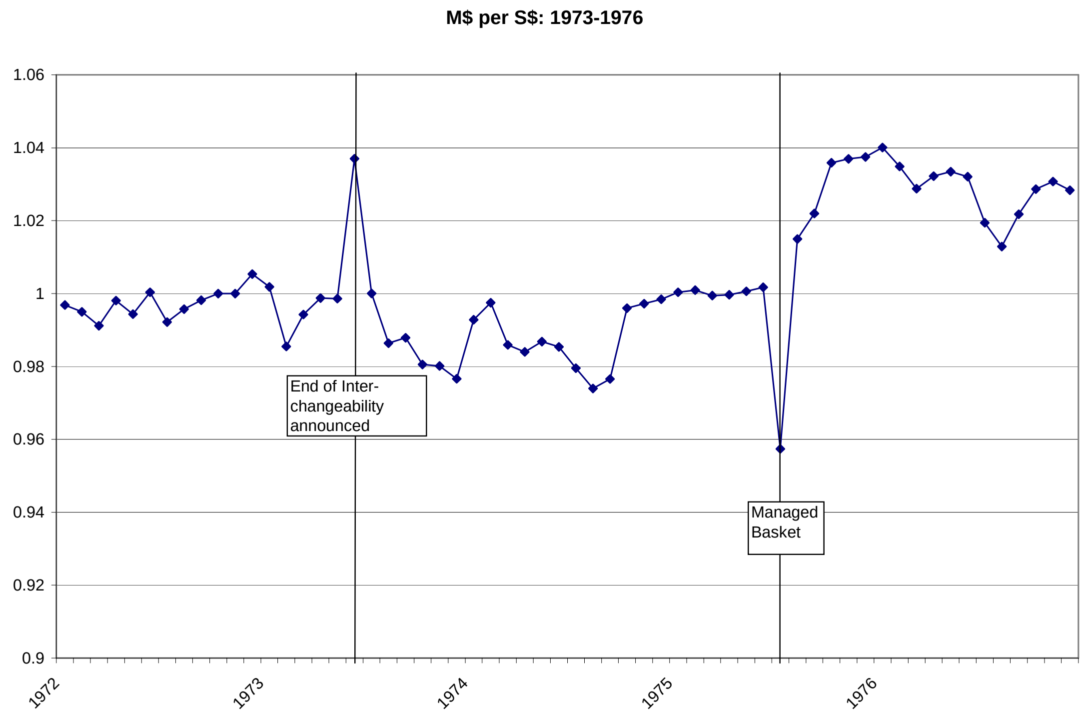
Figure 7 shows movements in the effective exchange rate on a bilateral trade-weighted basis (covering four trading partners and 56% of Malaysia's trade). This shows that the various shocks to the international monetary system in the early 1970s provided Malaysia with opportunities for sequential appreciation as part of the campaign to contain inflationary pressure during 1972-1974. The Nixon Shock had a small impact on the effective exchange rate because the USA comprised only about 11% of Malaysia's trade. Pegging to the US$ in July 1972 when sterling floated provided an opportunity for a further appreciation, but the Yen soon appreciated against the US$ and since 18% of total trade was with Japan, the M$ appreciation was reversed towards the end of the year. The adjustment of the US$ peg in February 1973 allowed another one-off appreciation but as other currencies began to float against the US$, the effective rate depreciated again. During the 1974 oil crisis the US$ appreciated due to its role as a petrocurrency and this led to a renewal of the effective appreciation of the M$. This was then reversed by the adoption of the basket in July 1975, when the opportunity was taken for a general devaluation.

Figure 7



Malaysia's exchange rate management was complicated by the transferability of currencies between Singapore and Malaysia since this effectively tied their policies together. Also about 22% of Malaysia's exports were consigned to Singapore so fluctuations in this bilateral rate could be costly. The generalised float from March 1973 seems to have been a catalyst for a range of exchange control amendments announced on 8 May 1973. Many controls on outward capital flows were relaxed and the discrimination in favour of sterling area countries was abandoned. At the same time it was announced that the interchangeability arrangements with the S$ would be unilaterally terminated, although the central bank continued to accept S$ at market rates until 7 August 1973. The interchangeability was a constraint on Malaysia's policy sovereignty that became increasingly binding as Malaysia and Singapore took different paths to development. On 8 May it was also announced that there would be separate stock exchanges in Singapore and Malaysia. The end of interchangeability did free Malaysia to adopt a more independent exchange rate policy, but they still maintained stability with the S$ by operating with reference to a trade-weighted basket of currencies that must have included a large S$ component. Figure 8 shows that there was a sharp depreciation in the M$ against the S$ in June 1973 immediately after the suspension of transferability, but the rate quickly returned close to par and varied between .98 and 1.0 until the move to the basket in July 1975 prompted a brief appreciation. Under the basket regime, the M$ was allowed to depreciate against the S$.

Figure 8



Summary and Conclusions

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. The process was prolonged by traditional relationships with London that persisted despite repeated betrayals of Malaysia's interests. Locally, continued political hostility with Singapore was to some extent overcome by their common interest in negotiating with London over the disbursement of their sterling reserves. At the same time, however, Malaysian ministers were acutely aware that at home they did not benefit from the comparison with the more forward looking and independent policy of Singapore in 1967. Drawing on this experience, and their betrayal by advisers in London, Malaysia tried to drive a hard bargain over the freedom to determine the currency composition of their reserves in 1968. In this, they successfully achieved a deal equivalent to that of Australia and Singapore, but it was not much better than the status quo ante. They faced a further betrayal 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 total trade. This was due to the illiquidity of many sterling assets that made the sterling agreements non-binding, and the lack of reliable alternatives to sterling as the US$ declined and the countries of strong currencies resisted their use as reserves.

The analysis shows that Malaysian officials consistently 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 because of intransigence on the part of London and lack of concerted cooperation from other sterling holders. It took the float of sterling in June 1972, at a time when inflation was surging, to push ministers to abandon sterling both as an anchor currency and to abrogate their sterling agreements. In the end they took capital losses by getting out of sterling at a much lower rate than they had bought their assets, and when the market value of British government securities was low. With hindsight, if (like Singapore) Malaysia had retained their MSP for a further three months, they would have been entitled to compensation.

This episode does show greater independence in international monetary affairs. Malaysia was the only country to abrogate their sterling agreements in 1972, although most other sterling countries joined Malaysia by shifting their anchor to the US$ at this time. The continued weakness of the US$, however, eventually revealed this to be a flawed strategy and many countries left the US$ peg by the Summer of 1973. With the relaxation of exchange controls from May 1973, Malaysia remained caught in a trade-off between an independent domestic policy and exchange rate stability, and they chose a middle road of dirty floating. Relaxing the pegged exchange rate paved the way for a new solution to the Trilemma, as policy independence became a real possibility. A trade-weighted basket of currencies was adopted in September 1975 to cope with the instability in international currencies, and the central bank's intervention was reduced to promoting orderly markets and moderating day-to-day fluctuations.

Malaysia's transition to independence was not concluded by the celebration of Merdeka in 1957. The traditional links with sterling that had provided a stable environment for the inward investment vital for industrialisation were maintained, but at the cost of policy sovereignty. The monetary entanglement with Singapore was a further transitional challenge to true independence. In the end, Malaysian policy makers learned (slowly) how to identify and act in their own interests and were able to take advantage of shocks in the international monetary system to move toward greater independence in their exchange rate regime and reserves management.

[1] This research was funded by the ESRC Grant RES165-25-0004 as part of the World Economy and Finance Research programme and by the British Academy Committee for Southeast Asian Studies. It has benefited from the research assistance of Niall MacKenzie.
[2] C.R. Schenk, 'The Origins of a Central Bank in Malaya and the Transition to Independence; 1954-60', *Journal of Imperial and Commonwealth History*, 21(2), pp 409-31, May 1993.
[3] Letter from Lim to Tan, 8 November 1965. Reproduced in Republic of Singapore, *White Paper on Currency*, Cmd 20, 1966.
[4] 'Memorandum on proposed currency and banking arrangements between Singapore and Malaysia', 12 November 1965. Reproduced in Republic of Singapore, *White Paper on Currency*, Cmd 20, 1966.
[5] Report to the Governments of Malaysia and Singapore, IMF Mission, November/December 1965. Reproduced in Republic of Singapore, *White Paper on Currency*, Cmd 20, 1966.
[6] 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).
[7] HSBC Group Archive GHO238 Kuala Lumpur Office Half Year ending 31 December 1967.
[8] Lee Hock Lock, *Central Banking in Malaysia; a study of the development of the financial system and monetary management*, Butterworths, 1987. p. 11-19.
[9] 'Malaysian Currency Agreement', CC Lucas and Mackay, 4 January 1960. National Archives UK [hereafter PRO] T236/5149.
[10] A Mackay to AW Taylor, 26 January 1960. PRO T236/5149.
[11] Inward telegram from UK delegation in KL to Commonwealth Relations Office, 9 February 1960. PRO T236/5149.
[12] Brief for Chancellor's meeting with Tan Siew Sin, 10 July 1967. PRO T312/1955.
[13] Lee Hock Lock, *Central Banking*, p. 464.
[14] The main purpose of the visit to London was to discuss British troop withdrawals.
[15] DF Hubback memo, 26 July 1967. PRO T312/1955.
[16] Note for the record. Visit of the Malaysian Fin Min meeting with CoE at 6pm on 10 July 1967. PRO T312/1955.
[17] Brief for the Chancellor, July 1967. PRO T312/1955.
[18] Jeremy Morse to Sir Denis Rickett, 9 February 1968. PRO T312/1955.
[19] A. Mackay (Undersecretary HMT) to DW Fogarty, High Commission, KL, 29 Feb. 1968. PRO T312/1955.
[20] Visit of Governor Ismail, 24 May 1968, BIS Archive [hereafter BISA] 2/337 Central Bank of Malaysia.
[21] Deposits Received, Bank Negara Malaysia, 25 September 1968. BISA 2/337 Central Bank of Malaysia.
[22] D. Stone to A. Mackay, 16 September 1969. PRO T312/2312.
[23] Letter from Choi Siew Hong, Bank Negara Malaysia, to Sir Leslie O'Brien, Governor, BoE, 03 March 19 1971. Bank of England Archive [hereafter BE] OV44/229.
[24] Letter from Ismail to BIS, 13 June 1971. BISA 2/337 Central Bank of Malaysia.
[25] Undated negotiating brief. BE OV44/242.
[26] Inward Telegram London to Canberra from Australian High Commission, Critchley, 19 July 1968. Australia National Archives, South East Asia - Intra regional relations - Singapore and Malaysia, A1838.
[27] Undated negotiating brief. BE OV44/242.
[28] Negotiating Brief for Malaysia, Singapore and Brunei, July 1968 BE OV44/242.
[29] Telegram no 849 addressed to CO from Kuala Lumpur from Sir M Walker, 11 July 1968. BE OV44/242.
[30] Telegram from Sir M Walker (British High Commissioner) to Commonwealth Office, 25 July 1968. BE OV44/242.
[31] Telegram from KL to Commonwealth Office, 5 September 1968. BE OV44/242.
[32] Ibid.
[33] Minutes of Meeting of Sterling Negotiations Group, 5 September 1968. BE OV44/242.
[34] R Hay minute 20 October 1968. BE OV44/247.
[35] Draft for ministers by Commonwealth Office sent to MoD, 10 September 1968. PRO FCO24/37.
[36] Progress Report by Fenton, 5 September 1968. BE OV44/171.

[37] Telegram from Commonwealth Office to KL, 10 September 1968 and reply 13 September 1968. BE OV44/242.
[38] Note by REB, 14 April 1970. BE OV44/244.
[39] Letter from Haslam to MacKay, 10 October 1968. BE OV44/242.
[40] Letter from Douglas Stone to Jeremy Morse, 22 February 1971. BE OV44/244.
[41] Note for the record re: Sterling Agreements- Singapore and Malaysia by CJ Morse, 11 March 1971. OV44/244.
[42] Note of a meeting held in the Chancellor of the Exchequer's Room between Chancellor and Tan Siew Sin, Treasury Chambers, 14 May 1971. BE OV44/244.
[43] Report of the meeting by Douglas Home, 17 May 1971. OV44/244.
[44] Telegram from Tan Siew Sin to Chancellor, 14 August 1971. BE OV44/245.
[45] Memo by JA Marshall, 8 September 1971. PRO T312/2834.
[46] Correspondence between Douglas-Home (London) and Johnston (KL), August-September 1971. FCO 59/642.
[47] Memo by J A Marshall, 8 September 1971. PRO T312/2834.
[48] Tan to Barber 21 February 1972. PRO T312/2968. The letter concluded: 'If this proposal is acceptable to the Government of the UK, I suggest that this letter and your reply to that effect shall be regarded as constituting an amendment to the Sterling Agreement'
[49] AJ Wiggins brief for Sir Alan Neale, 21 March 1972. PRO T312/2968. Bahrein and Kuwait were also expected to follow Singapore. Together the 4 countries held 25% of sterling reserves.
[50] Minute of meeting between Bell and officials of Malaysian Treasury and central bank, KL, 12 April 1972. PRO T312/2698.
[51] Minute of meeting between Bell, Tan and Ismail, KL, 13 April 1972. PRO T312/2698.
[52] Ibid.
[53] Letter from Tan Siew Sin to APL Barber, 21 April 1972. PRO T312/2968.
[54] Letter from APL Barber to Tan Siew Sin, 12 May 1972. PRO T312/2968.
[55] Joint Press statement by Singapore and Malaysia, 24 March 1972. PRO T358/36. Singapore received only 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).
[56] AJ Wiggins to Mr Middleton for the CoE, 25 April 1972, PRO T312/2966.
[57] Note on Sterling Agreements, 25 April 1972, BE OV44/196.
[58] Letter from GR Bell to Sir Allan Neale, 15 April 1972. BE OV44/245.
[59] Bank of England memo 6 July 1972, BE OV44/245.
[60] Text of speech by Tan, distributed in August 1972 in London, T312/2968.
[61] D Wiggins to JG Littler, 10 October 1972. PRO T312/2968.
[62] Telegram from Johnston (KL) to FCO, 26 July 1972. BE OV44/245.
[63] Telegram from KL to London, 10 July 1972. PRO T312/2968.
[64] Telegram from Johnston (KL) to FCO, 26 July 1972. BE OV44/245
[65] Note by Stone for Jeremy Morse on an informal talk with Ismail. 1 August 1972. BE OV44/250.
[66] Telegram from Fogarty, British High Commission, Singapore to Commonwealth Office, 23 November 1967. PRO T312/1707.
[67] PJ Drake, *Financial Development in Malaya and Singapore*, ANU press, 1969. p. 229-231.
[68] SY Lee, *The Monetary and Banking Development of Malaysia*, Singapore U Press, 1974, pp. 246-251.
[69] Telegram from Johnston to FCO, 23 August 1971. PRO T312/2834
[70] Lee, *Central banking in Malaysia*, p. 176-82.
[71] K Young, WCF Bussink and P Hasan, *Malaysia: growth and equity in a multiracial society*, World Bank, 1980. p. 37.
[72] Lee, *Central Banking in Malaysia*, p. 152-3.