The Politics of Economic Policy-Making under Harold Wilson and James Callaghan and the 1976 IMF crisis

by

Christopher James Rogers

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University of Warwick, Department of Politics and International Studies

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Declaration

I hereby declare that the work contained in this thesis is my own, that the thesis contains no published material that did not arise from work on the thesis or material that has been used in another thesis, and that the thesis has not been submitted for examination for a degree at another university.

Abstract

The thesis examines the politics of economic policy-making during the Wilson / Callaghan administration with a specific focus on the 1976 IMF crisis. It offers a critique of existing accounts that are based on an artificial distinction between state and market, in which there is an assumed power relationship that allows market actors to discipline state managers when policies diverge from accepted principles and norms, and argue that the fall in the value of sterling and IMF conditionality were examples of this disciplinary potential at work during 1976. This thesis presents a substantial, archive-based re-assessment of events from an open Marxist perspective. It argues that the state is an inherent feature of the social relations of capitalist accumulation, and that whilst this means state managers must pursue policies generally favouring the reproduction of the social relations of production, this constraint is not disciplinary or deterministic. The thesis shows that the Labour government had long established preferences for deflationary policies and argues that they were implemented through the politics of depoliticisation. On this basis, the fall in the value of the pound and ultimately, IMF conditionality, are not understood to be the key determinants of policy outputs. Rather, market rhetoric and IMF conditionality are seen to have provided the Labour government with substantial room for manoeuvre to implement policies aimed at creating favourable conditions for accumulation whilst minimising political dissent by acting as a buttress between the government and its policies. The argument is developed in three phases. Firstly, it demonstrates how despite the manifesto commitments of the Labour Party, significant elements of the core executive had consistent and established preferences for the depreciation of sterling, a transfer of resources into the balance of payments, cuts in expenditure, and incomes policies. Secondly, it shows how austerity measures were justified during 1975 and the first half of 1976 by a slide in the exchange rate and expected external financing pressures, despite a wish to see the pound fall. Finally, it shows how in the final quarter of 1976, the core executive delayed taking fiscal action until after the IMF negotiations because of expectations of conditionality, that it broadly agreed with the Fund's prescriptions, and argued that this course was preferable to an alternative strategy because if an alternative was implemented, financial markets would force an even greater degree of austerity.

List of Abbreviations

AES	Alternative Economic Strategy
BIS	Bank for International Settlements
CPS	Centre for Policy Studies
EY	Ministerial Committee on Economic Strategy (4 April 1976 – 4 May 1979)
G10	Group of Ten Industrialised Countries (excluding Italy and France, plus the BIS and Switzerland)
GDP	Gross Domestic Product
IEA	Institute for Economic Affairs
IMF or Fund	International Monetary Fund
MES	Ministerial Committee on Economic Strategy (4 March 1974 – 4 April 1976)
MLR	Minimum Lending Rate
MRC	Modern Records Centre, University of Warwick
MTA	Medium Term Assessment
NIF	National Income Forecast
NUM	National Union of Mineworkers
OPEC	Organisation of Petroleum Exporting Countries
PESC	Public Expenditure Survey Committee
PCC	Policy Coordinating Committee
RPI	Retail Prices Index
SCE	Steering Committee on Economic Strategy

SDR	Special Drawing Rights
STEP	Short Term Economic Policy Group
TGWU	Transport and General Workers' Union
TNA	The National Archives
TUC	Trades Union Congress

Note on the referencing

The thesis uses a Harvard referencing system that identifies the author, year of publication and page number in parenthesis in the text. Full references are contained in the bibliography. Archival sources are referenced from the general to the specific (archive, file, document, date) in the text, and are included to file level in the bibliography. Ibid has been used to indicate reference to the source cited immediately prior, however where the same source is cited continuously over a number of pages, the full reference has been repeated periodically for ease of identification by the reader.

Chapter I

Introduction

The 1970s was a decade of fundamental restructuring in both the British and global economies, and as a result is a natural focal point for the study of public policy-making in Britain. Between 1970 and 1979 there were four general elections and three Prime Ministers in the United Kingdom, which creates an understandable impression that this was a period, at least of transition, if not profound political change. In the world economy, too, there was a great deal of uncertainty, caused by the collapse of the Bretton-Woods system of fixed exchange rates and the startling disequilibrium in international payments caused by the Organisation of Petroleum Exporting Countries' (OPEC) price increases in 1971 and 1973. Studying British responses to the challenges thrown up by the domestic political landscape and the evolving global economy are therefore essential in developing an understanding of both the origins of policies that emerged from this turbulent period, and how the events themselves fit into a broader picture of British economic management and attempts to address the problem of relative economic decline, which Gamble (1994, xiii) notes has been a problem faced by British policy-makers for a hundred years.

The Wilson / Callaghan government is perhaps of the greatest interest, as not only did it directly precede the election of the Conservative government that heralded the beginning of Thatcherism, but it was also an administration during which the government made significant retreats from its manifesto commitments because they

did not accord with the kinds of policies that overseas opinion, the Treasury, and the Labour Party leadership, believed were necessary if Britain was to successfully reverse its economic fortunes. Understanding the origins of these preferences, the way in which attempts were made to reconcile them, and why ultimately they failed, resulting in Britain's winter of discontent and the election of Mrs. Thatcher, has therefore received considerable academic attention.

Much of the work written contemporaneously with events in the 1970s has focussed on the problems of fiscal overload, ungovernability, and the contradictions inherent in social democracy. King (1975, 286-92) for instance, argued that governing Britain in the 1970s became more difficult because the range of government responsibilities grew to the extent that people had become insensitive to the demands placed on it, and that the ability of the government to exercise a range of responsibilities had declined because of an increase in the number of dependency relationships existing in the British economy. Samuel Brittan (1975, 129-40) likewise asserted that the nature of democratic party-political competition had contributed to undermining the ability to govern by encouraging unrealistic expectations through a process tantamount to bidding for office. Rose (1984, 358) later argued that these problems were amplified by the practice of building inefficiencies into structural practices, which was a product of the prioritisation of full-employment over other economic and political objectives.

An alternative perspective has been to consider events in the 1970s in terms of the decline of the post-war consensus in British policy-making. Addison (1977, 278)

notes that during the 1940s, 'the Conservatives were obliged to integrate some of Labour's most important demands into their own philosophy.' On this basis, it has been argued that it is appropriate to speak of the post-war period in terms of a consensus during which there was 'widespread elite agreement on policy goals and broad continuity in government policy' (Kavanagh, 1992, 175), which appeared to have been called into question by the 1970s by the failure of Keynesian economics to account for the simultaneous occurrence of inflation and unemployment, and the advancement and popularisation of monetarist economic theory. Kevin Hickson (2004, 150) endorses such a view on the basis that, until the late 1970s, it was possible to observe 'a fairly high degree of policy continuity based around the welfare state, the mixed economy [and] the use of Keynesian demand management.'

These frameworks for understanding change in 1970s however, have proved to be insufficient for the purposes of either describing or explaining events. As Birch (1984, 158) notes, explanations of the problems of governing Britain from 1945-79 based on the idea of overload lack universal applicability, either across countries or within Britain over time, whilst Grant (2000, 54) has asserted that the ungovernability thesis has 'not stood the test of time very well given that Mrs. Thatcher showed that the British state has considerable powers at its disposal if it is directed by someone with strong and clear political convictions.' The postwar consensus thesis has fared no better, on the grounds that it is conceptually ill-defined and empirically questionable, which has led Bulpitt (1995, 513) to suggest that although the consensus view 'of post 1945 British politics is accepted by […]

"normal" political science […] there is no point engaging in "heavy petting" with this thesis'.

A Re-assessment of the 1976 IMF crisis

Existing accounts of the 1976 IMF crisis have broadly shared an acceptance of analytical frameworks that accept the logic of a 'states and markets' approach. The key characteristic of these frameworks is the artificial analytical separation of state and market. This emphasis on the autonomy of state and market at the point of constitution is coupled with the assumption of a power relationship that allows market actors to discipline state managers or act as a catalyst for policy learning when policies diverge from accepted principles and norms. These accounts understand the fall in the value of sterling and IMF conditionality as evidence of the disciplinary potential of markets at work during 1976. However, conclusions based on an analytical separation of the state and the economy are theoretically questionable. As Matthew Watson (2006, 21) notes, 'the rule of law and systems of exchange [are] experienced as a totality within everyday life', which indicates that the analytical separation of states and markets is unhelpful and artificial. Furthermore, by opposing the state and market in such a reified way, these accounts implicitly accept a questionable rationalist ontology, which reduces governments to simple vote winners, and markets to rational profit seekers, and therefore fail to account for the complexity of the social relationships experienced in every day life.

In addition to these theoretical weaknesses, existing accounts of the IMF crisis have taken a broadly hermeneutical approach to studying the events of 1976, and focus principally on interpretations of the Labour Party's policy documents, and the memoirs, diaries and published statements of individuals involved in policy-making, but have excluded the examination of the official papers of the Cabinet, the Treasury and the Bank of England. The exclusion of a substantial range of primary sources from the analysis has led to a skewed interpretation of events based on an inappropriately narrow principal actor focus, because in failing to account for official views on policy-making in a systematic and falsifiable way, existing accounts have tended to simply associate the preferences of the British government with the published statements and manifestos of the Labour Party. Not only does this fail to account for discrepancies between political arguments and the achievement of governing competence that may arise because of party statecraft, they exclude the views of a significant portion of the British state's economic policy-making apparatus from the analysis. This has served to exacerbate the extent to which market forces appear to have played a key role in determining policy outputs in the run up to and during the 1976 IMF crisis.

Whilst Hickson (2005, 227) has argued that the IMF 'discussions were so widely leaked that it can be said that the debate over the IMF application was one of the most open in postwar history', it is clear that a reliance on information reported by the press on the basis of leaks from official sources cannot be guaranteed to provide a thorough, balanced account of events that appreciates the diversity of activities undertaken by the civil service and the government. As Burnham et al. (2004, 172)

note, 'the reliability and accuracy of newspaper material cannot be presumed', on the grounds that material is shaped by the views of editors and journalists in the production process. As such, the assertion that 'the contents of national archives, if used with skill and judgement, can make a significant contribution to understanding the workings of modern government' (Burnham et al., 2004, 177) is astute, even if the only contribution archival sources make is to confirm initial judgements. As Lowe (1997, 240-1) notes, 'the great advantage of government records – properly used – is that, in their fullness, they reveal not only the complete range of influences to which government was subject at any given time but also what did not change.'

Douglas Wass' account of events in 1976 has gone some way to filling this gap in the literature, but despite his attempt to 'detach [himself] from events and to record facts, minutes, and memoranda irrespective of whether [he does or does not] emerge with a great deal of credit' (Wass, 2008, xii), his proximity to the events as the Permanent Secretary to the Treasury, will have undoubtedly shaped his selection of sources and interpretation of events. As he acknowledges, 'I do not believe that anyone as closely involved as I was can be wholly objective, and I confess to a lurking desire now that records are on public display not to be found wanting in what I did – and that I did not do – that eventful year' (ibid, xii). In addition to the problem of neutrality of authorship, which is enough to necessitate an independent examination of the archival sources of itself, Wass' account leaves many questions unanswered as a result of its heavy reliance on Treasury documents at the expense of other sources, the most notable of which is a failure to engage with substantive

questions about the relative role of state and market actors in shaping policy outputs in a fashion that goes beyond an explanation and defence of the Treasury's actions.

This thesis is therefore able to make a valuable contribution to the literature on the 1976 IMF crisis in two respects. Firstly, by making extensive use of archival sources, it is possible to offer a fuller account of events and report how policy preferences were implemented from a more 'neutral' position, in terms of my involvement in the events themselves, than has previously been possible. And secondly, by approaching the topic from an open Marxist perspective that understands the state as *social form*, it is possible to avoid presenting conclusions that rely on an artificial distinction between state and market. In contrast to existing accounts, the thesis argues that the state is an inherent feature of the social relations of capitalist accumulation, and that whilst this shapes state managers' preferences for policies generally geared towards renewing conditions for accumulation, the constraints of accumulation are not disciplinary and do not force convergence when policy diverges from accepted principles and norms through the exercise of structural power. It demonstrates that policy was not determined by market forces in the run up to and during the 1976 IMF crisis, but that state managers had clearly identifiable preferences for policies geared towards restoring the profitability of British industries throughout the 1974-76 period, and that these could not immediately be pursued because of their potential to exacerbate class antagonisms and call into question the political legitimacy of the Labour government. However, the fall in the value of the pound and IMF conditionality ultimately allowed the government to use market rhetoric and the rules of international institutions as

justification for implementing policies aimed at restoring conditions for profitable accumulation through the politics of depoliticisation. Far from determining policy outcomes therefore, currency instability and IMF conditionality provided strong and credible justifications for the implementation of policies aimed at reversing Britain's relative economic decline, and acted as a buttress between the government and the consequences of its policies. On this basis, the thesis is an original re-assessment of the 1976 crisis that is both methodologically and empirically robust.

Methodology

The principal research methods used in this study are the analysis and interpretation of a broad range of primary documents from various UK archives, the analysis and interpretation of a broad range of secondary sources such as government legislation, Hansard, and newspaper articles, and the critical analysis of tertiary literature.

The majority of the primary sources consulted are the relevant public records held at the National Archives (TNA) in Kew, which were released under the thirty-year rule in January 2007. I have consulted a broad range of documents that include the minutes and memoranda of relevant Cabinet meetings and Cabinet committee meetings, as well as files from the Office of the Prime Minister and other ministers closely involved with the economic policy-making process such as the Chancellor of the Duchy of Lancaster. In addition to these files, which principally cover issues with the direct involvement of ministers, I have made extensive use of Treasury sources from the Home Finance Division, the Overseas Finance Division, and the

papers of the Permanent Secretary, Sir Douglas Wass. In order to incorporate as broad a spectrum of views in the analysis as possible, and to act as counterweight and corroboration, I have also referred to documents in the archive of the Trades Union Congress (TUC) at the Modern Records Centre (MRC) at the University of Warwick, the Bank of England archive at Threadneedle Street, and sources from the archive of the International Monetary Fund.[1]

In addition to the benefits of using archival sources referred to above, it has been necessary to be aware of the potential pitfalls of an extensive documentary analysis, which are frequently discussed in terms of authenticity, credibility, representativeness and meaning (Scott, 1990, 19-25; Bryman, 2001, 375; Burnham et al., 2004, 185-86). Burnham et al. (2004, 186) note that the 'authenticity of a document concerns its genuineness', which requires the researcher to assess whether the document has been altered or compromised in any way. Examining credibility then makes it necessary to question the prerogatives of the author, and 'requires that the researcher pay particular attention to the conditions under which the document was produced and the material interests that may have driven the author to write the document' (ibid, 186). In the case of public records, the challenges posed by the need to assess the authenticity and credibility of public records are minimal, and limited to the identification of dates and authorship by virtue of the fact 'the form and content of such records are usually compatible with the procedures known to have been used by the government department responsible for its creation' (ibid,

[1] Dr. Ben Clift kindly supplied electronic versions of documents relating to the 1976 IMF crisis from the International Monetary Fund archive in Washington D. C.

186). During this study, whilst assessing the authenticity of documents posed minimal difficulties, it was at times difficult to identify the author of certain documents and to locate their role within the civil service, especially where documents are initialled rather than signed. I have made every effort to identify individuals by using resources at the National Archives and Civil Service Year Books, and have included this information to the greatest possible degree of accuracy in an index of names and offices in the annex.

It has been noted that 'the most serious challenge facing users of documentary sources concerns their response to questions of representativeness and meaning' (ibid, 187), and Scott (1990, 24) notes that it is essential to be sure that the documents used reflect the complete range of documentary sources relevant to the topic. This is particularly problematic, and Bryman (2001, 375) has argued that in the case of public records, the issue of representativeness 'is complicated in that materials like this are in a sense unique and it is precisely their official or quasi-official character that makes them interesting in their own right.' Furthermore, he notes that 'in the context of qualitative research this is not a meaningful question, because no case can be representative in a statistical sense' (ibid, 375). The challenge for the researcher, he argues, is in 'establishing a cogent theoretical account and possibly examining that account in other contexts' (ibid, 375).

Burnham et al. (2004, 187) have also noted that the issue of representativeness is significantly more problematic when dealing with collections that are not a matter of public record, because 'the selection of public records is formalized and carried out

according to established and accountable procedures', but in other archives, holdings may be collected on a rather more *ad hoc* basis. As the majority of sources consulted for this study are a matter of public record, this has not been a significant challenge, although where I have used materials from the TUC archive at the Modern Records Centre at the University of Warwick, I have tried to consult a broad range of secondary sources, such as the annual reports of the Trades Unions Congress, and its published statements, in order to support my archival findings.

The criterion of meaning also poses problems for the researcher, despite Burnham et al.'s (ibid, 187) assertion that 'for students of modern politics and international relations there should be little difficulty establishing the literal meaning of documents (unlike the situation facing the mediaeval historian).' Nevertheless, the use of qualitative research methods remains an exercise in interpretation, which necessarily opens up the possibility of bias in the research. As May (1997, 176) notes:

> History itself and our understanding of it can be informed by a selective reading of documents […] What people decide to record, to leave in or take out, is itself informed by decisions which relate to the social, political and economic environment of which they are a part.

As such, he suggests that history, 'like all social and natural sciences, it amenable to manipulation and selective influence' (ibid, 176). This reflects the concerns expressed by Sir Douglas Wass in his account of the IMF crisis referred to above, and there is no simple way to ensure that interpretations do not reflect inherent prejudices and personal beliefs in a process that is reliant on an individual's reading

for its outputs. However, I have given the relevant consideration to this potential pitfall of using documentary sources in the preparation of this study, and aimed to choose, read and reference my sources in a considered and conscientious way by consulting a range of archives that is as broad as possible, and examining a broad range of materials from within those archives so as to avoid using an unrepresentative selection of sources that simply reflects my own inherent beliefs about the policy-making process in the United Kingdom.

The extent to which this study relies heavily on documents from the National Archives may also be said to have contributed to a 'top down bias' that Lowe (1997, 245) argues can be corrected by reference to other public and private archival holdings. How important this is considered to be however, is fundamentally dependent on what Bulpitt (1995, 517) refers to as 'a problem of whose governing behaviour we decide to examine', or to use a colloquialism, the researcher's understanding of the answer to the question: 'who governs?' Bulpitt (ibid, 517-8) contends that from a historical politics perspective, focus should necessarily include those 'constantly close to high political issues', and he identifies the concept of the Court, defined as 'the formal Chief Executive plus his/her political friends and advisors' as the appropriate focal point for investigation. Whilst this study does not apply the concept of the Court in the strict sense applied by Bulpitt, it has a deliberate focus on the highest echelons of government and the civil service. This reflects my agreement with the assertions that power in Britain 'is highly concentrated in the executive branch, and within that, in the Treasury and the office of the Prime Minister' (Bernstein, 1983, 147), and that 'in economic policy-making

terms the most important set of actors within the state are those of the "core executive"', defined as 'a shorthand term for referring to the leading figures within the government, and for the senior officials in the state finance department and the national central bank' (Kettell, 2004, 24). This thesis pays a considerable degree of attention to the actions of civil servants, however this is not a reflection of my views about the relative importance of actors within the official and political spheres. Rather, it reflects the fact that a great deal of contingency planning examining the feasibility and legality of policy proposals is never raised explicitly at a political level because of the degree of expertise required in order to reach these judgements. This means that the civil service often plays a more substantial role, in terms of the volume of its work, in designing policy proposals and assessing the desirability of their implementation on legal and political grounds, than ministers.[2]

In addition to the methodological issues associated with documentary analysis are some practical difficulties that arise in carrying out archival research, which are related to access and the identification of relevant files. Once again, as the majority of sources used for this study are a matter of public record, I was able to access them freely at the National Archives in Kew, and because they were over thirty-years old, it was not necessary to request the release of any of these documents under the

[2] Of course, there are notable exceptions when policy proposals do stem largely from the ministerial level. For the purposes of this study, Tony Benn's advocacy of the Alternative Economic Strategy is a prime example. Nevertheless, the majority of the examination of legal and practical issues relating to implementation of the plan fell to the civil service.

Freedom of Information Act. Records from the Bank of England are subject to slightly stricter access conditions, and may be consulted only by permission of the archivist for genuine research purposes. Due to staffing constraints it is also necessary to organise visits to the Bank's archive several weeks in advance, and given the fact that the Bank's full archive can only be searched from within the archive itself, there remains the possibility that researchers may have to wait for a considerable amount of time before visiting the archive, only to find that the records they wish to view have not yet been transferred to the archive or have been retained beyond the normal thirty-year closure period. After providing verifiable identification I was granted access to the archive, although I did find that whilst the Bank's files relating to the 1976 IMF crisis were open for consultation, the papers of the Bank's Governor in this period were not available.[3] This proved to be slightly problematic because by the time that I was able to visit the archive, it was not

[3] At the conclusion of my visits I remained unsure on what grounds these documents had not been transferred to the archive. The archivists informed me that all of the Governor's files and duplicate letters from this year, with the exception of minutes of meetings with the Committee of London Clearing Bankers, had been retained on the grounds that the material contained therein had been deemed of sufficient sensitivity to extend closure beyond thirty years. My own judgement however, based on a review of the files in these series up to 1978 which also contain very few entries, and on the grounds that it is unlikely that *the majority* of these files contained sufficiently sensitive information for extended closure, was that they had not yet been catalogued as a result of the staffing shortages that also necessitate planning a visit to the archive so far in advance.

possible to complete a freedom of information request within the timeframe of the thesis. However, as the Governor's views are frequently reported in correspondence and memoranda retained in files held by the National Archives and elsewhere in the Bank of England archive, this has not proved to be a major constraint, even though access to the files would, of course, have been desirable for the purposes of establishing the representativeness of the files I was able to read and have referenced in the thesis.

In addition to problems of access, the task of finding relevant files within the archives can also be challenging, and there is a significant barrier to the researcher represented by the size of the National Archives' holdings (Burnham et al., 2004, 178). The identification of relevant files at the TUC archive was difficult in light of the fact that at the time I conducted my research, the catalogue was not searchable, which meant that the identification of documents relied on my reading whole sections of the catalogue.[4] At the National Archives the process has been made significantly easier by the sophisticated online search-engine, which allows files to be isolated by department, date range and key-words. However, this system is only as effective as allowed by the degree of precision contained in the description of files contained in the catalogue, and the search terms employed by the researcher. As Vickers (1997, 172) discovered during her research, this problem meant that she sometimes found that files she believed would be particularly relevant were of little

[4] The catalogue of the TUC archive at the Modern Records Centre at the University of Warwick has now been updated, and it is now possible to conduct simple searches of the holdings online.

interest, whereas others that were consulted with less hope of containing useful information turned out to be of great value. She therefore commented that: 'this would suggest that there were files I did not look at which may have contained useful information' (ibid, 172). Despite my attempts to review the relevant catalogues in as much detail as possible, and to use a variety of finding aids in order to isolate relevant files, there remains a possibility that there are files containing relevant information in the archives I used that have not been consulted.

Structure of the thesis

The thesis is divided into nine chapters. Chapter two frames the thesis analytically by reviewing various theoretical understandings of the nature of the relationship between the state and market, and the implications this is perceived to have for the politics of economic policy-making. It aims to critically review positions that identify sources of structural power as significant determinants in national economic-policy making from a states and markets perspective, and Marxist variants of state-theory based on the 'relative autonomy thesis.' It then demonstrates the benefits of approaching the topic from an open Marxist perspective, and viewing the state as *social form*. It argues that the state is an intrinsic feature of the class antagonism inherent in the social relations of capitalist production, which means that state managers must act in order to renew conditions for accumulation, but that these constraints are not disciplinary. Within these constraints, policy makers retain a considerable degree of policy autonomy, but because actions to renew conditions for profitable accumulation have the potential to intensify class antagonisms, it argues

that state managers can gain significant political benefits by depoliticising difficult aspects of economic policy. Chapter three then reviews the existing literature on the IMF crisis in detail. It demonstrates the extent to which this literature has broadly reflected the logic of states and markets approaches, and emphasises the disciplinary potential of market forces and market institutions in determining British policy outputs.

Chapters four and five provide context and begin the historical narrative by identifying the broad range of preferences faced by the Labour government after its election in February 1974. Chapter four focuses on the period between the 1974 general elections, outlines the Labour government's political inheritance in the Social Contract, the general economic situation with which it was faced, and demonstrates that despite substantial Treasury sympathy for the political constraints the government faced, which prevented a wholesale review of economic strategy, that policy was nevertheless broadly geared towards a fast improvement in the balance of payments and improving incentives for industrial investment. Chapter five then reviews the historical legacy of sterling's role as a reserve currency and the problems caused by the OPEC price increases, before demonstrating how these issues informed the decisive re-orientation of economic strategy from December 1974, which was based on concerns about de-mobilising capital and maintaining foreign confidence. Finally, it shows how these preferences were reflected in the April 1975 Budget.

Chapters six to eight offer a sustained analytical narrative of policy-making from the middle of 1975 until the IMF crisis of 1976, and demonstrate the way in which the Treasury and the Labour Party leadership consistently used market rhetoric and market rules in order to reconcile the views of the Labour left and the TUC with its preferences for deflationary policies through the politics of depoliticisation. Chapter six deals with exchange rate management, the imposition of the £6 pay policy of July 1975, the oil-facility and first credit tranche IMF loans of December that year, and the cuts in expenditure from the 1976 public expenditure white paper. In chapter seven I review the changes in monetary policy that precipitated the sharp decline in the pound and the arrangement of the multilateral $5.3 billion stand-by in June 1976. It also examines the justification of the public expenditure cuts of 22 July, official and ministerial attitudes towards Tony Benn's advocacy of generalised import controls in the Alternative Economic Strategy (AES), and how the case for a conditional drawing from the IMF was made.

Chapter eight reviews the reaction to the IMF application, and shows how alternative proposals such as international agreement on a safety net for the sterling balances, were marginalised on the grounds that they offered no solution to Britain's external financing problems in the long run. Finally, the chapter gives an account of the Treasury's negotiations with staff members of the International Monetary Fund, demonstrating the extent to which there was broad agreement with the Fund team at a substantive level from early in the negotiations. It also reviews the Cabinet discussions, and demonstrates how the political case was made by arguing that

alternative courses would require even greater deflationary action than that necessary in order to reach agreement with the IMF.

In chapter nine, I offer my conclusions. I argue that despite the presence of a broad range of preferences for economic policy within the British state, those of the core executive were consistently in favour of deflation so that Britain would be able to reverse its relative economic decline within the framework of international free trade. The chapter concludes by showing how this was achieved by justifying expenditure cuts because of a slide in the exchange rate despite established preferences for depreciation, arguing that market conditions had left the government no alternative to drawing on the Fund, and ultimately by deferring desired fiscal adjustments until they could be attributed to IMF conditionality. The fall in the value of the pound and IMF conditionality should not therefore be understood as disciplinary features of the international financial system, and it is not the case that British policy outputs were determined by market forces during the 1976 IMF crisis. Rather, the fall in the value of the pound and IMF conditionality provided the Labour government with the room for manoeuvre to pursue its established preferences for public expenditure cuts and incomes policy by acting as a buttress between the government and the social and political consequences of those policies.

Chapter II

The state, the economy and the politics of economic policy-making

The politics of economic policy-making is a salient issue in light of contemporary debates about globalisation, capital mobility, and the embedded nature of agreed principles in international economic regimes, which have all produced a wide literature that argues, to varying extents, that power in the world economy has shifted away from the national state and towards the market. This shift is seen to have imbued market actors with the ability to impinge on the policy autonomy of state managers by exercising structural power to create currency instability through capital flight, and denying access to multilateral credit facilities without the acceptance of explicit conditions designed to force policy changes. The relationship between the state and the economy is also a fundamental feature of Marxist state theory, which has moved away from straightforward economic determinism, and produced various attempts to construct a theory of economy and society that can explain the way in which governments are able to act in favour of accumulation without reducing their understanding of the state to structural functionalism.

This first half of this chapter discusses the relationship between states and global finance as understood broadly from a states and markets perspective, and shows how the logic of capital mobility and the accepted principles and norms underscoring international financial integration are often identified as having the potential to limit the freedom for individual states to decide upon and implement their own policies

independently. It will then assess the development of Marxist trends in state theory and the implications for policy-making of their varying perspectives on the relative autonomy of the state, and critiques these accounts based on their shared application of an artificial analytical separation between states and markets and their acceptance of the view that structural power can be used in order to force policy changes on reluctant governments at moments of crisis. The chapter then outlines an open Marxist perspective, which suggests that the state should be understood as an inherent feature of the class antagonism inherent in the social relations of capitalist production. The state is not understood in reified terms, and it is its existence as a moment in the social relations of capitalist accumulation that leads it to favour policies generally geared towards accumulation, and not disciplinary action or the threat of disciplinary action by market actors at times of crisis. Finally, it argues that as policies generally geared towards renewing conditions for accumulation have the potential to intensify class antagonisms, state managers often find it beneficial to depoliticise the consequences of its preferred policies by attributing them to market forces and market rules. Far from representing disciplinary features of an international state system in which power has increasingly shifted from state to market therefore, market rules and rhetoric can provide powerful justifications for state managers to pursue policies geared towards renewing conditions for profitable accumulation by depoliticising the social consequences of those policies.

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States and markets

'States and markets' approaches are generally concerned with the possession and expression of power by one group of actors over another, and focus on the varying forms that this power takes and how it is used. This section addresses two ways in which it has been suggested that power over states can be exercised. The first is through global finance and the logic of capital mobility, which is said to have the potential to destabilise national currencies when there is a lack of market confidence in the sustainability of economic policy. The second lies in the multilateral international economic framework, and the way in which it establishes norms governing access to credit, and rules of good conduct in economic policy-making. These approaches share the view that there are significant sources of structural power residing in the market and its institutions, and that they are able to effectively discipline state managers and therefore play a key role in determining policy outputs.

The mobility of capital is an undisputed fact of the modern world, with decreasing transaction costs and technological advances meaning that vast sums of money can flow very quickly, which has demonstrated the potential to destabilise national currencies. This has given rise to the capital mobility hypothesis, of which it has been written:

> there is nothing wrong with the logic of the proposition, which derives directly from the dilemma of the Unholy Trinity. Unless governments are willing to tolerate virtually unlimited currency instability, they must tailor

> their policies to avoid provoking massive or sudden capital movements (Cohen, 1998, 132).

The influence that the process has on governments stems from capital's ability to express itself through exit, voice, and loyalty, because 'the greater the ability of market actors to evade the preferences of public officials (Exit), the less the government will be able to count on or command submissive loyalty' (ibid, 132). As a result of this, it is argued that 'public policy, more and more, is pressured to conform to what markets desire, whether or not this coincides with the preferences of elected officials' (ibid, 133). Global finance therefore can be said to have undermined the authority 'once derived from legal-tender laws and other political interventions', and embodied it in 'the norms and expectations that rule the Darwinian struggle among currencies' (ibid, 146). 'The power of governance', Cohen concludes, 'now resides in that social institution we call the market' (ibid, 146).

Pauly (1997, 2) agrees that global finance 'manifests a perfectly reasonable fear: that the evolution of markets means, in effect, that the power to make substantive decisions affecting one's own material prospects and the prospects of our children is currently shifting out of our control.' However, the notion of capital mobility reflecting a full and final determinant in policy making is rejected. Instead, it is suggested that the fact that governments desire both 'the fruits that financial openness appears to promise [and] real influence over the shape of the tree', has led the international state system to a mid-point between states that have full autonomy in national policy-making and fully integrated cooperation (ibid, 5). This is said to

have contributed to creating a situation in which: 'economic commentators, prominent bankers, and conservative politicians, often abstracting from the fact that governments can let their exchange rates float, underscored the "discipline" on autonomous state action implied by capital mobility' (ibid, 33). As such, he argues that it nevertheless remains possible for states to retain their sovereignty within tighter constraints if they are willing to opt out and bear the costs of their isolation (ibid, 34). On this point, he notes that 'states, especially leading states, have demonstrated clear interests in capturing the benefits of deepening financial integration without fundamentally compromising their ultimate political authority over that process' (ibid, 42).

The ability for states to opt out of financial integration is, however, a subject of controversy because of the practical barriers to its achievement and the considerable costs it would bring. Helleiner (1992, 33) for instance, notes that the experience of the 1970s demonstrated that 'even a comprehensive system of financial controls is unable to prevent international financial movements taking place in a disguised fashion through leads and lags in current account payments', suggesting that the degree of sophistication in global transactions has meant that financial capital will always be able to circumvent regulation by national states. From a historical perspective, he goes on to demonstrate how the extensive regulation of the 1930s failed to prevent illegal capital transfers despite extensive penalties (ibid, 33), and he argues that the inevitability of capital mobility in the modern era is even more entrenched, because 'channels for evasion are much more extensive today.' They are said to include the proliferation of global telecommunications that allow for

speculative capital transactions to take place, and the growing sophistication of financial markets that has made the task of regulation increasingly difficult (ibid, 33-4).

Not only does Helleiner doubt that it is possible for national states to opt out of the system of global finance by imposing rigorous exchange controls, he suggests that it is increasingly unlikely any government would do so because of the costs involved in taking such action. Even when faced with capital flight, he notes that Britain and France, in 1976 and 1982-83 respectively, decided against introducing such measures on the grounds that 'there was the prospect of foreign retaliation and international isolation', as well as 'large domestic economic disruption', which forced even advocates of comprehensive exchange controls to 'acknowledge that the associated economic costs would prove greater than those linked to the austerity measures that the international markets were demanding' (ibid, 34). The inevitability of policy convergence therefore stems from the ability of financial transactions to create currency instability, and is reinforced by the ability of finance capital to avoid transaction restrictions, which in turn has served to deter governments from 'opting out' because of their reluctance to accept the costs involved. As Andrews (1994, 201) notes, as 'authorities become convinced […] that it is costly or even futile to resist the strong tendency of market and technological forces to produce further financial integration, they become less inclined to take such actions.'

However, it is not simply capital mobility that has been identified as a tangible constraint on the policy autonomy of state managers. The rules and norms underscoring the system of international cooperation are also understood to have a role to play in disciplining states. One of the most significant ways this can be achieved is through the control over access to credit, and as such is particularly relevant to countries in deficit. Strange (1994, 30) argues that 'finance – the control of credit – is the facet which has risen in importance in the last quarter century more rapidly than any other and has come to be of decisive importance in international economic relations.' The power to create credit has several, fundamental implications for economic policy-making:

> [It] implies the power to allow or to deny other people the possibility of spending today and paying back tomorrow, the power to let them exercise purchasing power and thus influence markets for production, and also the power to manage or mismanage the currency in which credit is denominated, thus affecting rates of exchange with credit denominated in other currencies (ibid, 90).

From the perspective of sovereign debt, this seems to imbue the IMF with considerable authority by virtue of its *de facto* status as an international lender of last resort and the conditionality associated with using its resources, but most importantly, because it 'alone could issue the stamp of approval that would satisfy the private bankers that it was "safe" to resume lending, even on a lower scale' (ibid, 112). It also has implications about the possibility for the United States to express its power through the auspices of multilateral institutions. This is because of the way

that voting power is organised within the Fund according to the size of a country's quota of Special Drawing Rights (SDR), which means that 'benefits that the United States receives from the IMF [are] far greater than those of any other member' (Officer, 1990, 30, see also Dominguez, 1993, 366-7; Bordo, 1993, 36).[1]

The extent of the power that this has conferred on the United States, however, is subject to some debate, and depends largely on the extent to which the existence of a financial hegemon is seen as either a necessary or as a sufficient condition for the stability of an international economic regime. Kirshner (1995, 156) for instance, notes of the Bretton Woods system, that 'the nature and design of the system […] were tailored to fit the economic and political goals of the United States in this era'. He argues this was achieved through the creation of the GATT, the strength of the dollar and the size of the American economy. The former served to ensure that the United States had access to important markets for its exports, whilst the latter meant 'the United States would be well placed to exploit monetary dependence' (ibid, 156). This account reflects the views of Robert Gilpin (1987, 23), who has argued that 'economic interdependence establishes hierarchical, dependency, and power relations among groups and national societies', and that as a response, 'states attempt to enhance their own independence and to increase the dependence of other states.'

[1] Much the same has been said of international bond-rating agencies because of 'the authoritative status market participants and societies attribute to the agencies' (Sinclair, 2005, 17), and the way in which this kind of normative authority is shaped 'along manifestly American lines' (ibid, 174).

The salience of American leadership in the system however, has been the subject of some debate. The accounts above reflect the logic of hegemonic stability theory, which argues that 'the overwhelming dominance of one country was necessary for the existence of an open and stable world economy', and that this hegemon 'served to co-ordinate and discipline other countries so that each could feel secure enough to open its markets and avoid beggar-thy-neighbor [sic] policies' (Milner, 1998, 113). However, it is conversely argued that once the institutions governing the world economy have been created, 'they take on a life of their own, and states come to see them as worth preserving [because they] provide information to states about each others' behaviour, reduce the cost of negotiating agreements, and can expose, and sometimes even punish, violations of agreements by states' (ibid, 116).

As Keohane and Nye (1973, 158-9) argued, the transnationalisation of investment, trade, and capital movements, contributed to the emergence of important and novel problems with which governments have been forced to deal in a context where the declining efficacy of force had shifted threats to states away from traditional security issues towards the economic sphere. They argue that this transformed the purposes of exercising power from the achievement of relative political gains to the achievement of absolute economic gains measured against nationally defined criteria through attempts to prevent burden shifting, such as the imposition of trade restrictions and competitive depreciation, by other nations (ibid, 159-60). As such, they argue that in the global context, domestic monetary policy:

> cannot be understood solely as the result of state action and interaction: the behaviour of multi-national enterprises and multi-national banks, the

> activities of international civil servants and the effects of national policies on internationalized forums of discussion must also be taken into account (ibid, 163).

This situation is seen to have given an important role for new actors in behaving as 'transmission belts' that contribute to the system by conveying policy sensitivities across national boundaries (ibid, 163).

Ruggie's understanding of international regimes shares such a benign view of the restrictions on state managers' policy autonomy implied by the existence of multilateral economic institutions. He notes that regimes 'have been defined as social institutions around which actor expectations converge in a given area of international relations', which 'limit the discretion of their constituent units to decide and act on issues that fall within the regime's domain' (Ruggie, 1980, 380). He notes that although regimes of this kind are inherently dependent on the backing of a financial hegemon, and as such are formed as a reflection of its views and interests – in the case of the postwar period, the United States – he nevertheless asserts that the regime derived its legitimacy from a widely shared set of social objectives (ibid, 397-8). As such, the disciplinary role of regimes is clearly qualified. Whilst they limit the range of policy options open to state managers, it is suggested that they do so in a way that is not deterministic: 'international economic regimes do not determine economic transactions', but rather, 'play a mediating role, by providing a permissive environment for the emergence of certain kinds of transactions, specifically transactions that are perceived to be complementary to the normative frameworks of the regimes having a bearing on them' (ibid, 404).

The implications of these approaches however, are nevertheless clear. Whilst there is little agreement on whether constraints on a state's autonomy to make economic policy independently are ultimately deterministic, a reflection of the interests of a financial hegemon or shared social values, it is nevertheless the case that real barriers to the exercise of autonomy in national policy-making by individual states are said to exist. Reflecting this position, it has been argued that within the international state system, 'the very nature of the actors cannot be understood except as part of some larger institutional framework', and that 'the possible options available at any given point in time are constrained by available institutional capabilities [that] are themselves a product of choices made during some earlier period' (Krasner, 1988, 72). Therefore, once states have made a decision to adopt the principles and rules of an institutional framework, that framework comes to impinge on the range of choices it is possible for them to make in the future. Institutional inertia that perpetuates these constraints on policy choices is therefore a product of individuals' sensitivities to cultural norms that are entrenched by a process of socialisation, and creates a situation in which the costs of change increase greatly leading to 'long periods of either relative stasis or path-dependent change' (ibid, 73-4). Or as Cooper (1968, 114) plainly phrases it: 'the price of international rules of good behaviour as set forth in the GATT and the IMF Articles has been a reduction in the range of instruments available to policy makers.'

It is not, however, simply neo-realist scholars that highlight the potential for multilateral institutions to influence national states. This *potential* for institutions

within the global order to influence the state is shared (albeit, developed from a neo-Gramscian perspective),[2] by Robert W. Cox (1981, 136), who argued that in an historical structure mediating between ideas, material capabilities and institutions, the framework for action contains clear enforcement potential. However, he argued that this kind of power will not be 'used in order to ensure the dominance of the strong to the extent that the weak accept the power relation as legitimate', and that as a result structural power should be understood as hegemonic rather than dictatorial (ibid, 137). He suggests that the historical structure is constituted of three spheres of activity – the social forces of production, forms of state, and world orders – which are related by the extent to which a change in one can produce a change in the other (the social forces of production could, for instance, promote nationalism, which in turn could play a role in fragmenting world order) (ibid, 138). So whilst the state is

[2] There is only *potential* because a fundamental difficulty caused by the adoption of such a neo-Gramscian approach lies in identifying the direction of causality. Whilst the interaction of social forces, forms of state and world orders, implies that change in each sphere has the potential to act as the catalyst for change in the other – and thereby act as a constraint on other spheres – establishing how this operates in practice is problematic. As Burnham (2006a, 30) notes, each level is interrelated, but no universal causality assumed, or rather, 'the question of lines of force is a historical one to be answered by a study of a particular case' (ibid, 32). As such, it is plausible to suggest that each sphere determines the other depending on particular historical circumstances, or as Bonefeld (2006, 177) phrases it, 'depending on historical circumstances, the economy is either run by the state or the state is run by the economy'.

not subservient to or bound by the world order *per se*, its role as an intermediary between global social forms and national social forces continues to leave it exposed to the hegemonic, if not dictatorial, enforcement potential of the world order, until a point is reached at which a fundamental change in one sphere of activity carries sufficient influence to bring about a change in the others.[3]

Gill and Law (1989, 476-79) draw on this position, and have argued that the Bretton-Woods regime of the postwar period was heavily dependent on the congruence of international ideas around the principles of embedded liberalism (ibid, 478), and that the power of capital has played a significant role in shaping policy outcomes. They note that it was the contradictory nature of state expenditures implied by embedded liberalism and the rise of transnational capital that influenced state behaviour and contributed to the decline of the regime. It is argued that the origins of this decline lay in the asymmetry of power between capital and labour, which is evident in the fact that an investment strike has a far greater impact on economic conditions than a labour strike, and served to contribute directly to the rise of British Thatcherism (ibid, 481). They conclude that although there was nothing inevitable about the adoption of monetarism and the fiscal orthodoxy this implies, it is clear that within the framework of material forces, institutions and ideas, capital has been able to exercise its structural power in order to promote ideas of sound finance, and by virtue of the fact, has gained hegemonic status in its own right (ibid, 485-6).

[3] For a review of Cox's position, see Bieler and Morton (2006a), for a critique, see Burnham (2006a).

Neo-liberal, neo-realist, and neo-Gramscian theories therefore each share an analytical view of the state that suggests under given conditions, forces outside of the state may act to determine policy, force convergence across states, or lock policy in to path dependent change. The mobility of capital is understood to have limited the policy autonomy of states because not only does it have the power to create currency instability where there is a lack of confidence in economic policy, but also because in practice, it is able to either avoid restrictions or impose costs on individual states that prevent them from opting out. Regimes and world orders have also been understood to possess enforcement potential, which stems from the widespread acceptance of a particular set of shared social and economic values that have been institutionalised and subsequently serve to limit the range of options available to policy-makers. Whilst the origins of these shared values are disputed, neo-realists arguing from a reflection of the interests of the foreign economic policy of the United States, and neo-Gramscians arguing from the interaction of ideas, institutions and material capabilities, there is an accepted view that policies must converge around these ideas until there is a fundamental change in the world order.

The relative autonomy of the state

Marxian perspectives have approached the issue of state managers' autonomy in economic policy-making from a different point of departure, which focuses not on the role of shared ideas and values in creating international regimes or world orders, but on how state behaviour has been historically conditioned by the capitalist mode

of production. Within this framework, it has been common to make a distinction between structural or instrumental understandings of the role of the state.

At its most basic level, structuralism is reflected in the simplistic economic determinism implied by an economic base / political superstructure approach that suggests the state has no real policy autonomy from the economy. However, the determinism inherent in the position has led to its widespread rejection. Although the functional claims on which economic determinism relies may be true in the sense that 'no society could survive for long unless it made arrangements for economic reproduction, [they are] also trite' (Jessop, 1990, 84). This is because the same could be said of the state 'unless it made adequate arrangements for its military defence, for internal law and order, for intergenerational reproduction or ideological cohesion': in short, the position 'ignores the extent to which the economic realm lacks the self-sufficiency needed for it to play such a determining role' (ibid, 84). A great deal of attention has therefore been focussed on the 'relative autonomy' of the state from the capitalist class and the capitalist mode of production, which has clearly drawn out the differences between instrumentalist and structural understandings of the state.

The debate between instrumentalism and structuralism has often been characterised in terms of the views expressed by Ralph Miliband and Nicos Poulantzas in the pages of *New Left Review* in the 1960s and 1970s. However, Barrow (2008, 84) notes that the association of Miliband's work with instrumentalism in the 1970s represents 'not only an oversimplification and caricature of Miliband's political

theory, but an artificial polemical construct superimposed on his and others' historical and empirical analysis of the state in capitalist society.' He argues that on closer examination, Miliband's position contains considerable nuance and sophistication. This includes Miliband's recognition that government power does not equate to state power (ibid, 90), his frequent references to the structural constraints faced by state managers (ibid, 99), and his recognition of the need for the state to have relative autonomy from the capitalist class (ibid, 103). On this basis, Barrow argues that 'one critic after another acknowledges the sophisticated, nuanced and multi-layered analysis in *The State and Capitalist Society*, but then still proceed to debunk his work on the basis of criticisms that apply only to an artificially constructed ideal type, rather than to his actual published works' (ibid, 95). Jessop (2008, 149-53) has also suggested that the debate should be considered a non-debate, and that the participants were 'unable to grasp and depict their opponent's stance within the controversy […] because they conceived the capitalist state in such radically different and fundamentally incommensurable terms that they were actually discussing two different types of theoretical object' (ibid, 150). However, despite these misconceptions about the exchange between Miliband and Poulantzas, it remains noteworthy for the debate that flowed from it.

The exchange between Miliband and Poulantzas was based on an epistemological disagreement on the appropriate focus of study (Poulantzas, 1969, 67). Poulantzas (1969, 69, original emphasis) noted that Miliband approached the problem of the capitalist state through 'a *direct* reply to bourgeois ideologies by the immediate examination of concrete fact', without any consideration of the Marxist theory of the

state. As such, he argued that this 'leads Miliband to attack bourgeois ideologies of the State whilst placing himself on their own terrain' (ibid, 69).[4] Instead, Poulantzas argued that it is not the social origin of members of the ruling class that is the salient issue, on the grounds that:

> The relation between the bourgeois class and the State is an *objective relation.* This means that if the *function* of the State in a determinate social formation and the *interests* of the dominant class in this formation *coincide*, it is by reason of the system itself: the direct participation of members of the ruling class in the State apparatus is not the *cause* but the *effect*, and moreover a chance and contingent one, of this objective coincidence (ibid, 73, original emphasis).

Understood in this way, Miliband's position posed problems for explaining the politics of economic policy-making, because, as Block (1987, 53) notes, it is widely accepted by critics of instrumentalism that in order 'to act in the general interest of capital, the state must be able to take actions against the particular interests of capitalists.' This requires the state to 'have some autonomy from direct ruling-class

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[4] Jessop (1990, 29-30) likewise noted, 'Miliband is interested in confronting liberal theorists of democracy with the "facts" about the social background, personal ties and shared values of economic and political elites' which does not strictly advance a theory of the capitalist state, but rather 'reproduces the liberal tendency to discuss politics in isolation from its complex articulation from economic forces', whereas Poulantzas identifies the state as a complex social relation in order to debunk the idea that 'the modern state is no more than a pliant tool of monopoly capital.'

control' (ibid, 53). This view stems from Marx's assertion that the 'state can only truly serve the ruling class in so far as it is relatively autonomous from the diverse fractions of this class' (Poulantzas, 1969, 74). In this instance, the simple association of the relationship between the social background of political and economic elites with those of the dominant capitalist class fails to account for the relative autonomy that is required by political elites so that they may take the necessary actions against the interests of particular fractions of capital in order to sustain capitalist relations of production as a whole (ibid, 74).

This position however, is replete with its own shortcomings, the most fundamental of which is Miliband's (1970, 57) assertion that the relative autonomy position does nothing more than substitute the ideas of objective relations and objective structures for the idea of a ruling class. As such, the implications of the relative autonomy thesis are that 'the state is not "manipulated" by the ruling class into doing its bidding: it does so autonomously but totally because of the "objective relations" imposed upon it by the system' (ibid, 57). This, Miliband argues, closely resembles a 'kind of structural determinism, or rather a structural super-determinism, which makes impossible a truly realistic consideration of the dialectical relationship between the state and the system' (ibid, 57).

The logical extension of the relative autonomy thesis to the point of 'structural super-determinism' is not the only grounds on which the position has been criticised. There is also a considerable question with regards to the limits of the state's autonomy, if indeed it is understood to be relatively autonomous from the capitalist

class, and the way in which the necessary limits on state power can be enforced if the state is to continue to be viewed as relatively autonomous. As Block (1987, 53) phrases it, 'the difficult [sic] is in specifying the nature, limits, and determinants of the relative autonomy.' On this problematic, it is worth quoting him at length:

> Relative autonomy theories assume that the ruling class will respond effectively to the state's abuse of that autonomy. But for the ruling class to be capable of taking such corrective actions, it must have some degree of political cohesion, an understanding of its general interests, and a high degree of political sophistication […] yet if the ruling class or a segment of it is class-conscious, then the degree of autonomy of the state is clearly quite limited (ibid, 53).

From this perspective, the relative autonomy thesis 'collapses back into a slightly more sophisticated version of instrumentalism' (ibid, 53). Whilst Block (ibid, 54) suggests that this problem can be overcome with the adoption of a framework that indentifies a division of labour between capitalists engaged in accumulation and political elites, Jessop offers a more radical, and ultimately, neater approach. He suggests that 'the concept of "relative autonomy" as a principle of explanation can be consigned to the theoretical dustbin' (Jessop, 1990, 103).

As an alternative, he proposes that the relationship between state and the economy be based in the concept of *autopoiesis* (Jessop, 1990; see also Jessop, 2001). In contrast to the relative autonomy thesis, autopoietic theories propose a condition of radical autonomy that 'emerges when the system in question defines its own boundaries relative to its environment, develops its own unifying operational code,

implements its own programmes […] obeys its own laws of motion' (Jessop, 1990, 320); 'there are no external controls on their internal reorganization and the only internal constraint is the goal of self-reproduction' (ibid, 321)[5].

The state and the economy are therefore defined as self-referential, self-reproducing and self-regulating systems, structurally coupled and which, whilst mutually indifferent, nevertheless 'form part of each other's environments and must co-exist and co-evolve in the same ecological system' (ibid, 328). Jessop suggests that the application of autopoietic theory to Marxist assumptions about the primacy of the economic system is therefore able to avoid both economic reductionism and the pitfalls of the relative autonomy thesis, if the primacy of the economic system is both qualified by the level of its autopoietic existence relative to other sub-systems and limited to understandings of capitalist societies (ibid, 334). In the context of Marx's understanding of the necessary role of crisis in creating conditions for renewed accumulation, the concept of structural coupling indicates that the state and economy interact in a fashion in which 'the development of one structure affects the evolution of the other: but it neither controls it in a hierarchical relation of command nor

[5] State centric theories, although distinctive from autopoietic theories, have also suggested that states and state elites form and pursue preferences in an independent way. For instance, Skocpol and Weir (1985), note that appointed and elected officials have their own interests and work in order to devise policies that have the best chance of furthering those interests, or at least not harming them, in a way consistent with the coercive, fiscal, judicial and administrative capacities of the state structure.

subordinates it through a functionalist logic which requires one system to act for and on behalf of the other system' (ibid, 359).

Open Marxism and the state as social form

Despite disagreements on the nature and extent of the state's autonomy from the economy, the accounts reviewed above all share in common a view of the state as a separate sphere of action, which presumes that it is possible for markets to impinge on its sovereignty or affect its development under given conditions. They also each lack a coherent and sustainable theory of economic action that goes beyond the implicit assumption of rationality. This exposes non-Marxist theories to the criticism that they represent little more than a 'black-box' understanding of policy outputs akin to a simplistic pluralism. Instrumentalist and structuralist Marxist accounts can likewise be criticised on the grounds that 'the first position is simply radical-sounding pluralism, [and] the second is an equally untenable Marxified Parsonian structural functionalism' (Burnham, 1995, 95).

In response to these inadequacies, Holloway (1995, 119) has argued that in order to understand change it is necessary to 'go beyond the category of "the state", or rather we need to go beyond the assumption of the separateness of the different states to find a way of discussing their unity.' To do so, he argues, it is necessary to 'understand the state not as a thing in itself, but as a social form, a form of social relations' (ibid, 116). This is based on an understanding that just as in the natural sciences, there are no absolute separations in social relations, which are actually

‘fluid, unpredictable, unstable, often passionate [and] rigidify into certain forms, forms which appear to acquire their own autonomy’ (ibid, 116). The state therefore, should be seen as ‘a relation between people which does not appear to be a relation between people, a social relation which exists in the form of something external to social relations’ (ibid, 116-7). The state should be seen to appear in its fetishised form from the development of the antagonistic and crisis-prone relations of capitalist production: ‘the very existence of the state is a constant process of struggle’ (ibid, 122).

Werner Bonefeld also takes this position. His examination of the state focuses on a discussion of the political and economic as constituting a unity that exists as a moment of contradiction, with the role performed by the state shaped by class struggle between capital and labour (Bonefeld, 1992, 98). In this formulation, ‘the economic and the political, although seemingly existing independently from each other, stand to each other as moments of one process’ (ibid, 100), and it is the social relations of production – ‘that is the class antagonism between capital and labour’ (ibid, 100) – which represent both the constitution and processes of social phenomena such as the state. As he eloquently phrases it:

> political relations do not primarily correspond to, or reproduce, economic relations (the so called functions of the state for capitalist accumulation). Rather, the political complements the economic only in a mediated form as a moment moving within the proper motion of class antagonism. The state is not a state in a capitalist society, but rather a moment of the class antagonism of capital and labour (ibid, 113).

The state therefore, 'is not autonomous, or simply *related to* "the economy", rather it is an integral aspect of the set of social relations whose overall form is determined by the manner in which the extraction of surplus from the immediate producer is secured' (Burnham, 1995, 93). As such, states 'are not to be thought of as "thing-like" institutions losing power to the market' (Burnham, 2006b, 76; see also Burnham, 2001a, 108)[6].

Understanding the state's relationship to the economy in this way – perceiving of the state as a social form – makes it necessary to examine the implications of those social relations if we are to understand the role of the state in a capitalist economy. These social relations are generally perceived to be unstable and crisis prone because of the contradictions inherent in the capitalist mode of production. In *Grundrisse,* Marx noted of the capitalist mode of production that the 'universality towards which it irresistibly strives encounters barriers in its own nature, which will, at a certain stage of its development, allow it to be recognized as being itself the greatest barrier to this tendency, and hence will drive towards its own suspension' (Marx, 1973, 410). The basis of these inherent crisis prone tendencies are said to lie in the constant evolution of the forces of production and the conflicts that this evolution creates within the social relations of production (Harvey, 2006, 180); the limits to production founded on capital are therefore based in the recognition that 'capital is

[6] Bieler and Morton (2003, 467-472) offer a brief review of such open Marxist theories of the state in their paper 'Globalisation, the state and class struggle: a "Critical Economy" engagement with Open Marxism'. See also Bieler and Morton (2006b).

not, as the economists believe, the *absolute* form for the forces of production [but] appears as the condition of the development of the forces of production as long as they require an external spur, which appears at the same time as their bridle' (Marx, 1973, 415, original emphasis).

Simon Clarke (2001, 95-6) notes that these inherent contradictions stem not from the anarchy of capitalism, but from the development of the forces of production aimed at the increase of exploitation and profit which is imposed on the capitalist by virtue of competition, and Harvey (2006, 192) has identified what he describes as a 'first-cut' theory of crisis. This is based on the contradiction between 'the capitalists' necessary passion for surplus-value-producing technological change' and the 'social imperative "accumulation for accumulation's sake"', which produces 'a surplus of capital relative to opportunities to employ that capital', or a state of overaccumulation. This perpetuates a tendency to produce 'non-values' through the employment of labour in the production of 'commodities that cannot fulfil social wants and needs' (ibid, 194), and results in the overproduction of commodities, surplus inventories, idle capital, increasing unemployment, and falling rates of return, as part of a process of devaluation that serves to exacerbate the antagonisms between capital and labour. As Simon Clarke (2001, 96-8) argues, overproduction and overaccumulation are intrinsically linked to the impoverishment and de-skilling of workers which polarises the dominant social classes and exacerbates struggle with a political character and on a national scale as workers form unions in order to protect their own interests. As Bonefeld (1992, 112) notes, 'the compulsion on each

individual capital, if its devaluation is to be avoided […] forces upon each capital the necessity of expelling living labour from the process of production.'

The possibility of overaccumulation therefore, poses inherent problems for the state. This is because the contradiction between the interests of labour and capital inherent in the expansion of accumulation intensifies as the rate of exploitation increases, and because the conditions for profitable accumulation are not naturally occurring, but require the state to intervene in order to smooth the circuit of capital. The state therefore appears to have clear and contradictory roles to play, both in ensuring the conditions for renewed accumulation, and in negating class antagonisms inherent in the social relations of production. This challenge is amplified by the global character of accumulation, which stands in contrast to the national political constitution of the state (Burnham, 1995, 94; Holloway, 1995, 125-6), which is 'defined, historically and repeatedly, through their relation to the totality of capitalist relations' (Holloway, 1995, 125). This requires the state to both attract and retain globally mobile capital and manage the class antagonisms this produces at a domestic level.

On the national manifestation of the state and the global character of accumulation, Burnham (1995, 103) notes:

> the neo-realist image of independent and equal sovereign nation states is a fetishised form of appearance, since the global system does not comprise an aggregation of compartmentalised units, but is rather a single system in which state power is allocated between territorial entities.

Therefore, it is necessary to move beyond images of the state conceived along fundamentally national lines on the grounds that individual states are simply localised manifestations of the social relations of capitalist production that are fundamentally global in character. Individual nation states therefore, are linked through international systems of exchange that mean money is not bound by individual currencies, and in so far as states are dependent on attracting money as the source of their revenue, states are 'confined within limits imposed by the accumulation of capital on a world scale' (ibid, 103). This introduces an international element into domestic state interests broadly conceived, on the grounds that the management of domestic class antagonisms is dependent on the maintenance of global capital relations more broadly: 'whilst each national state strives to regulate the terms of class conflict within its jurisdiction, the overall interests of national states are not directly opposed, and relations of antagonism and collaboration are thereby reproduced at the interstate level' (ibid, 103). Although 'national states pursue a plethora of policies […] the "success" of these "national" policies depends upon re-establishing conditions for the expanded accumulation of capital on a global scale' (ibid, 105).

On this point, Holloway is agreed. On the grounds that the state is a manifestation of class struggle inherent in the social relations of production, and the fact that these relationships between people exist in an undefined space, he notes:

> The global nature of capitalist social relations is thus not the result of the recent "internationalisation" or "globalisation" of capital […] Rather, it is inherent in the nature of the capitalist relation of exploitation as a relation,

> mediated through money, between free worker and free capitalist, a relation freed from spatial constraint (Holloway, 1995, 123).

As a result of this freedom of capital within the spatially unlimited relations of production therefore, and as a result of the state's dependence on the reproduction of these relations within its own boundaries, 'it must seek to attract and, once attracted, to immobilise capital within its territory', and it is the 'existence of more or less favourable conditions for capital accumulation in different state territories' that creates the impression of relative positions of hegemony or subordination (ibid, 127).

Critics of the Open Marxist position have suggested that its focus on the social relations of capitalist production demonstrates a tendency to 'project a "totalising" theory, rooted in central organising principles, capable of accounting for the myriad of contradictory forms of relations between capital, the state and labour' (Bieler and Morton, 2003, 473); or as Bruff (2009, 337) phrases it, 'Open Marxism's ontology totalises human social practice by way of its focus on capitalist social relations.' He notes that the emphasis on the essential properties of accumulation means that 'the *epistemological modesty* proclaimed by Open Marxists […] is in fact an assertion of *epistemological austerity*' (ibid, 337, original emphasis). This has led for a call to 'move beyond the Puritanism of Open Marxism and embrace richer accounts of human social practice in capitalist societies' (ibid, 341) through the examination of a broader range of social relations, a position shared by Roberts (2002, 88), who notes that 'open Marxists have yet to develop a set of categories which usefully allow us to explore the distinct ideological characteristics of social forms of life which, at first glance, seem to have nothing whatsoever in common with capital and labour.'

'What does it mean to say', Roberts asks, 'that writing poetry can be analysed through the capital-labour relation?' (ibid, 88).

These criticisms suggesting that open Marxism actually presents totalising ontology and a closed theory of human social practices however, misrepresent the position. As Werner Bonefeld notes (2009, 357), open Marxism makes no attempt to elevate laws of historically specific social organisations into general laws of history, but 'seeks to dissolve the autarky of things by revealing their social constitution in human practice.' This means that the way in which 'things' appear under given historical conditions in their fetishised forms, 'does not make [them] any less "human", as if the world of things were a world apart' (ibid, 357). As such, open Marxism's understanding of the state as a nationally manifested moment in the crisis prone social relations of global capitalist accumulation does not determine the way in which national capitalisms develop, or imply convergence around a particular system of managing accumulation,[7] beyond the general constraint that state managers must act in order to create conditions conducive to the general reproduction of those relations and to manage the class antagonisms this gives rise to. As Bonefeld (2009, 357) succinctly phrases it, 'the anatomy of the man can explain the anatomy of the ape, but […] the anatomy of the ape does not explain the anatomy of the man.'

[7] There is a wide literature on national varieties of capitalism. See *inter alia* Whitley (1998), Dore, Lazonick and O'Sullivan (1999), Allen (2004). However, the classic volume is Hall and Soskice eds. (2001). For a review of the text see Howell (2003).

So far in this section I have made a number of claims. Firstly, I have argued that the state should be conceived as a manifestation of the class antagonism inherent in the crisis prone social relations of capitalist production, and that this is a national manifestation in relation to the global character of accumulation. Secondly, I have shown that this requires states to act in the general interest of accumulation in order to ensure the reproduction of these relations, and that this requires states to attract internationally mobile capital and attempt to de-mobilise it by creating favourable conditions for profitability relative to other nations. Finally, I have argued that these general constraints are intrinsic, not disciplinary, and do not determine the specific ways in which individual states will seek to attract and retain capital or regulate accumulation and the class struggle inherent therein. The question however remains, of how state managers are able to act in the general interests of accumulation without precipitating a political crisis when the costs of these policies must often be carried by labour, on which the political legitimacy of state managers depends.

Governing strategies and the politics of depoliticisation

Each of the objectives that the state derives from its nature as a feature of the social relations of production, such as a ready supply of cheap labour for exploitation, low rates of corporate taxation, and a robust counter inflation strategy (see Kettell, 2004, 19), shares in common the fact that the costs associated with them are most likely to be borne by labour, on whom the political legitimacy of governing parties and state managers is dependent. The tendency for actions the state must take to smooth the process of accumulation to exacerbate class antagonisms is therefore problematic

from the point of view of the government's statecraft and other high political objectives, specifically the objective of achieving and maintaining office.[8]

A successful statecraft[9] strategy, it has been argued, includes five dimensions. These are party management, a winning electoral strategy, political argument hegemony, governing competence, and another winning electoral strategy. Party management refers to the need for party leaders to foster and maintain a good relationship with its backbenchers, party bureaucracy and pressure groups on whose support it depends (Bulpitt, 1986, 21). A winning electoral strategy requires the manufacture of a package of policies that can be sold to the electorate, whilst political argument hegemony refers to the party's ability to achieve a level of dominance in the elite debate about the nature of problems and the policies required to resolve them (ibid, 21-2). Governing competence refers to the ability of governments to foster belief that policy choices are correct, whilst another winning electoral strategy is, of course, self-explanatory (ibid, 22). An important feature to take from this model of statecraft however, is that 'there is no reason why the electoral strategy and political argument dimensions should "fit" its operations under the governing competence

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[8] Offe (1975, 126, original emphasis) long ago noted that 'the *existence* of a capitalist state presupposes the systematic *denial* of its nature as a *capitalist* state', but argued that ultimately, states are unable to perform and balance all of their necessary functions despite their continued attempts to find a strategy that permits this (ibid, 144).

[9] Bulpitt (1986, 21) defines statecraft as 'the art of winning elections and achieving some degree of governing competence in office.'

category' (ibid, 22), and it is from the reality of this position that state managers in contemporary capitalism can achieve their high political aims and act in the interests of accumulation without unduly exacerbating class antagonisms.

In order to contain these class antagonisms, state managers may at times find it expedient in order to manage the economy in an overtly politicised way, with the state playing a direct and highly visible role in economic management. The clearest example of this is the kind of state management of the economy associated with post-war Keynesian social democracy in Britain, when the government took responsibility for the provision of welfare and the level of unemployment (Kettell, 2004, 25). However, the politicisation of economic policy issues carries with it inherent risks. As Kettell (ibid, 25) notes, 'state intervention can lead to the politicisation of issues which have hitherto been regarded as being of a purely "economic" character […] and can thus lead to growing demands and pressure over these issues being directed at the state itself.' However, as the state must act in order to renew conditions for profitable accumulation, this has the potential to exacerbate class conflict to the point that governing authorities are called into question. As Kettell (ibid, 25) phrases it, 'in such circumstances this can aggravate class unrest, and can even lead to a wholesale crisis of political authority itself.' Therefore, given the inherent risks of politicised modes of governing the economy, state managers have often employed strategies geared towards reducing the political salience of economic policy-making, through the politics of depoliticisation.

As Burnham (2001b, 127-8) explains, depoliticisation is a statecraft strategy through which governments aim to achieve a certain level of governing competence in the realm of economic management by distancing themselves from policy decisions, but which nevertheless remains a highly political governing strategy (ibid, 136). As such, Flinders and Buller (2006, 295-6, original emphasis) have defined depoliticisation as '*the range of tools, mechanisms and institutions through which politicians can attempt to move to an indirect governing relationship and/or seek to persuade the demos that they can no longer be reasonably held responsible for a certain issue, policy field or specific decision*.' However, the quintessential definition of depoliticisation is that of Burnham (1999, 47; 2001b, 128), who writes that it 'is the process of placing at one remove the political character of decision making.' He notes that by employing a strategy of depoliticisation, 'in many respects state managers retain arms-length control of economic processes while benefitting from the distancing effects of depoliticisation' (Burnham, 1999, 47, see also 2001b, 127).

Discussion of depoliticisation therefore does not attempt to remove the politics from economic policy-making. As Kettell (2008, 631) notes, 'in a democratic polity, where the political legitimacy of government derives from the pursuit of the "national interest" […] policy-making must […] display at least a semblant of a connection to the views and wishes of the electorate', but despite the innate political nature of strategies of depoliticisation, its benefits are clear. By reducing the salience of particular issues in the eyes of the electorate, or making a convincing case that certain issues lie beyond the scope of discretionary decision making, the

government can 'change expectations about the effectiveness and credibility of decision making' (Burnham, 1999, 47), which makes it less likely that an economic crisis will escalate into a political crisis that has the potential to undermine the legitimacy of the governing party when the social and economic costs of policies required to resolve it fall on the general population (Kettell, 2008, 631). As such, it is possible to see the logic of markets, and the *appearance* that power has moved from states to markets, as 'providing the strongest possible public justification governments can muster for maintaining downward pressure on wages'. Market rhetoric and rules can therefore 'provide governments with considerable power *vis-à-vis* the working class' (Burnham, 1999, 47).

Methods of depoliticising economic policy-making have, on the one hand, been framed in terms of debates surrounding 'rules' versus 'discretion', however Flinders and Buller (2006) have attempted to move beyond this dichotomy, and suggested that strong and distant rules are not the only ways in which governments can depoliticise difficult aspects of policy. They identify three such ways. The first of these is *institutional depoliticisation*, which occurs when a 'formalised principal agent relationship is established in which the former (elected politician) sets broad parameters while the latter (appointed administrator or governing board) enjoys day-to-day managerial and specialist freedom within the broad framework set' (ibid, 298). The second way in which state managers can depoliticise policy is *rule-based depoliticisation,* in which state managers adopt 'a policy that builds explicit rules into the decision-making process that constrain the need for political discretion' (ibid, 303-4). The final strategy they identify is *preference shaping depoliticisation*.

This involves 'recourse to ideological, discursive or rhetorical claims in order to justify a political position that a certain issue or function does, or should, lie beyond the scope of politics or the capacity for state control' (ibid, 307).

It comes as no surprise that British elites in economic policy-making have used strategies of depoliticisation in order to change expectations about the credibility of decision making and to insulate the governing parties from the potential consequences of unpopular policies, in either a historical or a contemporary context. It has been argued that the return to the Gold-Standard at the pre-war parity of $4.86 in 1925, for instance, would encourage the control of wages, economic modernisation, and facilitate an adjustment from declining industries to newer forms of production whilst helping to 'insulate the core executive from the adverse consequences of these economic effects' (Kettell, 2004, 166-7). Kunz (1987, 91) has likewise argued that in 1931 the Bank of England was concerned about British budgetary excesses and believed 'that the Government needed to be pushed into action and the most effective prod would be a loss of gold', and Burnham (2003) has shown how in 1952 the Treasury considered abandoning the fixed rate under Bretton-Woods in order to shift the strain of the balance of payments deficit from the reserves to the rate.

There is also a burgeoning literature that suggests Britain's membership of the Exchange Rate Mechanism from 1990-92 helped to anchor the economy by imposing a robust anti-inflationary strategy whilst offsetting the political consequences of austerity (see Bonefeld and Burnham 1996, 1998; Burnham, 1999,

Kettell, 2008), and the New Labour government's decision to grant the Bank of England monetary policy autonomy in 1997 is presented as a clear example of institutional depoliticisation (Burnham, 2001b). In addition to the Bank of England's independence, Watson and Hay (2003, 290) have also demonstrated the way in which New Labour has used contemporary discourses on economic policy making as an expedient way to invoke 'globalisation as an exogenous economic constraint […] to render the otherwise contingent necessary.'[10]

Conclusions

In this chapter I have shown that there is a wide variety of literature suggesting that the imperatives of global finance possess disciplinary potential, are able to penalise states in the event that confidence in economic policies breaks, and that states' subscription to the principles and norms of international regimes and multilateral institutions exposes them to various enforcement mechanisms, with differing degrees of emphasis placed on the consensual limits of policy autonomy that play a role in locking policy in to path dependent change. Neo-Gramscians also note that the world order contains enforcement potential, whilst a wide variety of Marxist

[10] See also Matthew Watson (2006), who draws on the depoliticisation thesis from a classical liberal perspective to demonstrate the way in which people have become increasingly socialised to accept the links between the imperatives of legitimation and accumulation as a means of resolving the 'coordination problem' that arises out of the contradiction between economic and social behaviour, as reflected in Adam Smith's *Wealth of Nations* and *Theory of Moral Sentiments.*

literature has debated the nature of the state's autonomy from the economy and its implications for economic policy-making, ranging from the complete absence of policy autonomy implied by economic determinism, through various understandings of the relative autonomy thesis, to the radial autonomy theory of autopoiesis.

I have also demonstrated that each of these approaches shares in common their reliance on the assumption that the state and the economy are fundamentally separate, which fails to acknowledge the role of social interaction and implies that governments are nothing more than rational vote winners or circuit managers, and that market actors are simply rational profit seekers. But most fundamentally, the artificial separation of the state and market on which they rely suggests that markets have the ability to play a key role in determining policy outputs through the exercise of structural power. I have suggested that this weakness can be resolved by perceiving of the state as a *social form* that is a manifestation of the class antagonisms inherent in the social relations of production. By understanding the national basis of the state in relation to the global foundations of accumulation, it is then possible to see that the state has a key function in smoothing the inherent crisis prone tendencies of capitalist accumulation in order to ensure the reproduction of the social relations of production. This makes state managers subject to the general constraints of accumulation, which involves justifying measures of austerity in order to be able to attract and retain globally mobile capital whilst managing the increased class antagonisms that this creates, but demonstrates that specific policies are not determined by the exercise of structural power possessed outside the state when

policy diverges from accepted principles and norms as implied by 'states and markets' approaches.

Rather, the principal problem state managers face is how they can prevent the social consequences of these policies from translating into a political crisis. I have also shown that in order to achieve this, there are significant benefits in employing the politics of depoliticisation, whereby government appeals to market rules and market rhetoric can help to persuade dissenters that certain issues lie or should lie beyond the scope of discretionary political action. As such, far from being features of a disciplinary system that has the ability to play a determining role in the politics of economic policy-making, market rhetoric and rules can provide strong justifications for state managers to act according to their imperative to improve conditions for profitable accumulation whilst minimising political dissent. It is also clear that this has been common practice for political elites in the twentieth century, however, despite widespread awareness of this *modus operandi* of the British Treasury, the Bank of England, and various governing parties, no empirical consideration has yet been given to the possibility that such processes were at work from 1974-76.

Chapter III

Decisive influence, de-mystifying the IMF crisis, and social learning

In the previous chapter I argued that the state's form as a moment in the social relations of production, inherently shaped by the class antagonisms within the crisis prone tendencies of capital accumulation, often provides state managers with the incentive to depoliticise difficult aspects of policy by an appeal to the rules or rhetoric of market forces, because highly politicised strategies run the risk that an economic crisis will quickly escalate into a political crisis. In relation to the 1976 IMF crisis, several authors have made the assertion that such a process was at work, but it has received no significant empirical examination (see Clarke, S., 1988, 314-5; Holloway, 1995, 128; Bonefeld and Burnham, 1998, 41). Instead, a vast body of literature displays continuity of belief that there was no underlying strategic vision to British policy. A significant amount of the literature also advances the position that British policy was ultimately determined by external forces, either through the exercise of structural power and the imposition of IMF conditionality, or the simultaneous occurrences of inflation and unemployment that served to undermine the Keynesian paradigm and force policy-makers to adopt new policies as part of a process of social learning. In between these two positions sit principally narrative accounts of the IMF crisis. As such, it is possible to outline three broad approaches to studies of the 1976 IMF crisis, which this chapter reviews in turn:

1. Accounts that have emphasised the extent to which the events in the run up to December 1976, and December 1976 itself, played a decisive role in

imposing retrenchment on a reluctant Labour government. This argument has been developed substantially from 'global finance', 'regimes' and structural Marxist perspectives.

2. Narrative accounts that have aimed to de-mystify the events surrounding the 1976 IMF crisis by demonstrating how policy changes that have often been associated with IMF conditionality were in place before December 1976. These accounts have either denied that there was a strategic element to British policy – suggesting instead that it was made largely 'on the hoof' – or make no attempt to engage substantively with the question of the extent to which British economic policy outputs were determined by external forces during the crisis.
3. Accounts that associate policy changes during the 1976 IMF crisis with a process of social learning. These accounts emphasise constraints on economic policy-making in so far as they suggest that the delegitimation of the Keynesian paradigm forced policy-makers to consider new theoretical approaches, and limited the range of choices they could make which had the potential to preserve overseas confidence.

Decisive influence

The decisive influence hypothesis attempts to identify specific processes and institutions through which pressure was directly exerted on the British government during the 1976 IMF crisis. Firstly, it has been suggested that the system of global finance and the nature of international regimes that underscore it have

overemphasised the degree of cooperation and the mutual benefits they contain, to the point of disguising the way in which these structures actually operate on a coercive basis. Secondly, it has been argued that there is a natural tendency for radical socialist solutions to economic crises to be moderated by the fact that the context within which the government must operate is a capitalist global economy.

Bernstein's thesis on the 1976 IMF crisis reflects the first position, with a specific focus on the influences operating on economic policy-making through the international system of global finance, and specifically through the control of access to international credit. She has identified three distinct phases of borrowing, which serve to increasingly limit the autonomy available to domestic policy-makers as they pass from each phase of borrowing to the next. This system is described as 'an international hierarchy of lending […] which provides the framework for international influence' (Bernstein, 1983, 657). In the first phase of borrowing, finance is freely available from private institutions and there is little pressure for governments to change their policies because there are no existing mechanisms for the effective exercise of such influence. In the second phase, private financial avenues have been exhausted and governments must seek recourse to other central banks, which may impose conditions such as future recourse to the International Monetary Fund if a satisfactory improvement in economic conditions is not achieved within a given timescale. If this is the case, governments then become subject to the third-tier of the hierarchy, where 'international influence is direct, and lending is conditional on policy changes bargained with the IMF as the representative of international creditors' (ibid, 657-8).

The ability for the structure of global finance to restrict national policy autonomy through the IMF is also developed by Harmon from the perspective of regime theory, which, he argues, disguises the extent to which coercion plays an important role in the creation and maintenance of international economic regimes. He notes:

> Functionalist voluntarism […] leads to an underemphasis both on the roles of coercion in regime formation and on the importance of discipline and the manipulation of incentives and punishments in sustaining regime arrangements. The normative bias in favour of cooperation within the regime concept tends to confuse international "cooperation" with what might be more appropriately characterized as manipulative coercion and the discipline of enforcing cooperation (Harmon, 1997, 15).

He argues that manifestations of the implicit costs suggested by regime theory in the event that policy does not coincide with established principles and norms can be clearly identified in the fact that 'runs on the currency and a loss of confidence in the future value of assets denominated in that currency can occur in the face of real or perceived movements away from the liberal norms that embody the postwar regimes' (ibid, 15). This is especially problematic for governments in deficit, who will find financial assistance forthcoming only with conditions attached (ibid, 16).

Bernstein notes that the application of a strict sixth month time limit to the $5.3 billion G10[1] stand-by in June 1976 was a key moment when the forces of global finance began to limit the policy autonomy of the British government, but she notes that for reasons of political acceptability, explicit conditionality relating to the details of policy were not applied before recourse to the Fund. She concedes that 'there is little question that the Fund is – and defines itself […] as "the creditors' instrument"', but also notes that it has an appearance of political neutrality stemming from the multilateralism that underscores it, which allows it to 'fulfil a set of functions which other creditors are reluctant or unable to perform' (Bernstein, 1983, 50). On this, Harmon (1997, 145-6) agrees:

> Loan conditionality is more tolerable when the policy changes can be presented by the economic authorities as their own decision. In June 1976, explicit bilateral conditionality – i.e., overt American involvement and intervention into British domestic policy decisions – would have been unacceptable.

The June stand-by is therefore seen as an important bridge in the transition between low conditionality borrowings and the explicit constraints placed on British economic policy by IMF conditionality, and Harmon has used the Labour Party's pre-election commitments and manifestos in order to demonstrate the extent of the influence that these coercive forces ultimately had on British policy. He notes that

[1] Minus France and Italy, plus the Bank for International Settlements and Switzerland. Hereafter this group is referred to as G10 for the purposes of convenient abbreviation.

both Harold Wilson and Anthony Crosland had believed that the main problem the Labour government had faced during its incumbency from 1964-70 had been the inherited balance of payments position which became more acute because of low levels of growth and sterling's role in the international payments system. It was this view, he suggests, that precipitated the commitment in *Labour's Programme 1973,* that 'Labour will refuse to distort the domestic economy in order to maintain an unrealistic exchange rate', and the assertion that 'Britain must avoid international commitments which might hamper growth' (Labour Party, 1973, 16), which he understands as a significant 'disavowal of an exchange rate commitment' (Harmon, 1997, 55).

He also notes that Labour's domestic objectives were couched in language associated with the social democratic heritage, and that many of them were radical in comparison to the party's recent revisionist past, especially the commitment to make steps towards the 'redistribution of incomes and wealth [and] the greater accountability of economic power' (ibid, 60). He notes that by the end of 1976, the possibility for the Labour government to realistically achieve any of these objectives had escaped them, that this state of affairs was a direct result of 'the chronic lack of market confidence that was made manifest with the persistent downward pressure on sterling', and that it must be recognised that the IMF played the decisive role in the sense that 'it was only with the explicit binding of the policy of the British economic authorities that the economic and political crises in Britain in 1976 were resolved' (ibid, 229-30). On this, Karen Bernstein is agreed; she argues that whether or not measures taken by the Labour government independently of the Fund would have

been sufficient to resolve the crisis is a moot point, because it cannot be answered (Bernstein, 1983, 649). She argues that as history stands, measures in place before the crisis were not sufficient to resolve it, and that this resolution occurred only when policies 'along the lines preferred by creditors and sufficient as defined by them' were in place (ibid, 658). Neither author perceives the fact that elements of the Treasury and the Bank of England had decided that policy changes were desirable in order to turn the British economy around prior to the crisis as significant (Bernstein, 1983, 367; Harmon 1997, 145) – Harmon because of his belief that for autonomy to exist the government must have a range of options from which to choose, which he believes had gone by December 1976 (Harmon, 1997, 6), and Bernstein (1983, 656) on the grounds that 'although the eventual cuts were desired by a portion of the Government, it would be difficult to argue that they were desired by the Government as a whole.'

Both of these extensive accounts reflect understandings of the relationship between state and market in terms of their separateness, and identify constraints on policy autonomy akin to those implied by the logic of global finance and regime theory. However, the argument that the British state's autonomy in economic policy-making was bound during the IMF crisis has also been made from a structural Marxist perspective by David Coates (1980), who uses a distinctly partisan register in order to highlight the way in which structural forces manifest in the inherent contradictions of the capitalist world economy served to limit the policy autonomy of the Labour government. Policy changes, he asserts, can be understood as the Labour government's response to four paradoxes it faced in the global economy. The first of

these was the fact that 'the foreign loans raised to prevent immediate and draconian cuts in the social wage in the end (by the burden that their repayments place on Government spending in total) became one cause of the severity of the cuts in social expenditure that had to be imposed' (Coates, 1980, 19). Secondly, 'the international indebtedness of the economy made the pound weak [and] worked against the restructuring of industry that indebtedness required' (ibid, 20). Thirdly, he argues that 'inflationary pressures kept industrial costs high and product demand low, and so squeezed the rate of return on investment at the very time when the cost of borrowing was so high that only the most profitable ventures could generate the rate of return required to cover the borrowing costs involved' (ibid, 22). Finally, he notes that 'the existence of a public sector deficit was vital to the maintenance of existing levels of output and employment, but its financing militated against the strengthening of those in the next period' (ibid, 25).

In confronting these paradoxes, he believes that the government was compelled to act in favour of capital at the expense of its more radical aspirations, and that this process represents part of a wider trend for Labour governments in power to 'succumb to more moderate aspirations and more conservative policies as they experience the constraints that can be exercised against a reforming government by centres of private power' (ibid, 154). He argues that economic recovery in Britain required a coordinated effort between all powerful British interests and would have been best achieved by creating a climate of social justice, and that the tragedy of the 1974-79 Labour government was to discover 'how incompatible the search for social

justice was to be with the requirements of significantly placed groupings both inside and outside Britain' (ibid, 16).

In addition to the accounts framed explicitly by theories of the state that emphasise its separateness from the market, and the ability of the market to discipline state managers, the decisive influence thesis is also reflected by the official history of the International Monetary Fund, which reviews all of the significant reforms of the international monetary system and Fund activities since its creation in 1944. It notes that the context of the events of 1976 was one shaped fundamentally by the OPEC price increases of 1973, which had led the Fund staff to believe that 'the problems of the U.K. economy were basic and in need of resolution over the long term' (de Vries, 1985a, 416). Reflecting this position, she notes that it was possible to agree Britain's transactions with the Fund under the 1975 oil facility and first credit tranche on the basis of existing policies because they appeared to be having some success, especially incomes policies (ibid, 465). However, in 1976, the Fund's views were subject to a substantial re-appraisal, and by the time it had become clear that Britain would apply for a stand-by of its full quota of SDR 3,360 million, she notes that 'it was by no means certain […] that the executive board would approve such a large amount' (ibid, 467). This leads her to the conclusion that the Fund's position played a significant role in shaping British policy outcomes during the crisis, and she suggests that in coming to terms with the extent of the conditions required by the Fund, 'the Government authorities involved, without question, considered themselves "pushed" by the Fund's officials' (ibid, 478).

Contemporaneous accounts also share the view that the extent of Britain's borrowing prior to the IMF crisis and IMF conditionality in 1976 played a fundamental role in determining economic policy. Keegan and Pennant-Rea (1979, 159) for instance, suggested that retrenchment had become inevitable as early as the first applications to the IMF for drawings under the oil facility and first credit tranche in 1975, because the need for these loans demonstrated the extent to which the intentions of the Labour government differed from those that were compatible with fostering and maintaining the confidence of financiers outside Britain. As such, they note that despite the low-conditionality of the drawings, they may have represented 'more of a noose than many observers realised at the time' (ibid, 159). They go on to note that as withdrawals of sterling began in earnest during March 1976, the intentions of interested parties within the United States[2] were to 'use the fall in sterling balances to ensnare the British Government' (ibid, 163), and that ultimately, it was inevitable that during the negotiations of the terms of the loan that, 'the IMF, like any bank manager, will exact a price for its money, and the supplicant is simply not in a position to sound convincing when he says, "my policies are all right; just give me the money'" (ibid, 165).

Fay and Young (14 May 1978, 33) also note that American interests played a fundamental role in determining outputs, and were insistent that the G10 stand-by in June be repaid in six months at the outside in order to force Britain under IMF

[2] They refer specifically to Undersecretary of the US Treasury, Edwin Yeo; Secretary of the US Treasury, William Simon, and; Chairman of the Federal Reserve Board of the Federal Reserve Bank of New York, Arthur Burns.

discipline should it not be able to repay. They furthermore argued that despite the claims of British officials and ministers that the loan had been arranged with relative ease, the Americans had essentially put up their share of the money 'as bait' (ibid, 35). They also note that US officials were obdurate in their opposition to a sterling balances agreement as a means of avoiding IMF conditionality, Edwin Yeo informing the Chancellor of the Duchy of Lancaster, Harold Lever, that 'Britain would not get the IMF loan at all if Callaghan continued to try and have a safety net for sterling' (ibid, 21 May 1978, 33). In the final analysis, they suggest that Callaghan was only convinced of the need to accept conditions to the extent suggested by the Fund during an unpleasant meeting with the Fund's Managing Directory, Johannes Witteveen, on 1 December (ibid, 28 May 1978, 33).

Accounts emphasising the decisive influence of the IMF in shaping policy outcomes are those that have come to be most widely accepted in general discourses about British economic and social history, and the history of the Labour party. Tomlinson (1990, 280) for instance, suggests that the extent of Britain's drawings from the Fund throughout 1975 made conditionality inevitable in 1976, noting that 'the approach was bound to lead to a loan with conditions, as Britain's unconditional tranche of borrowing had been taken up in 1975.' Peter Clarke (2004, 353) notes in a similar register, that in completing the arrangement of the loan, 'the terms available were naturally dictated by the lenders.' However, the quintessential expression of this orthodox view is that of David Reynolds (2000, 238), who notes that the conditions of the IMF loan demonstrate that the Labour government was 'humiliatingly bailed out by the IMF on tough, deflationary terms.'

De-mystifying the crisis

Narrative accounts of the 1976 IMF crisis have played a substantial role in helping to de-mystify the influence of the IMF during the crisis by constructing a time-line of events that shows that a number of policy initiatives associated with Fund conditionality were actually in place before the arrival of the Fund team in December 1976. The most substantial account of this kind is that of then Permanent Secretary to the Treasury, Sir Douglas Wass (2008), who reviews events in order to assess the performance of the Treasury in advising the government on appropriate responses to the sterling crises of 1975 and 1976 by looking at macro-economic policy making in each calendar year from 1974.

At the end of the first year of the Labour government, he notes that the principal problems with which they had been faced were the loss of national income that occurred as a result of the OPEC price increases, and the rise in inflation associated with the abandonment of formal incomes policy. In addition to this, he notes that the large balance of payments deficit was problematic, and the 'significant increase in public expenditure which occurred in the financial year 1974-75 largely due to the measures of the March Budget and the July mini-Budget' had added to the difficulties of effectively managing the economy on the grounds that it 'implicitly made the share of national income which flowed to the personal and private sector much less when those sectors were already being squeezed' (ibid, 87).

He notes that whilst officials had identified the problems facing the government, the Treasury 'was not very successful in devising satisfactory remedies for them.' However, this statement is qualified by reference to the political situation, and he notes that the 'sharp increase in public spending in 1974-75 was of course a political decision which the Treasury was in no position to prevent, or for that matter, to oppose' (ibid, 87). Even though officials had some success in persuading ministers of the need to limit expenditure increases in future years, he notes that the targets set were based on wholly unrealistic assumptions about the prospects for future growth, and that as a result, the Treasury's attempts to control public expenditure can only be described as a moderate success (ibid, 87-8). On the issue of diverting resources to the external sector, he notes that the Treasury fared no better on the grounds that whilst it had advocated depreciation of sterling, it had failed to convince ministers of the importance of the issue, and had not been able to propose a practical method for achieving it (ibid, 88). Finally, with regard to inflation, he absolves the Treasury of responsibility for policy failures on the grounds that whilst officials had doubts about the viability of voluntary incomes restraint as the key-stone in counter-inflationary strategy, it was in no position to argue for alternatives without having given the Social Contract a chance to work (ibid, 88). Therefore, despite Wass' attempts to present a neutral view of events, his account nevertheless leans towards a defence of the Treasury in the sense that where policy was seen to have been most ineffective, especially with regards to public expenditure and counter-inflation policy, he makes the judgement that it was beyond the remit of the Treasury to intervene substantially because these were political decisions.

In 1974 therefore, the image that Wass presents is of a Treasury acutely aware of the economic difficulties Britain faced, but unable to act decisively both because of its lack of ideas about how policy could be made effective, and because of its sensitivities to the political needs of the government. Of 1975, he gives a more positive appraisal of the Treasury's performance, albeit with some caution. He notes that the pay policy agreed with the TUC had looked to be a reasonable success, and that although the applications for the oil facility and the first credit tranche loans from the IMF had not been approved by the end of the year, there was no reason to think they would not be. This significantly eased the external financing outlook (ibid, 162), however, he notes that because Britain was still critically dependent on the confidence of its creditors, the issue of public expenditure remained problematic despite substantial cuts in planned expenditure for 1978-79 agreed for inclusion in the 1976 Public Expenditure White Paper, and the introduction of Cash Limits (ibid, 163).

At the beginning of 1976, he notes with regard to exchange rate management that 'the issue was still unresolved when events contrived to solve it for us' (ibid, 163). This solution was a slide in the rate that was provoked by a reduction in the Minimum Lending Rate (MLR) on 4 March 1976, and whilst he acknowledges that the Treasury had been in favour of depreciation, notes that it occurred by accident in light of market conditions (ibid, 179-81). He then argues that events on the foreign exchanges underscored the events of the rest of the year, as sterling continued to slide until the cuts of July 1976 (ibid, 210). However, despite these measures, and the arrangement of the $5.3 billion G10 stand-by in June, which had not decisively

stopped the slide, the Treasury was convinced of the necessity to begin making preparations for an application to the Fund.

In resolving the crisis, and of the IMF conditions themselves, he notes that improvements in Britain's economic performance, specifically with regards to investment in and speculation against sterling in the foreign exchange markets,

> had begun to take place before any of the measures agreed with the Fund, notably the public expenditure cuts and the commitments to containment of the [Public Sector Borrowing Requirement (PSBR)] and of the growth of the monetary variables for 1977-78 and 1978-79 took effect (ibid, 308).

He therefore concludes that the turnaround was 'due either to expectations that the commitments would be honoured or the fact that the IMF had blessed the Government's economic programme gave it some sort of legitimacy' (ibid, 308). This suggests that the Fund's involvement was beneficial largely as a presentational aid, a view reinforced by decisions taken in 1977 that 'were a virtual cancellation of the cuts of December 1976 and […] were made without damage to the commitments on PSBR and the monetary variables' (ibid, 311). He also demonstrates that during the negotiations with the IMF, there was a considerable degree of overlap between the views of the Fund team and Treasury officials, that the Treasury did not make significant attempts to dissuade the Fund team from pursuing its objectives, and that he believes the Fund team was correct to push for them given British officials' agreement (ibid, 312). On the basis of his examination, he concludes:

> That there was no specific contingency plan for the events of 1976 is clear […] beyond a simple statement that there would have to be unspecified

> "crash" measures – public expenditure cuts, interest rate increases, etc. – there was no plan to deal with a situation where the major official sterling holders decided, almost *en masse*, to sell a significant part of their holdings (ibid, 345).

The kind of incremental change in policy described by Wass reflects the account of Ludlam (1992a), who, whilst noting that the government was confronted by 'actual and potential creditors of monetarist persuasion, among them stronger states whose view boiled down to the advice of the under-secretary of the US Treasury to his British counterpart to cut public spending in order to "get your people back on the reservation"' (ibid, 714), makes a principally narrative – although important – contribution to the literature, by identifying 'four myths' of the 1976 IMF crisis.

The first of the myths that he identifies is the association of public expenditure cuts with the IMF loan. He notes that as early as 1974 Denis Healey had informed Cabinet that there was a pressing need to cut the PSBR and that the cuts imposed by their Conservative predecessors could not be restored. Furthermore, he shows that cuts of £1.1 billion were announced in April 1975, and further planned cuts of £3.6 billion were announced in February 1976 (ibid, 716-7). The second of the myths he identifies concerns the imposition of a system of Cash Limits on public expenditure. He notes that far from being a condition of the IMF loan, the introduction of the system had been announced in February 1975, and notes that 'as early as the July 1976 crisis, ministers were aware that cash limits were producing an incalculable underspend' (ibid, 720). Thirdly, Ludlam shows that money supply targeting had

also been introduced prior to the arrival of the IMF in London in December 1976 as an important element of government policy. In July 1976 the government had set a target for the growth of broad money (M3) of 12 per cent, and Ludlam notes that the statistic had 'acquired overwhelming significance to monetarist theory and policy prescription in the mid-1970s', but that for the British government, was not seen to be critical (ibid, 721). Finally, he argues that the government had ended its commitment to maintaining levels of relatively full employment through demand management at the time of its first Budget in April 1974, which was 'mildly deflationary at a time when unemployment was already at 2.5 per cent' (ibid, 724).

Whilst Ludlam does not explicitly engage with questions about the extent to which British policy outputs were determined by or formed as the response to crises in the foreign exchange markets throughout the period 1974-76, he draws three broad conclusions. Firstly, he argues that the 'Thatcherite economic policy programme was at least prefigured, if not actually implemented between 1974 and 1979' (ibid, 713). Secondly, he notes that the increased importance assigned to monetary policy by ministers and officials 'had less to do with theoretical conversion and more to do with the formation of public opinion' (ibid, 723), and lastly, he notes that 'the IMF deal merely codified a change of political discourse already well underway and proceeding under the stewardship of British social democracy' (ibid, 727). This view is endorsed by Clift and Tomlinson (2008, 566), who note that agreement with the IMF 'did not push British policy onto paths which would otherwise have been untrodden.'

Whilst these positions show that British policy was already changing during a turbulent period for British economic management, as the empirical narrative of this thesis will confirm, they lack an appreciation of the consistency and coherence in economic strategy that was evident from 1974-76. As a result they further contribute to the view that the Wilson / Callaghan administration was one in which economic policy-making was characterised by indecision, and in many ways mirror positions that have argued that economic policy in Britain during this period was changing incrementally, through a process of social learning.

Social learning and the IMF crisis

These narrative accounts have therefore contributed to the literature by making it demonstrably clear that there was no single moment at which significant structural pressure was applied to the British government, either in the run up to the 1976 crisis, or during the crisis itself, and have implied a gradual, and at times, ad hoc, approach to policy change. Narrative frameworks of this kind are strongly reflected in accounts of the crisis that have identified social learning as the key determinant in economic policy-making under the 1974-79 Labour government. These accounts imply that the delegitimation of the Keynesian paradigm limited the choices available to political elites and forced them to consider other intellectual approaches to economic policy-making, and ultimately, to integrate these into their policy-making.

Identifying the influence of new ideas on economic policy-making is not a new approach to explaining change in Britain. The conversion of Treasury officials to Keynesian principles of macroeconomic management after 1945, for instance, has been described as the result of piecemeal acceptance of Keynesian ideas throughout the 1940s that eventually resulted in incomes policies and principles of demand management becoming widely accepted within the Treasury, and shaping policy outputs from then on (see Booth, 1983, especially 107 and 122-3; Oliver and Pemberton, 2004, 421-3). This however, is not an uncontested position. In response, it has been argued that the subjugation of economic objectives to the manipulation of fiscal policy in order to sustain relatively full levels of employment could never and did never exist in the UK (see Tomlinson, 1981, 73; 1984, 259), despite the 'long and tortuous process by which Keynesian ideas permeated [the Treasury]' (Tomlinson, 1984, 258).[3] In light of this debate however, and the historical coincidence of the rise in popularity of monetarist economic doctrine and the adoption of policy changes that seemed to endorse it during the 1976 IMF crisis, it is only natural to consider the extent to which those ideas were significant in shaping change.

[3] Oliver and Pemberton (2004, 425-5) argue that Tomlinson takes this kind of revisionism too far, and argue that there were clearly significant shifts in the goals and instruments of policy between the 1930s and 1950s, of which the Keynesian framework was the most significant, and that whilst battles over diverging policy suggestions such as Robot in the 1950s had to be fought, they were fought and won.

Heclo (1974, 305) argued that understanding policy changes as responses to 'a change in the possession and relationships of power among conflicting groups' does not capture the dynamic of the policy-making process. Instead, he argues that policies are a product of the state's 'collective puzzlement on society's behalf.' This belief is strongly reflected in Peter A. Hall's discussion of policy change in Britain during the 1970s. He suggests that it is the cumulative acquisition of knowledge by policy makers that dictates policy change, which can be divided into three distinct phases, described as follows:

> We can call the process whereby instrument settings are changed in the light of experience or new knowledge while the overall goals and instruments of policy remain the same, a process of first order change […] when the instruments of policy as well as their settings are altered in response to past experience even though the overall goals of policy remain the same, might be said to reflect a process of second order change [and] simultaneous changes in all three components of policy: the instrument settings, the instruments themselves, and the hierarchy of goals behind policy [are] instances of third order change (Hall, 1993, 278-9).[4]

[4] Oliver and Pemberton (2004, 420) have attempted to refine this framework, and suggest that failure to stabilise a paradigm through first and second order change does not result in paradigm shift. They argue instead that an exogenous crisis is also necessary in order to force policy-makers to face the inadequacies of the existing paradigm (ibid, 434).

Policy change, he argues, can be equated with the kind of revolutions in scientific theory described by Thomas Kuhn. Kuhn (1996, 66) noted that initial advances in theory are 'achieved only by discarding some previously standard beliefs or procedures and, simultaneously, by replacing those components of the previous paradigm with others', and that crisis provides 'the indication […] that occasion for retooling has arrived' (ibid, 76). Subsequently, these events provoke scientists to change the nature of their research, which is accompanied by the 'proliferation of competing articulations, the willingness to try anything, the expression of explicit discontent, the recourse to philosophy and the debate over fundamentals' (ibid, 91), which allows for the emergence and application of new paradigms.

This structure is applied to Britain's experiences in the 1970s by suggesting that British macroeconomic policy had, until the 1976 sterling crisis, operated within a Keynesian framework which specified and prioritised both the aims of policy and the means by which these ends were to be reached, at which point there was a shift in this framework towards monetarist modes of macro-economic management (Hall, 1993, 279). He suggests that the 'radical shift from Keynesian to monetarist modes of macroeconomic regulation' (ibid, 279) began with basic changes in MLR and fiscal policy consistent with 'normal' policy-making, escalated to include changes in the instruments of policy-making like the introduction of Competition and Credit Control under the Heath government in 1971, and the imposition of Cash Limits in 1975, with the movement towards the monetarist mode of macro-economic management beginning at the time of the IMF loan in 1976, before becoming more

formally institutionalised with the election of the Conservative government in 1979 (ibid, 283-4).

Kevin Hickson has also used an analytical framework of this kind in order to assess the impact of the IMF settlement on British politics. He begins from the point of departure that, if defined as broad continuity in policy, it is possible to identify a period of postwar consensus in economic policy-making (Hickson, 2004, 147-50; 2005, 42). He proceeds to demonstrate that the ideas of economic liberalism, as distinct from monetarism, became increasingly popular as a result of the impact of the OPEC price increases and the collapse of the Bretton-Woods system, before being incorporated into policy after influential think tanks like the Institute for Economic Affairs (IEA) and the Centre for Policy Studies (CPS) helped to politicise academic debates by disseminating ideas to a wide audience that included political elites (Hickson, 2005, 176). Burk and Cairncross (1992, 129) also note that 1976 was a turning point in the philosophical basis of economic policy-making, and suggest that the IMF crisis represented the victory of the market over a government in deficit resulting from the delegitimation of demand-management orthodoxies (ibid, 131-8).

There is agreement amongst accounts of this kind that in order for policy to change, there had to be a situation in which 'economic commentators and public figures alike [began] to search for alternatives to the Keynesian paradigm' (Hall, 1993, 286), creating a larger pool of resources in the 'marketplace of ideas' on which policy-makers could draw. These accounts also demonstrate that in the 1970s, a wide

number of solutions to British economic problems were proposed from both academic and political sources.

Bacon and Eltis had made an important contribution in mounting an attack on the scale of resources taken by the public-sector, noting that economic problems would be easier to solve if a greater proportion of national output was marketable and Britain had a stronger industrial base (Bacon and Eltis, 1996, 3). Their argument was that consumption by industry was increasingly reduced as more resources were siphoned off in order to pay for employment in the public services at the expense of exports and investment, which were squeezed during deflationary periods of the 'stop-go' economic cycle (ibid, 19). Problems were compounded in times of unemployment, when the government provided jobs in the public sector, which required the increased taxation of profit makers, and served to reduce investment and actually increase unemployment over time (ibid, 24).

Burk and Cairncross (1992, 149) note that the idea that 'the growth of public expenditure represented a denial of resources to the market and their pre-emption by the state' was also reinforced by the views of the New Cambridge School of economists, which believed that the public sector deficit was a mirror image of the trade balance and argued that the overseas sector could only move into profit 'by greater budgetary discipline designed to cut the public sector deficit' (ibid, 150). This School was also in favour of introducing import controls because of 'a new found pessimism about the uses of devaluation' (ibid, 151). This view was shared by advocates of the AES, who wished to see the commitment to full-employment

maintained through government stimulation of aggregate demand, the democratisation of industry, and centralised planning (Hickson, 2005, 178). However, it is the views of monetarists that have received the greatest attention.

Milton Friedman had been one of the fiercest critics of the Keynesian mode of macro-economic management, especially the neo-Keynesian adoption of the Phillips Curve relationship between inflation and unemployment after 1958. He had argued that there is 'no stable trade-off between inflation and unemployment; there is a "natural rate of unemployment", which is consistent with real forces and real perceptions' (Friedman, 1976, 15). The Phillips Curve model he believed, was predicated upon confusion between *nominal* and *real* wages and was false on this basis: 'no economic theorist', he noted, 'has ever asserted that the demand and supply of labour were functions of the *nominal* wage rate' (Friedman, 1975, 15, original emphasis). The implication of this analysis was that there are in fact two Phillips Curves – one representing the short-run, and one representing the long-run. The long-run curve incorporates the fact that wage bargainers negotiate on the basis of imperfect information about the *real* wage rate, which drives inflation, but does not reduce unemployment over the long-run. In essence, there is 'a *short-run* "trade-off" between inflation and unemployment, but no *long-run* "trade-off"' (ibid, 21, original emphasis).

The salience of this argument in the British case was based in the fact that the 'natural-rate' hypothesis as it was then understood, 'relegates the importance of unemployment in macroeconomic strategy' (Hickson, 2005, 182). This is because

the suggestion that attempts to reduce unemployment below its natural rate will simply lead to higher inflation implicitly legitimises austerity measures whilst stopping short of actively encouraging the creation of slack in the economy (ibid, 182). The mathematical logic that was the basis of the 'natural rate hypothesis' therefore conveyed the policy measures it implied with a certain degree of political neutrality, however superficial this was. As Burk and Cairncross (1992, 139-40) note, monetarist doctrine was able to 'offer a convenient and convincing explanation of the inflation that followed the Barber boom', but the overly simplistic idea that controlling inflation was simply a matter of controlling the rate of growth of the money supply concealed the highly political nature of the process in practice, which was dependent upon a rise in the level of unemployment as the decisive check on rising prices. Presented in this way, they note, the monetarist doctrine was a far less appealing way of controlling the rate of price increases 'than the apparently innocuous – indeed desirable – slowing down of monetary expansion' (ibid, 140).

These accounts therefore share a belief that ideas and economic doctrines have a significant role to play in shaping policy outcomes. They also note that the 1970s was a period of change marked by the declining legitimacy of the Keynesian paradigm and the rise of various other policy prescriptions that had robust analytical foundations, which were politicised by the advocacy of important think tanks and political elites with a global reach. As Hall notes, 'the media magnified the prominence given to monetarist doctrine and catapulted it onto the public agenda', showing how 'policy changed, not as a result of autonomous action by the state, but in response to evolving social debate that soon became bound up with electoral

competition' (Hall, 1993, 288). This suggests that the 1970s saw the rise of a new set of shared values that ensured policy change in Britain because of the extent to which these values had gained widespread legitimacy in other countries and financial markets.

However, the social learning thesis does not present the IMF crisis as the end-point in this process. As noted above, Hall (1993, 283-4) identifies 1976 as a transitory year in economic policy-making, and suggests that the new paradigm was not entrenched until the election of Mrs. Thatcher. According to one review of the literature of the IMF crisis, it is Hickson's account that should be understood as assigning the most significance to these events in terms of limiting the policy autonomy of the British state. Clift and Tomlinson (2008, 547) describe this understanding of events as a polemic, 'claiming that the IMF package was a humiliation in which Britain had lost the capacity to determine its own policies', however this interpretation overstates Hickson's position. Whilst he does conclude that the IMF loan forced Cabinet to accept a number of reforms in the field of monetary policy, he argued that the extent of this influence was limited, and stopped short of the widespread and unequivocal acceptance of the need to adopt fully-fledged monetarist machinery for macro-economic policy-making in Britain. This is based on his observation that the Labour government 'did not accept the "natural rate" hypothesis or the quantity theory [of money]', even though the Chancellor had 'accepted elements of the crowding-out theory and used the economic liberal supply-side argument' in order to win the political debate (Hickson, 2005, 226). His

position therefore is a moderate one, suggesting that the IMF loan represented the adoption of some, but not all, elements of a new governing philosophy.

Burk and Cairncross are more explicit in their conclusions about how far British policy was 'locked-in' to new ideas adopted during the 1976 IMF crisis, suggesting that whilst the period clearly shows the occurrence of a revolution in discourse, it did not translate itself into a revolution in policy-making. They note that the wider movement that had reacted against state intervention and high taxation whilst advocating the importance of free market solutions of which the monetarists were a part, was largely confined to academics and commentators, even though the IMF had been making attempts to convert members of the British Treasury to such understandings of the economy since 1968 (Burk and Cairncross, 1992, 143-4). They argue instead that events 'may have started new trains of thought; but it did little to change Treasury thinking at the top' (ibid, 144), and that although 'there were representatives of various schools of thought urging very different responses […] it is doubtful whether there were any out-and-out monetarists among them' (ibid, 161). They also note that the degree of long-term influence at the political level was limited. Whilst the Labour government accepted policy changes, it had done so only in so far as the new discourses had altered market perceptions about what constituted rectitude in economic policy making. They conclude:

> There was little change of heart in the Labour Party. The Prime Minister might denounce public spending as a way of coping with depression [but] the Chancellor had every intention of restoring the cuts when it seemed safe to do so and the PSBR was back above £9 billion by 1979 […] the rank and file

> demonstrated all too clearly in the winter of discontent that they had undergone no conversion (ibid, 228).

Conclusions

This chapter has shown that there is a broad literature on the 1976 IMF crisis, however it has also shown that, with the exception of historical accounts that have contributed to debunking myths about the crisis by demonstrating the way in which reforms in Britain began before the onset of crisis, the majority of this literature reflects theoretical positions that assume that external forces emanating from the logic of markets can play a key role in determining the economic policy output of states. The decisive influence thesis, in a straightforward application of the logics of global finance, regime theory, and structural Marxism, have argued that in the run up to, and during the 1976 IMF crisis, pressure was applied to British policy makers directly through the structures of the world economy. The social learning thesis, whilst accepting that policy changed over a sustained period, suggests that the policy autonomy of policy-makers was limited by the delegitimation of the Keynesian paradigm and resulted in a situation where applying its principles in policy was not sufficient to sustain the confidence of external actors. As such, it has been argued that the Labour government was forced to consider alternative courses, such as monetarism, favoured by the media, academics, and external markets.

The reification of state and market in each of these accounts however, is inherently problematic, and has contributed to an oversimplification of events in Britain in

1976. Firstly, by failing to acknowledge the way state preferences are shaped by the contradictory imperatives of accumulation and legitimation that arise from its existence as a moment in the antagonistic social relations of production, they fail to recognise the problem of policy-making as a response to these contradictions. This is exacerbated by the exclusion of the Treasury and the Bank of England from the analyses, which means that the range of preferences within the British state and the degree of conflict that resulted from them, is concealed. Whilst empirical studies of events have had an important contribution in debunking popular myths about the timeframe over which policy changes in Britain occurred in 1976, and have shown the depoliticisation hypothesis to be *plausible*, they stop short of making the case because they fail to appreciate the degree of coherence in economic policy-making. As such, like those accounts that assign a considerable degree of importance to structural sources of power in determining policy outputs, they fail to acknowledge the benefits governments can gain from the use of market rules and market rhetoric in order to justify austerity policies through the politics of depoliticisation, and the extent to which such a governing strategy was deployed during the Wilson / Callaghan administration.

Chapter IV

Managing the inheritance: economic policy in the short parliament, February – October 1974

The previous chapter reviewed existing accounts of the 1976 IMF crisis and argued that as a result of their theoretical perspectives they took insufficient account of the range of preferences within the British state, which has served to exacerbate the extent to which it appears as if expressions of structural power from market actors and market institutions played a key role in determining economic policy outputs from 1974-76. In this chapter I will demonstrate that the Labour government was faced with an inherent tension between its broad economic objectives and the views of the labour movement. On the one hand, it had to respond to the wishes of the electorate that desired social reforms to improve the standard of living and was vehemently opposed to government intervention in the wage determination process. These wishes were reflected in the rhetoric of the Social Contract and the Labour Party's 1974 General Election manifestos. On the other hand, it had to appease the views of the overseas sterling balance holders on whose confidence the stability of the pound depended, and who were sceptical about the effectiveness of voluntary collective bargaining and suspicious of substantial public expenditure. Confidence was further hampered by the large balance of payments deficit, and the fact that domestic businesses had found their profits substantially squeezed by price control, which offered them little incentive to rationalise and achieve greater international competitiveness.

The inherent tension between the domestic and external demands of economic policy was, however, recognised by officials and ministers alike at an early stage, and reflecting this, the government clearly demonstrated that its commitment to the principles of the Social Contract was very limited. On balance, it was accepted in the Treasury, the Bank of England, and to a more limited extent, the Cabinet, that economic policy must be geared towards diverting resources into exports to assist the correction of the balance of payments, even if this meant foregoing commitments to social expenditure. However, the conflict in objectives meant that economic policy between February and October 1974 was the product of a series of compromises stemming from the need for the Labour government to simultaneously maintain its electoral support, its credibility amongst those on whom it was dependent for borrowing, and to restore domestic industries to profitability. The chapter will demonstrate that the result of these compromises was invariably the deference or cancellation of public expenditures promised in Labour's general election manifesto in order to transfer resources into the balance of payments. This began at the time of the March 1974 Budget, and was moderated only by small concessions to the social wage in a package of measures announced in July in anticipation of an autumn general election.

The social and political inheritance

As Gamble (1994, xvi) notes, the 'favourite political scapegoat for the British disease used to be the trade unions', and significant difficulties for both the 1964-70

Labour government and the 1970-74 Conservative governments arose from their attempts to reform Britain's system of industrial relations. Trade union resistance to such attempts made a significant contribution to shaping the Labour Party when it was out of office, and in many ways set the boundaries for the political discourse about incomes policies and collective bargaining by virtue of its effectiveness and because trade union hostility to government intervention in industrial relations was historically entrenched. The previous Labour administration's attempt to reform industrial relations, *In Place of Strife,* had argued that the climate of industrial relations in Britain meant that 'management and employees are able to unfairly exploit the consumer', and had 'produced a growing number of lightning strikes and contributed little to increasing efficiency' (Cmnd. 3888, 1969, 5). However, the proposal to legislate so that strike actions would have to be democratically agreed by union ballot, and to establish a body to enforce settlements arising from industrial disputes, was defeated in the House of Commons. According to one author, the debate over *In Place of Strife* contributed to relations between the TUC and the Labour party reaching 'their "historical nadir" in 1969' (Ludlam, 1992b, 155).

The 1971 *Industrial Relations Act* was similarly damaging in political terms for Edward Heath's Conservative government. The Act was intended as a wide-ranging reform of the structure of British industrial relations, and was designed to effectively criminalise any form of industrial action deemed to be 'unfair'. According to Brown (1983, 180) it provided that:

> it was an unfair industrial practice for any person to induce or threaten to induce someone else to break a contract of any kind – that is, virtually any

> practice, for any person to lead a strike – unless that person was acting within the scope of his authority on behalf of a trade union.

It meant that the enforcement of injunctions under the Act would require the imprisonment of transgressors, which was especially problematic because the activities it criminalised had long been 'generally regarded as vital to trade unionism' (ibid, 180). In essence, Brown writes, any enforcement of the Act, 'conferred a martyr's crown on [transgressors] and a stigma on the Act and the Court' (ibid, 180-1). The result of the legislation was a situation in which the majority of unions refused to register under the Act, despite the financial penalties they incurred as a result, negating any supposed gains and antagonising a significant proportion of the politically active population.

The trades unions' resistance to incomes policies and their belief in free collective bargaining matched their opposition to the structural reform of the system of industrial relations more generally. Edward Heath had operated two such policies from 1970-74. The first was the public sector pay policy of de-escalation known as 'n-1', but the most significant in political terms was the *Counter Inflation (Temporary Provisions) Bill*, which was to operate in tandem with statutory price controls from 1972. The Bill operated on incomes in three phases: firstly, there was to be a six month statutory wage freeze, followed by stage two, which would create a Pay Board and a Price Commission, which were empowered to impose 'rollbacks' or fines on firms in violation of the set limits to profits, prices, and wages (see Fishbein, 1984, 106). This was to begin in 1973, and like the first phase of the policy, had provoked only minor discontent.

Attempts to implement the third phase of the policy however, were a political disaster. The National Union of Mineworkers (NUM) had requested an exceptional 'unsociable hours' payment, which the government unwisely treated as a constitutional issue rather than a notable exception. Peter Clarke (2004, 337-8) notes that the government 'guilelessly wrote this provision into the general guidelines for phase three, instead of keeping it […] as a special treat for the miners alone.' This had the effect of antagonising and mobilising one of Britain's most militant unions. The oversight prompted the NUM to institute an overtime ban in November as it pursued its claims for extra payments to mineworkers, and unable to break the impasse and anticipating a strike by the miners, the government 'pre-emptively instituted a three-day week for British industry' in December 1973 (ibid, 338).

The February election, held on the issue of 'who governs Britain', therefore occurred with the country 'hamstrung in the darkness of [a] three-day week' (ibid, 339). Whilst Pliatzky (1984, 117) notes that in the general election of February 1974, 'very few Labour voters […] were conscious of what they were voting for, as distinct from an end to the three day week', the Labour Party (1974a, 192) campaigned on the promise to bring about 'a fundamental and irreversible shift in the balance of power and wealth in favour of the working people and their families', as they would again in October (see Labour Party, 1974b, 213). However, the broader programme of policies with which the Labour party was associated keenly reflected the industrial relations landscape that had blighted its predecessors.

This broader programme was known as the Social Contract, and had emerged from the meetings of the TUC / Labour Party Liaison Committee. The committee had first met in January 1972 on the initiative of the General Secretary of the Transport and General Workers' Union (TGWU), Jack Jones, who had 'a clear determination on his part to rebuild a close relationship between the TUC and the Labour Party after the divisive conflict of 1969' (Taylor, 2000, 209). This determination was no doubt principally shaped by the possibility of exploiting the political weakness of the Heath government in light of the unpopularity of the *Industrial Relations Act*, and the extent to which the committee's suggestions represent concessions to the labour movement reflects this.

The principal policy document emerging out of the committee's meetings was *Economic Policy and the Cost of Living*, which called for statutory measures to control food prices as part of 'a wide-ranging and permanent system of *price controls*', the expansion of subsidies for house building and transportation, the redistribution of incomes and wealth, and a prompt return to voluntary collective bargaining (TUC / Labour Party Liaison Committee, 1973, 313, original emphasis). Many accounts emphasise the degree of cooperation between the Labour Party and the TUC implied by the document, Koelble (1987, 257) noting that it 'established a deal in which the unions would support the Government's attempts to fight inflation by curbing their wage demands [in return for] favourable industrial policy, unemployment relief and structural modernization.' Harmon (1997, 56) likewise suggests that:

> the foundation of the Social Contract as it emerged in 1973 and 1974 was a *quid pro quo* commitment between a future Labour Government and its trade union allies, in which the Government, through its progressive economic, social and industrial policies, would create an appropriate "climate" to which the trade unions would respond with income restraint.

However, the image of two groups with shared interests reaching amicable agreement in order to achieve mutually beneficial outcomes, whilst intuitively appealing, fails to capture the dynamic of the relationship between the Labour Party and the TUC. As Tarling and Wilkinson (1977, 395) noted, it was significant that *Economic Policy and the Cost of Living* contained no specific commitment to incomes policy, reflecting the unions' wariness of such policies. As such, Taylor (2000, 210) has noted that the Liaison Committee simply provided a forum for the TUC to press for improvements in areas it deemed of importance, without making any of its own undertakings. In this sense, there was an asymmetry of purpose in the ideas that underpinned the Social Contract, and the 1973 document on which it was based was, in actual fact, 'little more than a shopping list of TUC demands' (ibid, 210).

The process of forming the Social Contract may therefore rightly be described as the 'most systematic attempt ever in Britain to make an agreement between the governing party and the trade unions' (Tomlinson, 1990, 301), however the extent of the compromises made by the TUC need to be carefully qualified. It remained insistent that it would not make promises on wage restraint that it would be unable to

deliver, in light of which it postponed calls for generalised wage restraint until the summer of 1974 (see Taylor, 2000, 211). As such, the claim that the Social Contract was 'an arrangement whereby the TUC agreed to collaborate with a voluntary incomes policy in return for the repeal of the 1971 Act and some modest economic benefits' (Sheldrake, 1991, 77), is both an overstatement of the extent of TUC commitments and an understatement of the demands it had made on a future Labour government in return for its support. In many respects, it was because of the inadequacies of the partnership between the TUC and the Labour Party, and not because of its strength, that the Social Contract was acceptable to the TUC as the centrepiece of Labour's 1974 general election manifestos. Furthermore, although the Labour Party was committed in principle to the Social Contract, the main reason for this was an electoral consideration, and the extent of its commitment, especially amongst the party leadership, was in practice far weaker.

The social and political context of industrial militancy in Britain in the 1960s and 1970s therefore helps to explain the significant leftward shift of the Labour Party between 1970 and 1974,[1] even if this shift was only really reflected in the Party's rhetoric rather than the beliefs of the Parliamentary Labour Party (PLP) leadership. Taking a broader view, the PLP had astutely noted that this leftward shift would

[1] Wickham-Jones (1996, 26-32) notes that the leftward shift in opposition is also partly explained by the status of the National Executive Committee (NEC) as the administrative authority of the party, which allows it to dominate the immediate and medium term policy-making of the party, whilst the Parliamentary Labour Party (PLP) is able to reassert its control over policy when in office.

need to accommodate a broader economic strategy that addressed the 'problem of improving economic performance by raising the rate of economic growth, while maintaining full employment and achieving balance-of-payments equilibrium' (Tarling and Wilkinson, 1977, 396). This was problematic because it required incentivising industry through higher profits and lower corporate taxation (ibid, 396), and stood in contradiction to the principles of the Social Contract. It was also made considerably more difficult in light of the Labour government's economic inheritance.

The economic inheritance

The economic situation that the Labour Party inherited in February 1974 was difficult and worsening, and Denis Healey (2006, 392) recalls that the Conservatives had left him 'an economy on the brink of collapse.' In 1974, the balance of payments was in deficit by £3.3 billion (Central Statistical Office [CSO] 1977, 46), and as figure IV.1 shows, had stood in deficit for six years out of ten between 1965 and 1974, and been in especially steep decline between 1973 and 1974, in part due to the increased import costs resulting from the OPEC price increases. The indication that inflation showed little sign of abating was perhaps the greatest difficulty for policy makers given the vulnerability of sterling to destabilising capital flows. As table IV.2 shows, in the first quarter of 1974 the retail prices index (RPI) had increased by 12.8 per cent on the first quarter of the previous year.

Figure IV.1, Balance of Payments 1965-75, Seasonally Adjusted, £ million

	Visible Trade		Invisibles				
Year	Exports (f.o.b.)	Imports (f.o.b.)	Total	Credits	Debits	Balance	Current Balance
1965	4848	5071	-223	2871	2674	197	-26
1966	5203	5269	-66	2955	2788	167	101
1967	5139	5693	-554	3245	2989	256	-298
1968	6282	6949	-667	3809	3414	395	-272
1969	7075	7231	-156	4315	3699	616	460
1970	7907	7932	-25	5006	4248	758	733
1971	8810	8530	280	5550	4746	804	1084
1972	9141	9843	-702	6109	5253	856	154
1973	11772	14106	-2334	8396	6774	1622	-712
1974	15899	21119	-5220	10169	8272	1897	-3323
1975	18768	21972	-3204	11047	9499	1548	-1656

Source: CSO (1977) *Economic Trends,* Number 279, London: HMSO, 46

Figure IV.2, Retail Price Index 1973-74, 1970 average = 100

		RPI	Percentage Increase*
Year	Quarter	All Items	All Items
1973	1	123	7.99
	2	126.9	9.40
	3	128.8	9.15
	4	133.2	10.26
1974	1	138.8	12.85
	2	147	15.84
	3	150.7	17.00
	4	157.5	18.24

Source: CSO (1976) *Economic Trends,* Annual Supplement, Number 2, London: HMSO, 96-7

*** Percentage increase on same quarter of previous year (my calculation)**

Despite the fact that these indicators meant the government's credibility amongst the financial markets would be closely linked to their improvement, there were some positive indicators in the economy. Whilst public expenditure had increased by 18.1

per cent between 1972 and 1973, investment had increased by 23.5 per cent in comparison to increases in current expenditure of just 13.8 percent (CSO, 1977, 54). The scale of this investment, whilst falling short of that required in order to decisively solve the problem of the competitive position of British industry, nevertheless indicated that Britain's economy was moving in the right direction, and that for the time being at least, it remained a suitable lending prospect. The real difficulty for British policy was that this confidence was fickle, and short-run improvements did not necessarily generate enough confidence to ensure that Britain's external deficit could be financed in the long-run. As a result of this, the diversion of resources towards exports and attempts to rationalise industry remained central to a sustainable governing strategy, a view reflected in the frequent dialogues between British and IMF officials in the early 1970s.

Clift and Tomlinson (2008, 549) have noted that 'UK-IMF interactions were a "repeated-game" in the two decades [1956-1976]', with the result that 'UK politicians and officials became very familiar with IMF preferences and opinions in relation to particular policies.' In discussions between the Treasury and the Fund in 1973, when Britain considered applying to the Fund in the wake of worrying economic forecasts, these views were once again put forward. The rationale for the British approach stemmed from a Treasury paper circulated for discussion by the Budget Committee (BC) at the end of the year, which noted that despite a fall in unemployment of around 20,000 per month since June, increases in the number of vacancies had waned, and exports were rising more slowly than imports (The National Archives [TNA] T 171/1092, BC (O) (74) 1, 30 November 1973). In

addition to the additional slack emerging in the economy, 'import prices were up more than 20 per cent and export prices by 10 per cent', and the 'general impression given […] by the growth of M3 is disarray' (ibid).

The Treasury also forecast that the PSBR would rise sharply and corporate profit margins would fall because of the 'sharp increases in the assumed rate of pay and price rises and the further deterioration in the current external account' (TNA T 171/1092, BC (O) (74) 2, 2 December 1973). The energy crisis also posed a significant problem because of the difficulties this created for maintaining levels of private consumption, and the head of the Central Policy Review Staff (CPRS), Sir Kenneth Berrill, noted that with the balance of payments deficit likely to double between 1973 and 1974 (TNA T 171/1092, BC (O) (74) 5, 7 December 1973), the government should try to encourage people to accept a reduction in consumption levels, reduce public expenditure and tighten its monetary stance in order to help with the balance of payments (ibid).

The Conservative government broached the possibility of drawing from the Fund when Anthony Barber met the managing director of the IMF, Johannes Witteveen, in mid-January, on the grounds that 'UK reserves, although stronger than in the past, remain[ed] insufficient to inspire and maintain confidence' (TNA T 354/282, Littler to Fogarty, 7 January 1974). Barber believed that it would be necessary to 'have access to really big sums' in order to achieve this (TNA T 354/282, Barber to Heath, 7 January 1974). In the Chancellor's meeting with Witteveen, the managing director expressed the view that measures the government had taken to cut expenditure in

December had been welcomed, but that it was feared that they may have been insufficient to impose the required limits on domestic demand and make room for increasing the volume of British exports (TNA T 354/181, Note of a Meeting, 15 January 1974). More importantly from the point of view of financing the balance of payments and with regard to conditionality, Witteveen noted that 'in principle […] the IMF would be ready to help financing the UK's deficit *if it could be shown that action was being taken to restore Britain's underlying balance of payments position*' (ibid, emphasis added). The head of the Overseas Finance Division, Sir Derek Mitchell, captured the policy dilemma concisely: whilst 'there was no lack of goodwill towards the UK within the Fund […] unless and until our economic and political uncertainties were eased, there would be no guarantee that our application for a standby would get approval other than on terms which we might find unacceptable' (TNA T 233/2950, Mitchell to Allen, 22 January 1974).

Whilst the prospect of a drawing from the Fund had passed by the end of January 1974 (see TNA T 233/2950, Walsh to Cassell, 30 January 1974), the episode is informative in two respects. Firstly, it demonstrates the extent to which the economy that the Labour government inherited was on the verge of requiring funds from the IMF, and that UK officials were well aware of what the implications of such a course would be with regards to conditionality. But secondly, and more significantly, the economic inheritance and the Treasury's awareness of what constituted rectitude in economic policy-making in the eyes of overseas opinion, help to explain the substantially more moderate approach to policy-making that

emerged between February and October 1974 than had been suggested by the Labour Party's general election manifestos and the rhetoric of the Social Contract.

It has been shown that the British political and economic contexts were problematic by the spring of 1974. The opposition on principle to incomes policy meant that voluntarism had to form the centrepiece of Labour's counter-inflation strategy if it was to maintain its office, and demands for subsidies represented a burden to the public purse whilst distorting the investment incentives that Britain badly needed if the competitiveness of its industry was to improve. The IMF had also indicated that genuine attempts to restore the economy to a fundamental equilibrium were required if Britain wished to use the Fund's resources. The Labour government therefore faced the problem of how it was to simultaneously satisfy the electorate, which expected the government to act in a way that reflected the commitments it had made in its election manifesto despite the fact that the PLP leadership was not as committed to it as the more left-leaning policy-making apparatus of the Party, and transfer resources into the balance of payments at a rate sufficient to avoid a critical break in confidence.

The March Budget

As Barnett (1982, 24) recalls, 'the decisions about the growth of expenditure were made in the first three weeks of coming into office and announced by the Chancellor in his Budget statement.' Healey (2006, 393) recalls that the Budget was 'received with rapture by the Labour movement as representing the first step in that

"irreversible transfer of wealth and power to the working people and their families"' that the Labour Party had promised. However, other members of the Cabinet have not spoken as favourably of the package. Secretary of State for Energy, Tony Benn (1989, 127), for instance, noted that it was 'a Budget that will undoubtedly disappoint the Party and the movement, and one which as I was listening to it, I was convinced was written by the Treasury and not by Ministers.' Harold Lever also shared this view, the Secretary of State for Social Services, Barbara Castle (1980, 51), recording in her diary that Lever believed 'the essence of our policy was the Social Contract, which, above all, was based on reducing unemployment and going for growth. He thought the Budget would inevitably increase unemployment and we should be in trouble with the trade unions.' However, despite disagreement in retrospect about how the government's first Budget should be judged, it was clear that its modesty in comparison to the election manifesto promises was determined by the importance of a broader set of macro-economic objectives.

At a meeting with the Chancellor on Budget strategy in early March, the Permanent Secretary to the Treasury, Sir Douglas Allen, outlined the problems that had to be considered in preparing the forthcoming Budget. He noted: 'on the public expenditure side, the Government's proposals on pensions and food subsidies could add a great deal to demand.' On the revenue side, he suggested that 'it would first be necessary to offset the extra spending proposals', and that overall, 'if the Chancellor still wished to go hard for an improvement in the balance of payments, the Budget should be mildly deflationary' (TNA T 171/1053, Note of a Meeting, 7 March 1974). The Chancellor's own proposal demonstrated an acute awareness of the

balance that had to be struck. He told officials that he was willing to continue with the levels of expenditure he had inherited from the previous administration and that he favoured additional cuts from the defence budget, as well as prestige projects such as Concorde, so that it would be possible for him to propose the desired increases in pensions, and food and rent subsidies (ibid).

Despite making these offsetting savings, the Chancellor also emphasised to his colleagues the need for the government to show that the increases in expenditure were prudent. He noted: 'in order to avoid a disastrous loss of confidence, I must show in my Budget how the extra expenditure, and the effects on demand of all these additional commitments, are going to be met by increased taxation' (TNA CAB 129/175, C (74) 2, 12 March 1974). The Budget was therefore clearly planned with the implications for foreign confidence in sterling at the forefront of the agenda, and an awareness that a 'giveaway Budget', justified by the government's commitments under the Social Contract and its parliamentary vulnerability, would be damaging. As such, the Budget judgement was focussed on the current economic situation, the balance of payments position, foreign confidence, and the demand effects of fiscal changes.

The CPRS' view of broader macro-economic strategy however, was not encouraging. It noted that the four major objectives of the government were the redistribution of wealth, the stimulation of industrial production, the correction of the balance of payments and the control of inflation, but that in the context the government found itself, they were objectives 'which may or may not be compatible'

(TNA CAB 130/726, Misc 9 (74) 2, 12 March 1974). The CPRS was also clear on where it believed the compromise should fall. It suggested that the government should prioritise quick action to prevent any further worsening of the balance of payments situation, secure an improvement in company liquidity, and pursue social expenditure to prevent the worst off in society from suffering disproportionately the effects of the current crisis (ibid). On the public expenditure front more generally however, the CPRS noted that the government's tax yield was likely to be insufficient to meet the manifesto commitments to increasing pensions and child cash allowances, and that as a result, it would be necessary to question 'how quickly can or should other Manifesto proposals involving higher expenditure be implemented.' It noted starkly that, 'there is very little money in the till and inadequate scope for filling it up' (ibid). Just two weeks into its office therefore, Wilson's government was being advised by its civil servants that the conflicting demands of economic policy would require it to retreat from its pledges in order to prioritise the correction of the external accounts and the maintenance of foreign confidence.

On 15 March, it was noted that whilst under other circumstances, an unemployment figure of 600,000 would point to the need for a slightly reflationary Budget, this would not be appropriate given the broader picture of the state of affairs. Berrill noted that in the event of a reflationary Budget, 'the rest of the world would be bound to ask how we were proposing to tackle the balance of payments problem [and] the implications for confidence would be serious' (TNA T 171/1053, Note of a Meeting, 15 March 1974). It was argued that a Budget that took a modest amount

out of demand would not be objectionable on these grounds, and allowed the government leeway to undertake reflationary action later in the year if conditions had improved (ibid). By the middle of the month, a weight of official opinion favoured a Budget that would take about £200 million out of demand annually (ibid), and despite the Treasury's belief overseas finance could always be mobilised in the event of need, could be justified in terms of the Steering Committee on Economic Strategy's (SCE) judgement of the following week, that 'the short-term policy of borrowing to meet the deficit could not easily be extended into the medium-term' (TNA CAB 134/3838, SCE (74) 2nd Meeting, 22 March 1974).

On the basis of these judgements, the Budget on 26 March included a 3 per cent increase in the basic and higher rates of income tax; increases in personal and child tax allowances; a £500 million commitment to additional food subsidies; the fixing of corporation tax at 52 per cent, £50 million of defence cuts, and the extension of VAT at a rate of 10 per cent to confectionary and petroleum (see Hansard, 26 March 1974, cols. 277-328). The TUC responded to the Budget with moderate approval, and at a meeting with government ministers on 27 March it was noted that 'there was approval of what the Government had already done, and an understanding that the Government was going in the right direction' (Modern Records Centre [MRC] MSS.292D/560.1/10, Econ Ctee 10/1, 27 March 1974). This view was also shared by leading financiers in New York City, who expressed their pleasure at the measures to the British ambassador, Sir Peter Ramsbotham, who reported that he had found amongst them that 'there was a general disposition to give HMG credit for a well judged Budget in difficult circumstances' (TNA T 354/174, Ramsbotham to

Callaghan, 3 April 1974). This was no doubt because the Budget implied that Britain would be giving greater priority the balance of payments deficit.

Interestingly, Sir Douglas Wass' appraisal of the March Budget focuses less on the indications it gave about the general direction of policy relative to the government's commitments in the Social Contract or its need to finance and correct the balance of payments deficit, than it does on the indication it had for the way in which policy would be made under the new administration. He notes (2008, 45) that the Budget 'was prepared in accordance with the usual conventions, that is to say that it was carried out within the Treasury and collective discussion was confined to the usual Cabinet meeting on the eve of Budget Day', but that it had become 'evident that in future decisions on economic policy would generally be taken more collectively than had conventionally been the case' (ibid, 45). However, he acknowledges that there is little documentary evidence to support this assertion, beyond the extensive use of the Ministerial Committee on Economic strategy later in the period (ibid, 45), and his statements on the subject appear to reflect his concern with demonstrating the technical and administrative responsibilities of various government agencies, rather than an attempt to engage in substantive issues about the direction of policy.

The balance of payments

Subsequent to the Budget announcement, the balance of payments problem posed two questions for Treasury officials and government ministers. The first was how the deficit was to be financed, and the second concerned the appropriate pace of

adjustment. Whilst there was no uniformity of opinion on the issue, a review of economic policy decisions demonstrates that policies were frequently geared to balance of payments priorities at the expense of social objectives during Wilson's short parliament. These priorities emerged from the generally accepted answer to the first question, which was that the deficit would be bridged by overseas borrowing in the short-run, and a transfer of resources in the medium to long-run. This, in turn, was dependent on the maintenance of credibility and confidence amongst foreign lenders, however, in choosing to prioritise the balance of payments, the credibility constraint was, for all intents and purposes, self-imposed. The extent to which these priorities had implications for the wider population was dependent on the more widely debated answer to the second question, because this carried with it more direct consequences for the rate of increase in public expenditure, and whilst political decisions were eventually moderate, official opinion strongly favoured a more aggressive approach.

The reason that it was widely accepted that short-term borrowing was the preferred method of balance of payments adjustment despite the ever-present possibility of a collapse in confidence that could de-rail this strategy is straightforward. As one official noted, confidence could be treated as a long-run consideration because 'although there is no lender of last resort in a formal sense, ways would inevitably be found to mobilise sufficient resources for last resort lending in the event of need' (TNA T 354/347, Walker to Hedley-Miller, 17 May 1974). The strategy was also agreed upon at a time when European banks were lending freely, so the prospect of Britain's borrowing opportunities being suddenly curtailed was not considered a

matter for immediate concern either by the Treasury or the Bank of England (ibid). This confidence was no doubt bolstered by Witteveen's assurance earlier in the year that IMF financing would be available if Britain could demonstrate it was addressing the balance of payments problem, and in this respect the borrowing strategy would be commensurate with Britain's broader economic objectives even in the event that the issue of confidence required policy changes.

Wass (2008, 52) notes that the commitment to using short-term finance in order to finance the balance of payments throughout 1974 through 'tapping up' credit from Iran and Saudi Arabia, along with the increase in the sterling balances held by the OPEC countries, was effective in so far as these funds were 'more than sufficient to provide the UK with the finance it needed that year', and that as such, 'the Treasury and the Bank could congratulate themselves on having so successfully dealt with a potentially difficult problem' (ibid, 52). However, he also acknowledges that this strategy 'did give a very large hostage to fortune as the Treasury and the Bank were to discover in the course of 1975 and 1976' (ibid, 52) as the short-term credit it had secured 'became the single most volatile element in the whole scene when the exchange value of sterling came to be questioned' (ibid, 52). This however, is a curious assessment, because it implies that neither the Treasury nor the Bank had immediately recognised the extent to which the extensive use of short-term funds for balance of payments financing would add to sterling's vulnerability in the future. Given the expertise in these institutions, this seems implausible, and once again Wass' analysis appears as an attempt to defend the actions of the Treasury lest they

be interpreted as fundamental errors or strategic attempts to justify the introduction of policies that ran counter to the government's electoral mandate.

Despite the confidence in the availability of necessary finance to meet Britain's needs in the short and medium-term however, the prospect of borrowing from the Fund was again on the agenda by April 1974. The annual Article VIII consultation[2] was due to begin in May, and Healey was advised by Treasury officials that this would be the opportune moment to begin negotiations for a standby if he felt this was necessary (TNA T 354/223, Fogarty to Mitchell, 8 April 1974). The official view was that such a course was not, on balance, necessary, but it was nevertheless noted that an approach to the Fund in 1975 'might well be found a desirable course' (ibid). This borrowing strategy lends itself to the inference that there was substantial weight of opinion in favour of pursuing policy concordant with that suggested by the Fund prior to the emergence of any obvious need, in spite of the implications this had for the rate of increase in public expenditure and private consumption. This view is supported by the early rejection of generalised import restrictions as an appropriate mechanism to be used for the purposes of balance of payments correction, with the Treasury noting in March that the United States should be advised that 'the UK very much wants to avoid direct restrictions on imports' (TNA T 354/174, Fogarty to France, 26 March 1974), and Cabinet conclusions of 26 July

[2] Wass (2008, 63) notes that the assessment reached by the Fund during the consultation was 'surprisingly mild', showing a concern about policy, or the lack of it, for counter-inflation, and DCE, which he describes as 'a routine hobby-horse of the Fund'.

recording that the Chancellor was committed to a solution 'within the framework of a mixed economy, with a suitable blend of greater industrial efficiency and social idealism' (TNA CAB 128/55, CC (74) 29th Conclusions, 26 July 1974).

The short and medium-term balance of payments strategy clearly had at its base, therefore, the explicit acceptance that it would be necessary to sustain international confidence, and to reduce the public sector's claim on resources in order to improve the export position. Deciding on the pace of adjustment however, was a less clear-cut affair, and international and domestic opinions had parallel bearing on policy. In principle, prevailing international opinion favoured 'burden-sharing' in order to avoid a return to the kind of beggar-thy-neighbour policies that had proved problematic in the interwar period. The emphasis on the pace of balance of payments adjustment fell on the side of caution because of the potential consequences of one nation unilaterally trying to improve its position at the expense of others. However, in practice, as Healey recalls, despite his own best efforts to avoid burden shifting, it nevertheless came to pass as 'Britain and Italy were alone in following the advice of the international institutions and in fulfilling their promises made earlier to the IMF' (Healey, 2006, 393).

Despite calls for international good will on this issue, and Healey's willingness to exercise it, official opinion in the UK did not accept that a modest pace of adjustment was appropriate for Britain, and the Treasury prepared two scenarios in June 1974. The question under consideration was whether the UK should aim to 'give the highest practicable priority to the growth of exports and to the closing of

the external deficit; or whether we should take a more leisurely path, insofar as our creditors will allow us, and rely more heavily on the flow of North Sea Oil to restore the balance of payments to equilibrium' (TNA T 364/16, Wass to France, 15 June 1974). Case I, the more leisurely of the proposals, aimed to achieve balance on the non-oil portion of the deficit by 1979, and predicted that by this time Britain would have accumulated some £17 billion of external debt based on a transfer of £100 million per annum into the balance of payments. Case II, the more aggressive stance, argued for a more rapid adjustment, which would achieve balance in the non-oil deficit by 1978. If this path were taken, it was estimated that Britain would have accumulated only £11 billion of external debt based on a transfer of £400 million per annum into the balance of payments (ibid).

The case for the more leisurely approach rested largely on the fact that the more aggressive stance would have domestic political consequences because of the degree of austerity that an annual £400 million transfer of resources into the balance of payments would impose. The attempt to eradicate the balance of payments deficit too quickly would also add to world deflationary pressures and could therefore be self-defeating, especially as the prospects for North Sea Oil production were widely known to be very good, and could therefore provide collateral to make borrowing a comfortable prospect in the short-run (ibid). On the other hand, Case II was supported because officials believed 'we simply cannot assume that foreign credit to the tune of circa £17 billion will be available to us over the next 5 years [because] there is a grave risk that the UK's creditworthiness will come under suspicion' (ibid). Furthermore, if Britain did adopt this strategy and found itself burdened with

£17 billion of debt in 1980, the interest payments alone would take up nearly half of the revenues of North Sea Oil (ibid).

The Treasury therefore believed that whilst the aggressive approach risked precipitating austerity and provoking domestic dissatisfaction, there was a danger that making any slower progress would damage Britain's ability to borrow and make holders of sterling balances uneasy about the currency's future prospects. A sharp decline in the rate that such a scenario would bring about would require even more drastic domestic deflation to shore up confidence, creating in the process 'domestic unrest, galloping inflation and heavy unemployment' (ibid). As such, the Treasury position noted that prudence demanded the government to 'lean on the side of severity' (ibid), despite the recognition that the political consequences of austerity may be problematic if the government was unable to explain and justify such a course of action to the electorate in terms it would accept.

The Bank of England's view on this issue was also located at the severe end of the spectrum, even more so than the Treasury's recommendation. Governor of the Bank, Gordon Richardson, advocated 'aiming for *at least* as rapid a rate of progress with the balance of payments [as suggested by Case II]' (TNA T 364/16, Richardson to Wass, 18 June 1974, original emphasis). His view was that the Treasury's forecasts in terms of trade, the price of oil, and interest rates, may all prove to be optimistic and that in a worst case scenario, the balance of payments would actually end up in a worse position in 1977 than it was in 1974. He suggested that Britain would face accumulated debt, not of £17 billion as the Treasury predicted, but of £25

billion. This would take up three quarters of the revenues of North Sea Oil in interest repayments, not half as the Treasury believed (ibid). Whilst the Bank accepted the view that the £400 million annual rate of transfer into the balance of payments may be the limit of what was politically acceptable, it argued that under no circumstances should the government aim for less (ibid).

When the pace of adjustment was discussed with the Chancellor towards the end of June, Healey informed his officials that of the two options, he preferred the more conservative approach because it would be less likely to involve domestic costs in the short-term (TNA T 364/16, Note of a Meeting, 21 June 1974). Nevertheless, despite this initial conservatism on Healey's part, at Cabinet on 26 July he informed his colleagues that whilst the economy was predicted to grow by about £2,000 million per year, '£400 million would need to be devoted to increasing the rate at which the balance of payments deficit was being reduced' (TNA CAB 128/55, CC (74) 29th Conclusions, 26 July 1974). This, he warned, would leave room for only a 2.75 per cent increase in public expenditure, which, if accepted, would mean that 'any increase in one programme must come from reductions in other programmes or the contingency reserve' (ibid).

Counter-inflation and the July 'mini-Budget'

Whilst the government had been able to deliver a moderate Budget and agree that it was necessary to divert resources into the balance of payments relatively quickly on confidence grounds without provoking unmanageable discontent from the unions,

the aversion to incomes policy meant that counter-inflation strategy posed more of a problem from the point of view of its credibility, and was limited to price control, which had the disadvantage of providing disincentives to investment for industries. This was because of the operation of the 'Productivity Deduction' in the Price Code, which allowed firms to pass on only 50 per cent of increased wage costs to the consumer. This was inherently problematic in so far as the long-run balance of payments position was linked to the performance of British industry, which required a significant amount of investment if it was to become internationally competitive, and which government policy was actively discouraging through the Price Code.

The Price Code was kept under review by the Official Committee on Price Control (PCO), which had concluded by early August that whilst the Code had held down the RPI as a whole by approximately 2 per cent, and the prices of goods and services covered by the Code directly by 4 per cent, 'the effect had been achieved primarily by depressing industry's profits by approximately 8 per cent, although maybe more' (TNA CAB 134/3814, PCO (74) 5th Meeting, 12 August 1974). The extensive costs in relation to modest benefits therefore showed the impact of the Price Code to be disproportionate, and leant themselves to stark and straightforward conclusions, with the Committee noting that 'it was common ground that in the present circumstances the Code was too severe [and] the bad effects on investment and industrial confidence were not wholly compensated for by the good effect on prices' (ibid). Within the Department of Industry, one official, Peter Carey, advocated the outright abolition of the Price Code in a note to the new Permanent Secretary to the Treasury, Sir Douglas Wass. He wrote that the Price Code had 'done relatively little to restrain

inflation; it has caused, and is continuing to cause, a good deal of harm to industry; and it is increasingly irrelevant in light of the short-term economic outlook' (TNA CAB 134/3814, Carey to Wass, 29 August 1974). He went on to note that 'the continuation of the Code for *any* further period is likely to do more harm than good, whatever modifications may be introduced' (ibid, original emphasis). Whilst this position was rejected by the Treasury on political grounds (see TNA CAB 134/3814, Wass to Carey, 5 September 1974), it was a shared view that the Price Code was a contradictory instrument in need of reform.

The Bank of England's view was that the operation of the Price Code was placing undue pressure on firms' liquidity positions, and it was noted that 'the crux of the problem is the low level of profits which companies are able to retain [and] that some immediate relief from price and profit control is essential' (TNA T 233/2778, Bank of England Paper, 5 September 1974). The CPRS took a similar position, arguing that price control, in combination with other pressures on company liquidity like the Advanced Corporation Tax Surcharge and social security payments, had caused profits to fall by 30 per cent between the fourth quarter of 1973 and the first quarter of 1974 (TNA T 233/2778, CPRS Staff Paper, 19 September 1974). As such, it estimated that British industry would be required to borrow in the region of £2.7 billion to cover capital requirements even to sustain existing levels of production, and would be reluctant to do so given the uncertainty of future prospects (ibid). It believed that continuing on the present course of prices policies would mean that companies would be forced to self-correct by 'reducing their cash requirements by taking measures such as laying off labour, cutting back on

investment plans, reducing R & D and maintenance, providing less support for export activities and reducing stocks' (ibid). On this basis, the CPRS recommended that price control should be immediately relaxed, accompanied by reductions in Corporation Tax and the abandonment of the Advanced Corporation Tax Surcharge, and the encouragement of Banks to lend to British industry on terms that it could afford (ibid).

The Price Code therefore, whilst politically popular and in accord with the Social Contract, was widely felt to be economically damaging, reflecting the contradiction between the wishes of the electorate and the needs of the economy, especially in a context where wage claims continued unabated – one account placing the rate of increase at 30 per cent (Tomlinson, 1990, 301), and another arguing that, as a strategy against inflation, the Social Contract was 'clearly worthless' (Morgan, 2001, 377). These views accurately reflect opinions from within the civil service, as by the end of June the Official Committee on Pay Negotiations had been informed that the Pay Board had received reports of infringement rates on wage guidelines of 20 per cent (TNA CAB 134/3809, PA (74) 9th Meeting, 20 June 1974), which was especially problematic in light of the fact that this had occurred despite the TUC's statement on collective bargaining in the year ahead, which had emphasised the fact that there was little room in the economy for increasing personal consumption, and that a period of twelve-months should be allowed to pass before pay deals should be re-negotiated (see TNA CAB 129/177, C (74) 59, 18 June 1974).

This made the credibility of counter-inflation policy problematic, because it demonstrated the fact that ministers could not be sure that the TUC would be able to ensure the exercise of restraint in wage claims even if it had wanted to. However, the problem of incomes was not just down to the unilateral action of the unions. The rate of increase in incomes was also added to by the Labour government's decision to honour 'threshold agreements'. Sawyer (1991, 176) notes that stage III of Heath's incomes policy allowed wages to rise by £2.25 per week, or 7 per cent, up to a maximum of £350 per annum, with an additional 'threshold payment' for every 1 per cent rise in the RPI above 7 per cent on the October 1973 index, and as Barbara Castle (1980, 114) noted, this clearly meant that 'every rise in retail prices above the threshold brought an automatic wage increase.'

This was significant because the automaticity of the system removed the time lag between increases in prices and increases in wages, directly fuelling inflationary pressures and doing nothing to remove inflationary expectations from the economy (Ormerod, 1991, 58). In combination therefore, the tendency for wage settlements to exceed TUC guidelines despite calls for voluntary wage restraint, and the increases in wages granted when thresholds were triggered – no fewer than eleven times before the agreement expired (ibid, 58) – shows that government policy was actually contributing to the inflationary problem on the incomes side. This, no doubt, played a significant role in the Labour Party coming to be so closely associated with inflation (ibid, 59-60), and in combination with the Price Code, the government was clearly operating a set of policies that were not only ineffective, but they also were counter-intuitive when considered in the context of the broader economic goals,

notably the restoration of the balance of payments to equilibrium and the maintenance of overseas confidence. As such, they provoked considerable weight of opinion in favour of retreating from the Social Contract commitments on price control in order to increase incentives. However, the government's electoral weakness meant that concessions would have to be made to ensure a renewed governing mandate.

Barnett (1982, 31) recalls, 'the 22 July statement was made in the expectation of an autumn General Election', and Dell (1991, 76) notes that preparation for the measures began because 'as the summer of 1974 wore on Denis Healey became increasingly optimistic about the British economy.' These expectations had been bolstered by his visit to Washington D. C. in June, where 'he had found that confidence in the British economy was far greater abroad than it was at home' (ibid, 76), and on this basis, he informed Cabinet on 8 July that some kind of Budget package would be introduced later in the month (ibid, 78).

Preparation for the measures had, however, begun earlier. Various packages had been discussed at the Official Budget Committee meeting on 5 July, and after discussion about the conflict between the requirements of Britain's external and domestic objectives, Sir Douglas Wass presented three packages. He said that the measures could either be in the form of a large package aimed primarily at reducing prices; could take no net action, or; could take the form of a small package to give some incentives to industry, take some action on prices, and carry a smaller risk of causing a break in confidence' (TNA T 171/1095, BC (O) (74) 4th Meeting, 5 July

1974). It was the shared view of the committee that none of the strategies were risk free. The main disadvantage of a larger package would be the impact on overseas opinion, although it was felt that this could be 'mitigated if the Government were able to demonstrate that it had obtained a genuine *quid pro quo* from the TUC' (ibid). A smaller package, on the other hand, carried the risk of becoming 'a rag-bag of items with no discernable underlying strategy' which, if not received well at home, could have an even bigger negative impact on overseas confidence than the larger package (ibid).

Despite the broad acceptance of the risks involved in introducing a package at this stage, there was no consensus as to what form it should take, and 'there was substantial support for the view that, on balance, it would be better to wait until the autumn before taking steps to reflate demand' (TNA T 171/1092, BC (O) (74) 18, 8 July 1974). Nevertheless, the Treasury put forward two possible packages for consideration. Package 'A' proposed to cut the rate of VAT by half, increasing demand by £936 million and cutting the RPI by 2.5 per cent directly. It also included support for rate payers through the Rate Support Grant (RSG) at a cost of £100 million, and doubling the Regional Employment Premium (REP), also at a cost of £100 million, but creating 20,000 new jobs in the regions in the process (TNA T 171/1151, Airey to Wass, 9 July 1974). The major objections to this package were the need for substantial legislation to cut the rate of VAT by 5 per cent, and the risks involved, which were two-fold. Firstly, it would fail if 'overseas opinion interpreted it as simply another politically motivated premature reflation by the UK'; and secondly, it would fail 'if it became apparent that the pay-off, in terms of reduced

wages pressure by the unions, was not going to materialise' (ibid). Package 'B' in contrast, aimed to provide a demand stimulus be relieving the financial position of firms by reducing employers' National Insurance contributions. It also proposed to quadruple the REP at a cost of £360 million a year, creating 60,000 new jobs (ibid). The argument against this package was the risk that the element relating to National Insurance contributions would create pressure for employees' contributions to be similarly reduced, which would add further inflationary fuel. Like the first package, it would also require substantial legislation for it to be enacted (ibid).

The Treasury and the Bank of England both expressed concern about the growing size of the package as the date of its announcement approached (Dell, 1991, 79), and the Downing Street Policy Advisor, Bernard Donoughue, also recorded doubts about what the government was trying to achieve. In his diaries he notes:

> I argued that we needed an attack on price inflation rather than public expenditure to counter unemployment. [Wilson] said he hoped for a mixture of both […] I'm not sure you can have everything in the package and keep sterling safe, but he was very clear where we stood (Donoughue, 2005, 163).

The Bank of England likewise noted that 'the need for great caution springs from the danger of weakening confidence in sterling [and] the argument is therefore for postponement of large-scale action for the moment' (TNA T 171/1152, Bank of England Paper, 17 July 1974), and the following day Wass noted his agreement with the Bank's assessment (TNA T 171/1152, Wass to France, 18 July 1974).

Despite these warnings however, Healey announced a package that reduced VAT by 2 per cent, included relief for rate payers, doubled the REP, and gave £50 million of uncommitted funds for increased food subsidies (Hansard, 22 July 1974, cols. 1048-60). Dell (1991, 80) notes that the effects of this package would be to 'add under £200 million to demand by the end of 1974 and "a relatively small amount", some £340 million to the PSBR', and on reflection, Joel Barnett (1982, 32) notes of the July package that, 'all in all, there can be little doubt that we planned for too high a level of public expenditure in the expectation of levels of growth that, in the event, never materialised.' The July mini-Budget measures therefore seem to display convincing evidence that the government's economic strategy remained focussed on delivery of its commitments made under the Social Contract. However, this judgement must be qualified by the context; the government was facing an autumn general election to confirm its mandate, and providing concessions to the electorate in this form was embarked upon despite advice to the contrary from officials in the civil service.

Conclusions

The contradictions between the government's commitments under the Social Contract and the needs of the wider economy therefore clearly presented difficulties that resulted in a number of compromises, which displayed the weakness of the PLP leadership's commitment to the principles of the Social Contract in practice. The March Budget was broadly neutral, and reflected a clear recognition of officials and ministers alike that the balance of payments represented a prior claim on resources to

current expenditure, which was confirmed in discussions during the middle of the year about the external financing strategy, when it was widely agreed that it was necessary to act decisively in order to restore the balance of payments to equilibrium because the levels of borrowing otherwise required would be unsustainable. The government was also operating a counter-inflation policy contradictory to these aims, both because it was failing to have an impact on the incomes side, and because the Price Code removed incentives to investment, and as a result it was widely felt that the Price Code was in need of substantial reform or abolition. Only in the preparation of the July 'mini-Budget' does the evidence suggest any political conviction to deliver on the Social Contract, and this occurred in the context of an upcoming election and despite strong civil service opposition.

Worryingly from the government's perspective, the measures it had taken elicited only weak responses from the TUC, such as reminders that the pay settlements of other unions should not be used as a lever in negotiations (see MRC MSS.292D/560.1/10, Econ Ctee, 10, 10 April 1974). However, the TUC continued to emphasise the 'need to reverse cuts and indeed increase public expenditure […] with the aim of solving both acute social problems and using resources at present lying idle' (MRC MSS.292D/560.1/10, Econ Ctee 15/2, 16 July 1974), without providing any indication it was able to deliver on wage restraint. In combination with concerns about the confidence implications a committed government response to the TUC's demands would have, this meant that neither the government nor officials were able to form or pursue a decisive economic strategy. With a renewed mandate secured in October however, it was possible to change this approach, with

preference falling firmly in favour of the balance of payments and foreign confidence ahead of the Social Contract.

Chapter V

The status of sterling and the decisive re-orientation of economic strategy, October 1974 – June 1975

In the previous chapter it was shown that there was an inherent conflict between the Labour government's commitments to redistribution under the Social Contract, which had been affirmed in its general election manifestos, and Britain's external economic position. It also showed that whilst the March Budget had made some concessions to the social wage, it was moderate and provoked only lukewarm approval from the trade unions. In many respects, it underscored the views that emerged strongly later in the year that the balance of payments represented a prior claim on resources to social expenditure on the grounds that Britain would not be able to continue borrowing indefinitely to finance its external deficit. There were also problems with regards to the distortion of incentives caused by the operation of the Price Code, and the inadequacy of TUC guidelines in order to produce wage restraint, which was causing officials concern. However, as a result of the Labour government's weak electoral position, it was nevertheless required that concessions had to be made to social expenditure despite official opposition.

This chapter shows how this compromise approach changed decisively after the October 1974 general election, with officials strongly advocating fiscal restraint and direct intervention in the wage determination process. It begins by reviewing the historical legacy of sterling's role as a reserve currency and the impact of the OPEC

price increases in order to show how the pound's vulnerability to speculation had played a key role in influencing Treasury opinions about what constituted sustainability in domestic economic policy. It then reviews the Treasury's arguments for a decisive re-orientation of economic strategy that would prioritise the competitiveness of British industry and the correction of the balance of payments ahead of social objectives, before showing how this re-orientation was reflected in the April Budget package.

The sterling balances

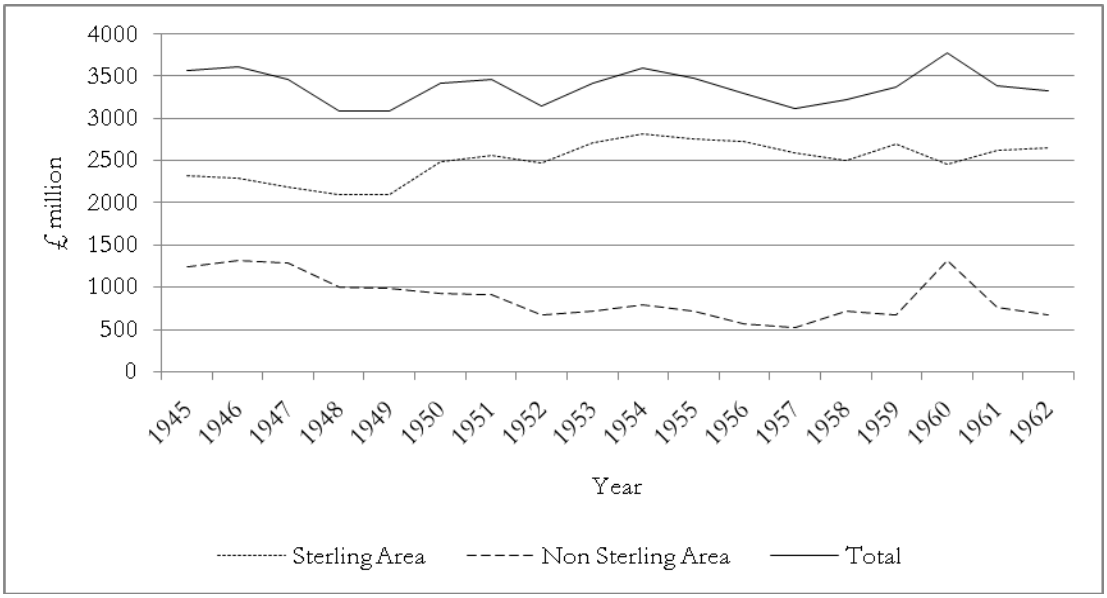
The sterling balances had long been a problem for British policy makers because they made Britain's foreign reserve position vulnerable when confidence in the pound waned and money flowed out of sterling. In a worst-case scenario, the diversification of sterling holdings could quickly cause a run on the pound that official reserves would not be sufficient to reverse. This would call into question the value of the pound as a store of value and as a medium of exchange, and the Treasury's historical section noted that 'the "problem" of the sterling balances is one that constantly confronts the Treasury' (TNA T 267/29, Historical Memorandum No. 16, January 1972).

The origin of the balances had deep historical roots, dating from the operation of the trade and payments system in the nineteenth century, when the majority of trading nations used sterling as the currency of settlement for their international transactions. However, the 1940s saw further accumulations as 'the dedication of the UK

economy to the single purpose of winning the War distorted beyond recognition the normal channels of trade' (ibid). These wartime distortions had a profound impact on the pattern of Britain's imports and exports as it remained necessary to import essential goods and services for the war effort whilst domestic production was geared almost exclusively to the same end, meaning:

> Those who exported to us were unable to use the sterling so acquired on the purchase of imports from us [so] unless that sterling could be used for the redemption of debt or purchases of goods and services from other countries of the sterling area, it could not be used at all (ibid).

Figure V.1, Sterling Balances 1945-62



Source: TNA T 267/29, Treasury Historical Memorandum No. 16, January 1972

The postwar period saw some of these balances run-down in an orderly fashion, however this occurred simultaneously with increases in balances elsewhere. As Figure V.1 shows, whilst the level of the balances held by the non-sterling area decreased between 1945 and 1962, there was a gradual increase of sterling area

balances, which contributed to producing a relative consistency in the total level of balances despite periodic peaks and troughs. In practice, this meant that for as long as Britain was unable to find an orderly way to run-down the balances, the pound would remain sensitive to fluctuations in the foreign exchange markets. As a result the Treasury had historically displayed a great deal of sensitivity to the effects that declining confidence in British macro-economic strategy could have on the value of sterling and therefore the level of foreign reserves. The importance of this became especially apparent in light of the establishment of the IMF to 'assist in the establishment of a multilateral system of payments in respect of current transactions between members and the elimination of foreign exchange restrictions which hamper the growth of world trade' (de Vries, 1985a, 14), because this meant that pressure would mount on the UK to introduce full convertibility.

As Burnham (1992, 245) notes, the sterling balances, 'when taken in conjunction with general convertibility posed a serious threat to Britain's foreign currency holdings', which had to be faced almost immediately after the abrupt end of the lend-lease programme and the United States' insistence that Britain make commitments to dismantling the system of imperial preferences. As Lairson and Skidmore (2003, 81) note, after successfully negotiating a $3.75 billion loan from the United States, Britain 'grudgingly gave verbal assurances and, as a first step in 1947, moved to make the pound fully convertible', however, in the context of a slide in Britain's gold and dollar reserves that had begun in 1946, convertibility forced Britain 'to use most of the $3.75 billion loan to support the pound' (ibid, 81), and abruptly brought the period of convertibility to an end.

Whilst the 1947 episode is historically remote to the events of the 1970s, it is illustrative of the practical difficulties that the Treasury had faced in attempting to maintain confidence in the pound arising because of the scale of the sterling balances. The result was to force the Treasury to examine schemes designed to stabilise the balances, which had included the possibility of negotiating voluntary blocking of the balances, agreed rates of run-down, and international safety nets (TNA T 267/29, Historical Memorandum, No. 16, January 1972). However, despite these attempts to remove the vulnerability of Britain's foreign reserves caused by the balances, by 1965 they were still extensive and the search for a mechanism to stabilise them remained important, especially as the election of the Labour government in 1964 was enough by itself to intensify market concerns about the value of the pound (Tomlinson, 1990, 241). The solution proposed by the Treasury was the result of extensive contingency planning examining the possibility of offering a guaranteed value to holders of sterling, negotiated at Basle in 1968.

The possibility of offering a guarantee to holders of sterling in order to prevent diversification in the event that Britain was forced to devalue began in earnest in the mid-1960s, and addressed three principal questions. In 1965, these were whether Britain should offer guarantees:

1. To holders of sterling in order to prevent diversification which may force a devaluation;
2. To holders of sterling to discourage diversification provoked by the belief that sterling was no longer a good reserve asset after devaluation, and;

3. To compensate holders of sterling for the loss in the dollar value of their reserves after devaluation (TNA T 267/33, Historical Memorandum, Number 19, June 1972).

The conclusion however, was that guarantees would not be credible if they were introduced before a sterling devaluation on the grounds that they may represent a commitment that Britain would be unable to honour, and that in a post-devaluation context, they may provoke suspicion that a further devaluation of sterling was inevitable (ibid). As such, the prospect of a sterling guarantee was shelved on the grounds of impracticality, and it remained the view in 1966-67 that the offer of a guarantee before devaluation would not be credible, and could be 'acutely embarrassing in the future, particularly if there were ever to be a round of competitive devaluations or if sterling were forced to float' (ibid). Whilst the Chancellor 'was inclined […] to offer guarantees after devaluation provided that the offer was coupled with a stipulation that the general problem of the sterling balances must be dealt with' (ibid), it was ultimately decided that finding a way of offering a guarantee that was both credible and limited Britain's exposure to movements in the balances remained an insurmountable problem.

The devaluation of November 1967 however, substantially altered this view by precipitating unrest amongst the overseas sterling area countries, which had begun to diversify their reserve positions in order to avoid future losses in the event of a further downward adjustment in the rate (Strange, 1971, 75). In negotiating a sterling guarantee therefore, the Treasury had a straightforward negotiating brief. In exchange for the offer of a guarantee, Britain 'wanted undertakings not to diversify

to any significant further extent (TNA T 267/33, Historical Memorandum No. 19, June 1972). These undertakings were to be related to five specific objectives of British policy, which were:

1. To obtain undertakings from countries that it would hold a minimum percentage proportion of its total external reserves in sterling that was not lower than the percentage as of June 1968;
2. To obtain undertakings that the promised dollar guarantee would exclude sterling holdings above 20 per cent of total official external reserves;
3. To persuade countries a charge should be levied for the guarantee;
4. For the undertakings to be valid for seven years, and subject to review at any time by mutual consent, and;
5. To obtain assurances that fifteen countries would make deposits of foreign currencies with the BIS totalling around $2,200 million (ibid).

The achievement of these objectives was a difficult task, however the agreements reached at Basle were sufficient for Britain to secure the funds it needed in order to help reverse the trend towards diversification in the medium-term whilst leaving the long-term problem of the sterling balances unresolved (ibid).

Tomlinson (1990, 243) has written that the Basle agreements contributed to the stabilisation of the sterling balances, and that in combination with the breakdown of the Bretton Woods system in the early 1970s, Britain was able for the first time to 'regard the value of sterling as entirely secondary to domestic economic objectives.' In actual fact, the sterling guarantees did not act as a vehicle for the orderly run-down of the balances or the phasing out of sterling's role as a reserve currency, and

actually contributed to Britain's vulnerability to confidence factors by contributing to a rise in the balances between September 1968 and September 1971 (see Zis, 1991, 109). The Treasury history of the Basle discussions also reflects this view, noting that despite the guarantees, 'balances increased by some £800 million in the ensuing two years', which was problematic because 'some day someone will want to draw them down again' (TNA T 267/33, Historical Memorandum Number 19, June 1972, 95). However, this view was not reflected in the Bank of England's official press release on the six month extension of the guarantees beyond their expiration date of 24 September 1973, in which it was noted that the guarantees 'have provided a valuable element of stability in the international monetary scene and Her Majesty's Government considers it to be in the interest of all that this stabilising element be continued for a further period' (Bank of England [BE] 3A 38/4, Sterling Agreements – Press Statement, 6 September 1973). Whilst in private it was noted that the agreements were not inherently desirable (see BE 3A 38/4, St. Clair to Walker, 13 March 1974), they were again extended in March 1974 (see BE 3A 38/4, Official Sterling Balances – Press Notice, 15 March 1974), and it was not until the November 1974 Budget that they were discontinued despite the clear recognition that the size of the balances increased the sensitivity of British policy to confidence factors, and the fact that guarantees had served only to exacerbate the problem.

Sterling's status as a reserve currency had therefore posed problems for the Treasury for nearly thirty years, and attempts to resolve it through the creation of multi-lateral facilities such as that at Basle in 1968, had been treated with scepticism for some time, and were eventually proven to be ineffective. In light of this, the confidence

issue was one that clearly resonated with officials as they attempted to keep the balances stable, however it was also something that became increasingly difficult in light of the large-scale disequilibrium in international payments that resulted from the OPEC price increases of the early 1970s.

The impact of OPEC price increases

The OPEC price increases of the early 1970s were the result of a number of factors. As de Vries (1985a, 307) notes, 'devaluations of the dollar in terms of gold in December 1971 and February 1973, followed by further depreciation of the dollar in terms of other major currencies after the introduction of floating rates in March 1973, reduced the receipts of oil exporting countries […] by as much as fifteen per cent.' This was coupled with hostilities in the Middle East in 1973, which prompted OPEC to impose an embargo on oil exports to the Netherlands and the United States to 'help induce the Government […] to temper their "pro-Israel policies"' (ibid, 306). The subsequent announcement that from 1 January 1974 the price for Saudi Arabian light crude would be doubled to $11.56 per barrel meant that the total increase in price between 6 October 1973 and 1 January 1974 was more than four times, and given the inelasticity of demand for petroleum products, 'a massive and startling disequilibrium in international payments was expected for 1974' (ibid, 308).

Skeet (1988, 58) notes that the OPEC price increases affected 'just about everybody in the world in one way or another', however for British policy makers, the difficulties were particularly acute. In light of sterling's dependence on the

maintenance of foreign confidence in its economic policies for stability, the failure of the Basle guarantee to reduce the pound's sensitivity to speculation by running down the balances, the disequilibrium in the British balance of payments caused by the OPEC increases, and the accumulation of large balances by oil exporters, meant that the issue of the credibility of domestic economic strategy became even more important, and ensured that Britain played a leading role in attempts to find a multilateral solution to correcting the imbalance.

In recognition of the risk that individual countries may revert to protectionist strategies in order to correct their current account deficits at the expense of others, the Committee of Twenty had issued a communiqué at its fifth meeting in Rome on 18 January 1973, emphasising the need for a cooperative response to the disequilibrium caused by the OPEC price increases. Members of the Committee:

> Agreed that in managing their international payments, countries must not adopt policies which would merely aggravate the problems of other countries. Accordingly, they stressed the importance of avoiding competitive depreciation and the escalation of restrictions on trade and payments. They further resolved to pursue policies that would sustain appropriate levels of economic activity and employment, whilst minimizing inflation (Committee of Twenty, 1973, 199).

The document went on to note that 'the Committee agreed that there should be the closest international cooperation and consultation in pursuit of these objectives' (ibid, 199), and as such, the concept of burden sharing became internationally accepted as part of a code of good practice.

The mere acceptance that the industrialised nations would, for a substantial period, legitimately find themselves with current account deficits did not, however, resolve the problem of how best to channel the surplus funds from oil producers to other nations, and this was an especially important question given the prevailing view that the 'prospective surpluses of oil exporters were beyond their capacity to absorb' (Harmon, 1997, 65). Strange (1997, 43) has argued that the decisions taken in response to the problems created by the OPEC price increases were of critical importance for international monetary relations. She notes that the United States rejected an early and substantial increase in the resources of the Fund because this 'seemed far too pro-Arab, too much like knuckling under to impudent newcomers', and suggests that the subsequent adoption of a hawkish posture towards OPEC effectively 'left governments wondering how to persuade the banks not to cut off too abruptly the supplies of credit' (ibid, 43). Cohen (1998, 127) notes that this represented the Americans foregoing an opportunity to 'exercise its influence over other actors through its control of access to dollar resources, either directly or through the decision making processes of the IMF.' As such, this represented an opportunity for Britain to be proactive in designing a system for recycling through official structures that would allow them access to funds relatively free from conditionality should they need to borrow to cover their deficits, and therefore insulate itself, in the short-run at least, from the sensitivities arising out of the size of the sterling balances and the pound's reserve role.

Britain's major role in securing such facilities was in successfully lobbying for the extension of the IMF's oil-facility into 1975. The first oil facility had been introduced in order to meet the inevitable financing requirements of net-importers of oil, especially the industrialising nations, on the initiative of the Fund's managing director, Johannes Witteveen. As de Vries (1985a, 314) notes, Witteveen had recognised that whilst emphasising the spirit of cooperation was desirable, it would not be enough to solve problems of the extent of those that faced the international economy. He also recognised that existing private financial arrangements would be insufficient to handle the task, at least in part because they 'would not ensure that the surplus funds of oil exporting nationals would find their way to the oil importing countries that needed them most' (ibid, 315). The oil facility was therefore proposed as a temporary bridging operation that would assist the adjustment of national economies.

The United States however, felt that a more appropriate solution would be to exert pressure on the oil exporting nations to make price reductions, and German officials were also reluctant to endorse the proposal for an oil facility (ibid, 315-7). In response however, Witteveen argued that without a recycling facility of some kind, 'the only alternative [for industrialising nations] was for them to curtail their imports and submit to corresponding hardships in the form of reduced economic growth, greater unemployment and even lower living standards' (ibid, 318), and on the back of these arguments, the Fund managed to negotiate agreement for a fund nominally open to all member nations with the exception of oil exporters and the United States,

and had secured funds amounting to SDR 1.8 billion from seven countries for the facility by August 1974 (ibid, 321).

British ministers and officials were strongly in favour of the extension of the oil facility. As Harold Lever noted in June 1974, there was little prospect of oil prices falling because of weakness in the OPEC cartel as the United States believed, and as such it was his view that the UK should attempt to bring the OPEC nations collectively to an understanding that they shared a mutual interest in stability with oil importers (TNA T 354/571, Lever to Wilson, 10 June 1974). Derek Mitchell was also concerned about the prospects for stability in the absence of a recycling mechanism, and whilst he acknowledged that the risk of a collapse in the Euro-currency markets was small, it was nevertheless the case that a point would be reached when 'the intermediation capacity of the Euro-banks was substantially reduced [and] there is accordingly a clear need to consider how to manage the switch over from short-term banking finance to longer-term forms of financing' (TNA T 354/571, Mitchell to France, 19 June 1974). He therefore concluded: 'either new machinery will be needed, or existing machinery will need to be adapted to the new situation' (ibid).

There was growing acceptance of this view in international circles by September 1974, as the situation in which oil exporters were lending to commercial banks on a short-term basis whilst the banks lent to oil importers on a medium to long-term basis, began to endanger the liquidity position of commercial banking enterprises. In light of the failure of the German Herstatt Bank in June 1974, the position was seen

as highly unsatisfactory, and Witteveen once again 'stressed the need for increasing official recycling of funds from oil exporters to oil importers and made a strong case for a substantial increase in recycling through the Fund' (de Vries, 1985a, 334). In the UK, Lever was broadly sympathetic to the idea of increasing the extent of official recycling facilities, but was nevertheless concerned that the funds made available would be dwarfed by the size of the problem. For his part, he emphasised the importance of making attempts to achieve either a drastic reduction in the oil price, or more feasibly, taking some of the surplus out of the system, which he suggested could be achieved by isolating the bulk of the producers' surpluses in an international fund which would be released only when the OPEC nations were able to use the surplus for the purchase of goods and services from abroad. In exchange, he argued that the oil exporters could be compensated with a low rate of interest (TNA T 354/571, Lever to Wilson, 1 November 1974).

The Treasury more broadly however, was not convinced that the oil money problem would be of a lasting duration, predicting that the disequilibrium would have petered out by 1980. This was based on the view that oil prices were bound to come down because the exporters' '*share of the market is bound to shrink as alternatives are developed, and they will not, once investments in new sources have been made, be able to win it back*' (TNA T 354/565, Oil Money Synopsis, 2 December 1974, original emphasis). In the interim however, it would be necessary to supplement recycling facilities for the simple reason that '*nobody gains if the international system cannot cope with the flow and collapses under the strain*' (ibid, original emphasis). Healey endorsed this view at a meeting in the Foreign Office on 6

December. He informed his colleagues that he believed 'the important thing was to set up alternative recycling mechanisms – as many as possible and as soon as possible' (TNA T 354/411, Note of a Meeting, 6 December 1974). Britain also made it clear that it was willing to exert diplomatic pressure on the United States if it did not endorse the renewal of the oil facility for 1975, by threatening to block its own recycling proposal for a 'common loan and guarantee facility' (ibid). Britain's ambassador to the United States, Sir Peter Ramsbotham, reported in early January that the architect of the American scheme, Henry Kissinger, had been rebuffed after informing him that unless the EEC finance ministers agreed in principle to supporting the American scheme, that the United States would not support the extended oil facility in the IMF. He told Kissinger as a point of fact that the United States had no authority to formally veto the IMF facility, and that any other means to do so would be seen as a deliberate barrier to cooperative actions in their formative stages (TNA T 354/411, Note for the Record, 9 January 1975).

Whether this intervention was decisive in and of itself is unclear, however the Executive Directors of the Fund agreed at the Interim Committee meeting on 15 and 16 January that the oil facility should be renewed and enlarged for 1975 (see de Vries, 1985a, 344). Whilst the United States once again voiced opposition on the grounds that it believed that financing structures were simply contributing to the accumulation of unsustainable levels of debt that some nations would never be able to repay (ibid, 340-1), the UK had nevertheless been key supporters of the recycling facilities, and by so doing had provided a buttress for the government that reduced the immediate concerns about maintaining the overseas confidence that was required

in order to prevent the diversification of the sterling balances by ensuring that a limited amount of low-conditionality finance would be available in the event of need.

The OPEC price increases therefore placed unprecedented strain on the international monetary system. However, it also provided an opportunity for Britain to take interim action to reduce the susceptibility of the sterling balances to declining confidence by negotiating the extension of the oil facility, which would mean Britain would be able to borrow in order to continue financing its deficit, and if necessary to supplement the reserves and support the rate, without engaging in politically difficult negotiations on conditionality. However, the Treasury was also acutely aware that this was only a temporary fix to the problems caused by vulnerability of the sterling balances, and in order to ensure the stability of the rate and continued external financing prospects, it would be necessary to make a decisive restatement of economic strategy.

The decisive re-orientation of economic strategy

Edmund Dell (1996, 410) recalled that in the preparation of Healey's spring Budget in 1974, 'the Treasury obeyed its political master and presented options, none of them too demanding.' By the end of the year however, 'the official Treasury had at last concluded that existing policies were not sustainable' (ibid, 412). The restatement of the Treasury's position occurred in the context of the November Budget, which had revealed that the PSBR had been nearly twice the Treasury

estimate, and was 'seen to have done little to deal with the UK's basic problems (Wass, 2008, 80), despite attempts to restore investment incentives through a reduction in the productivity deduction. The Budget however, was a success with the TUC, which described the measures as 'a courageous endeavour to protect employment, stimulate investment and promote social fairness' (MRC MSS.292D/560.1/11, Statement on the Autumn Budget, 12 November 1974). However, the TUC was also advocating an 'injection of some £1,500 million [into demand] over the next twelve months' in order to sustain acceptable levels of employment (MRC MSS.292D/560.1/11, Econ Ctee 2/3, no date), and it was clear in the Treasury's view that such measures were out of the question. Sir Douglas Wass expressed this view in a Treasury Policy Coordinating Committee (PCC) paper in December. He noted that 'a substantial shift [in economic policy] is called for' because 'we depend critically on overseas confidence to hold sterling balances and to maintain our capacity to borrow, either in sterling or dollars to finance our continuing deficit' (TNA T 277/3053, PCC (74) 4, 20 December 1974). He went on to note that 'confidence is growing more fragile and could collapse at any time' (ibid), before concluding that 'there is no longer any official support for existing policies' (ibid).

The Treasury proposed a number of domestic measures in order to ease the problem of overseas confidence that was so critical because of the overhang of the sterling balances and the scale of Britain's balance of payments deficit, and which had been exacerbated by the OPEC price increases. Wass noted that the primary objectives of economic strategy should be to simultaneously address the problem of inflation

whilst tackling 'the structural imbalance of the use of resources by which I mean a situation in which we are consuming as a nation 6 per cent more than we are producing, resulting in an excessively large balance of payments deficit quite apart from the oil price rises' (ibid). He believed that the best strategy for achieving these goals would be through a deflation of domestic demand and direct government intervention in the wage bargaining process (ibid).

The deflation of domestic demand would be achieved by a combination of changes in fiscal policy, including both increases in taxation and reductions in expenditure, 'which would work on demand partly directly and partly by reducing real personal disposable incomes', concurrently reducing the flow of imports, accelerating exports, and improving the balance of payments (TNA T 277/3053, PCC (74) 4, 20 December 1974). He also noted that whilst placing a figure on the kind of budgetary action that was called for was difficult, he believed that some contraction of the economy with an associated rise in unemployment would be beneficial both by removing bottlenecks where exporters had been held up by labour supply shortages, and reducing the rate of increase of wage settlements (ibid). He wrote starkly: 'this would inevitably give rise to severe social pressures and have serious consequences for the industrial sector but I cannot see any way of reducing inflation and improving the use of resources which does not involve increased unemployment' (ibid).

On the public expenditure side, he noted that action would need to be severe. The Permanent Secretary proposed that for the appropriate outcomes to be reached, 'the cuts will have to concentrate on actual spending on goods and services and it is

unlikely the social services could be spared' (ibid). These measures alone, however, were not thought to be sufficient to both restore fundamental balance of payments equilibrium and decisively tackle inflation, so Wass also held the view that 'we have no alternative but to attempt once more to break into the wage/price spiral by laying down a norm for the rate of pay increases', whether by statutory means or effective government leadership (ibid). In combination, these policy suggestions rejected the very essence of the Social Contract as the framework for economic management in terms of its approach to full employment as a legitimate economic aim, attitudes to social expenditure, and the government's role in industrial relations.

These policy recommendations were also made with an acute awareness of the potential political ramifications they held. The paper notes:

> I do not by any means underestimate the political costs of such a policy, which I would regret as much as the Chancellor himself and the most careful thought would have to be given to the industrial and social programmes required. But I now believe that the economic costs of clinging to the existing policy outweigh the political costs of abandoning it (ibid).

From Wass' point of view, it was likely to be the case that 'the Chancellor will feel that it is politically out of the question for him to embrace the recommendations I have put forward – at any rate without the external crisis that would justify it', however he also believed that failure to adopt measures of the kind proposed would precipitate an external crisis that Britain's reserves would be insufficient to rebuff, and that this would force the government to adopt similar measures in any event (ibid). After discussions with the Chancellor, Wass found his suspicions confirmed,

and reported back to PCC that Healey 'shares our anxieties [about inflation], but is extremely sceptical about the efficacy of a policy change which involves a departure from the Social Contract', and was 'wholly unsympathetic to an approach which seeks to correct the current account deficit solely by deflating domestic demand' (TNA T 277/3054, PCC (75) 33 (revise) 26 February 1975).

The reorientation of economic strategy was significantly influenced by the problems of financing the external deficit caused by evaporating confidence and the weakness of sterling, which were becoming more acute and used as justifications for policy changes in their own right. At the end of January, the prospects of financing the deficit in 1975 were uncertain, with 'questions now being raised about the UK's credit-worthiness […] bound to affect sterling inflows and the capacity to borrow in foreign currency' (TNA T 354/414, Financing the External Deficit in 1975, 22 January 1975). It was also noted that Britain remained especially vulnerable, and that predictions about external financing could become 'entirely unrealistic within a matter of hours' should confidence break dramatically (ibid).

The paper argued that the need to attract sterling inflows without provoking suspicion about the sustainability of economic policy founded on fears about the future value of sterling meant that traditional assumptions about widening the uncovered interest rate differential as a means of attracting investors to sterling did not hold. It was argued:

> A point could well be reached where the benefit would be more than offset by the damage done to confidence by what would be taken as a clear signal

> that the UK situation had become so bad that exceptionally high interest rates were necessary to contain it (ibid).

The Treasury argued therefore, that monetary policy alone was insufficient to address the problem, and could serve to be counterproductive considering that 'sharply reduced inflows from the major sterling holders in the OPEC group in the fourth quarter of 1974' were interpreted as a sign that confidence was already on the wane (ibid). The Treasury argued that this seepage of confidence was a product of increasingly sceptical market opinion about the concept of the oil deficit as an appropriate reason for borrowing, concern about the rate of increase of British debt servicing liabilities exceeding the implicit collateral of North Sea Oil revenues, and the persistence of UK inflation at a rate much higher than elsewhere in the world (ibid). It was predicted:

> If confidence remains in its present sickly state, there is a clear possibility that net sterling inflows would be negligible: whereas if confidence improves, it would seem justifiable to expect a total net inflow of the order of, say, £1,500 million. But no faith can be pinned in any "middle" forecast for the net sterling inflow: in some respects, such an outcome is the least probable (ibid).

There was also concern about the extent of the sterling balances that were held in liquid form by two holders, Saudi Arabia and Nigeria, and that attempts to attract inflows by using the uncovered interest rate differential would simply increase the vulnerability of the balances even if it did not create panic. As a result, it was argued that it was more desirable to seek medium-term finance through foreign currency

borrowing by the public sector (TNA T 354/414, Financing the External Deficit in 1975, 22 January 1975), but on the grounds that waning confidence had 'impaired the capacity of the public sector to borrow in foreign currency', it was felt that this avenue was likely to yield no more than £1 billion (ibid). Given the bleak prospects for attracting net-sterling in-flows and market borrowing, the Treasury also reviewed the possibility of bilateral and multilateral borrowing, each of which posed two questions, intrinsically linked to the confidence issue. The first was whether it would be possible to negotiate a loan of this kind without unfavourable conditions attached, and the second was how far any failed attempts would further dent confidence.

On the first question, it was felt that the prospects of borrowing on agreeable terms from Iran, Kuwait, and Saudi Arabia would be favourable, and although this could not be said with absolute certainty, the Treasury concluded that for the purposes of financing the balance of payments, 'the main focus will have to be on new bilateral deals, with the most immediate initiatives designed to take the temperature as to the possibility, amounts and timing of deals with one or a combination of Saudi Arabia, Kuwait and Iran.' On optimistic assumptions, it was felt that such financing avenues could yield approximately £2,250 million over twelve months (ibid). The government also had the prospect of borrowing from the IMF if required. With the successful extension of the oil facility into 1975, it was nominally possible to draw funds of up to $2,000 million from the oil facility, in addition to the $3,700 million that Britain had access to under its entitlement to draw two hundred per cent of quota on the General Account (ibid).

An early drawing against Britain's entitlement under the oil facility however, was problematic on the grounds that the UK's use of resources would leave less available for others, and was likely to 'be resented by the LDCs (and no doubt by others) and would seriously unbalance the whole operation' (TNA T 354/414, Financing the External Deficit in 1975, 22 January 1975). In contrast, a drawing on the General Account of the Fund was seen to have a potentially advantageous impact on confidence. It was suggested that 'the immediate effect of a drawing on the Fund would be favourable for confidence, especially if associated with what might appeal as a tough economic programme, blessed by the Fund' (ibid). On this basis, Wass (2008, 104) recalls that it was decided to treat the Fund as a fall back option, because the government 'might want to use the Fund in an emergency and as part of a programme to restore confidence.' These views expressed at the beginning of January had changed little by the beginning of March. Whilst the prospect of borrowing from the oil facility seemed more plausible if the approach could be delayed until the end of the year, it nevertheless remained the Treasury view that:

> Either seepage of confidence will be checked and reversed, in which case the auguries of the external financing side would improve significantly, or the seepage will continue, in which case the prognosis is bad (TNA T 354/414, External Financing: State of Play, 7 March 1975).

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The exchange rate and the balance of payments

Given the uncertain prospects for external financing in January, the Treasury considered a number of schemes that would reduce Britain's deficit and eliminate the need to attract sterling inflows over the medium-term, which began with consideration of 'the classic way to improve export prices [which] is of course to depreciate one's currency' (TNA T 354/414, External Financing: State of Play, 7 March 1975). However, the collapse of the Bretton Woods par-value system of fixed exchange rates made this considerably more difficult in light of the fact that it was unclear how a downward adjustment of the rate could be achieved in an orderly fashion. As Wass had noted, the absence of a formal mechanism for adjustment was compounded by the fact that interest rate adjustments could not be guaranteed to produce predictable outcomes, and that because the government could not publicly pursue a policy of depreciation because of the impact this would have for confidence, the authorities would not even be able to take any credit for benefits that were gained; whilst the strategy was economically risky, it would also be politically neutral (ibid).

It was however, suggested that 'an announcement that the authorities would no longer intervene to buy sterling at a rate above, say, $1.90, would quickly trigger a depreciation to about that level' (TNA T 358/207, Walker to Barratt, 11 March 1975), thus negating the difficulty of achieving the adjustment in the context of a floating rate system. Nevertheless, the strategy was laden with disadvantages, the most notable of which was the appearance that British policy had been directly

responsible for the erosion of £5 billion of official reserves and £2.5 billion of private sterling holdings. In addition to the considerable distrust that would be created, there was also the risk that the extent of the depreciation could not be effectively managed, carrying the possibility of a widespread diversification of sterling holdings that could serve to make the situation worse (ibid). It was argued plainly, 'the cumulative effect of all of these pressures could plainly be catastrophic' (ibid).[1]

Despite the practical difficulties of achieving the change in the rate, the Treasury continued to consider the possibility of achieving a 20 per cent depreciation of the pound. However, the size of the proposal posed as many problems as the absence of mechanisms to achieve it. It was noted in a PCC paper that Britain's 'major trading partners and the IMF would regard a 20 per cent depreciation, going well beyond what was required to restore competitiveness, as a form of international misconduct', which carried the added danger of becoming 'the first link in a chain reaction of competitive depreciations' (TNA T 277/3055, PCC (75) 41, 13 March 1975). However, a straightforward step-change in the rate or a depreciation by market

[1] There was also concern about the implications direct government involvement in securing sterling depreciation would have on the counter-inflation strategy, because it would clearly place pressure on the RPI as a result of increased import costs, and it was a distinct possibility that this would contribute to increased wage claims, a quick erosion of competitive gains, and as a result simply leave the economy in the same fundamental situation but with a higher rate of inflation (TNA T 358/207, Walker to Barratt, 11 March 1975).

forces however, were not the only possible ways in which Britain could try to use the exchange rate in order to help improve the competitive position of British industry.

Lord Kaldor was the architect of one such proposal, which advocated the application of an 'industrial value' for the pound sterling as part of a 'dual exchange rate' system, which would operate by devaluing the 'industrial pound' by a given percentage in relation to the pound sterling. The receipts of British exporters would be exchanged at the normal sterling rate, however importers of goods would only be able to obtain foreign exchange for their overseas transactions at the devalued 'industrial pound' rate (TNA T 277/3053, PCC (75) 20, 12 February 1975). The logic of the argument was fairly straightforward, in that the system appeared to allow Britain to reap 'all the benefits of a devaluation of the pound by x per cent on our trade balance without the disadvantage of a falling pound on internal costs' (ibid).

Whilst intellectually appealing, there is no evidence to suggest that the Treasury considered this a feasible alternative to depreciation, and it was feared that the international community would respond in a similar way to its introduction as it would to depreciation of 20 per cent. This was because the system in all but name was an import surcharge and export subsidy applied differentially to identical goods on the basis of their national origin, and as such, was likely to be perceived as a barrier to free trade (TNA T 277/3054, PCC (75) 33 (revise) 26 February 1975). Although the IMF and the EEC had tolerated a similar scheme operated by France in 1971 following monetary reforms, which might indicate 'that our international partners would be more disposed to condone it than they would an undisguised

subsidy and surcharge system' (ibid), by 18 March, the Chancellor had decided the scheme was not suitable for Britain and would only be accepted grudgingly overseas (Wass, 2008, 97).

Like the dual exchange rate system, taking direct action to restore the balance of payments through the introduction of import controls had an intuitive appeal on the grounds that they appeared to offer a solution to reducing imports whilst avoiding domestic price inflation associated with depreciation. However, there was also a considerable stigma attached to formal import restrictions, which carried additional objections on the grounds that their imposition would have a counter-intuitive effect by actually contributing to a substantial erosion of the efficiency of British industry by removing all incentives to invest and become internationally competitive. Treasury calculations showed that in order to make savings of £1,500 million through the introduction of import controls applied only to imports of manufactured consumer goods and non-essential producer goods, it would be necessary to impose quotas of up to 70 per cent, which would result in the substitution of imports with inferior goods which may in themselves rise in price as supply bottlenecks emerged (TNA T 277/3054, PCC (75) 33 (revise) 26 February 1975). On the other hand, if import restrictions were applied to a broader range of goods, there was the possibility that the supply of raw materials to the production process would be disrupted (ibid). Furthermore, the argument for import controls, taken in the context of the long-term aims of British policy, was weak given that they would inevitably divert resources from exports to the home market, which was counter to the government's stated aims of achieving export led growth (ibid). Given the strength

of official feeling about the complete unsuitability of a programme of import controls as a solution to the balance of payments problem, and the perception that there was growing enthusiasm for them at a political level, the Treasury plainly stated that it would 'prefer existing policy, with all its attendant risks, to a scheme of quantitative restrictions on imports' (ibid).

The difficulties caused by the sensitivity of the sterling balances to confidence factors and the demands of external financing had therefore caused the Treasury to engage in a substantial restatement of economic strategy, which was designed to make the case that in a world made up of reasonable persons, the only suitable action was to cut expenditure, increase taxation and intervene in the wage determination process. Whilst other options were considered, they were rejected on the grounds of impracticality, leaving little option for the government other than fiscal reductions, which underscored decisions included in the April Budget.

The April Budget

The TUC's economic review in January 1975 had noted that 'one of the overriding priorities of government policy will be to maintain employment', and that 'real resources will also have to be devoted to *public expenditure* on agreed social priorities' (MRC MSS.292D/560.1/11, Econ Ctee 4/5, 8 January 1975, original emphasis). These views were clearly reflected it its Budget recommendations to the Chancellor. The TUC informed Healey on 9 April that 'a neutral Budget would mean increasing unemployment, and against that background the TUC was calling

for an expansionary Budget' (MRC MSS.292D/560.1/12, Econ Ctee 7/1, 9 April 1975). It also argued that expenditure priorities should target social issues, and that the balance of payments difficulties should be addressed through a temporary scheme of import restrictions coupled with continued overseas borrowing (ibid). However, the Chancellor used the confidence issue in order to explain why this would not be possible and informed them that although 'up to now loans had been arranged commercially without any political conditions imposed', the current level of the UK's inflation 'might mean that this situation would not pertain in the future' (ibid).

Healey's discussions with the TUC were undoubtedly underscored by the reorientation of the views of the Treasury and its Budget recommendations, despite alternative suggestions. Tony Benn had informed the Ministerial Committee on Economic Strategy (MES) at the beginning of February that Britain was effectively faced with a choice between two economic strategies. In the first, the government's primary aims were the relatively quick improvement of the balance of payments and a sharp reduction of inflation. Achieving these goals would require the people to accept large cuts in the standard of living in exchange for better long-term employment prospects caused by a fiscal reduction of about £3 billion and direct intervention in wage determination (TNA CAB 134/3929, MES (75) 4, 11 February 1975). On the other hand, he argued that it would be possible to go for a slower improvement in the balance of payments whilst saving jobs and maintaining industrial capacity through selective intervention discussed extensively with the TUC. This would require greater explanation of the extent of the crisis to the people,

the maintenance of the price code, selective assistance to industry, and import controls (ibid). Benn's preference however, was clear:

> Strategy A and its variants entails, as a deliberate act of policy, a relatively sharp cut in living standards and employment, achieved by traditional indirect, macro-economic measures of a broadly indiscriminate nature. Strategy B, by contrast, is intended to operate more slowly and more selectively by direct action at particular points of weakness (ibid).

However, it was the view of the Permanent Secretary of the Treasury that the targets for public expenditure reductions should be in the region of £2 billion for 1975-76 and £4 billion for 1976-77 (TNA T 277/3053, PCC (75) 33 (revise), 26 February 1975). This was presented as Budget strategy Beta, along with packages including no new measures (Alpha), a package including the import surcharge / export subsidy scheme (Gamma), and a package including quantitative restrictions (Delta) (see TNA T 171/1182, Posner to France, 7 March 1975). The prediction for the current account on the basis of strategy Beta was an improvement of £1,300 million compared with Alpha, which may have risen to £2,250 million in the second year, at the cost of an increase in unemployment of 25,000 after one year, potentially rising to 125,000 after two years (ibid).

Within the Cabinet, the Treasury's programme 'Beta' was preferred to Tony Benn's alternative, with Healey informing officials that his colleagues had 'a general awareness […] that it would be necessary to squeeze expenditure', and that there would be 'little difficulty getting this agreed in principle' (TNA T 353/145, Note of a

Meeting, 28 February 1975). Healey finally declared his definite intentions to impose cuts on public expenditure programmes for 1976-77 to Cabinet on 13 March, which he justified on the grounds that they were inevitable because of Britain's tenuous external position (see TNA CAB 128/56, CC (75) 12th Conclusions, 13 March 1975). However, the cuts were not to go as far as the Treasury had desired on the grounds that they would have had 'arbitrary and disruptive effects' of the kind that he wished to avoid, and as a result were limited to a reduction of £1,000 million at 1974 survey prices (ibid). Whilst Wass (2008, 98-9) recalls that this decision was reached on the basis of views that were rather more political than economic, it was nevertheless enough to secure Cabinet agreement to the action, which led to what Barnett (1982, 64) described as 'the first big public expenditure cuts Cabinet' on 25 March.

Benn however, remained unconvinced of the case for cutting public expenditure, and on the eve of the Cabinet discussions wrote to Wilson once again illustrating his view that Britain had a choice of economic strategies, and that Healey's was essentially a conventional deflationary package that would lead to high unemployment (TNA PREM 16/341, Benn to Wilson, 24 March 1975). He emotively argued that the course was 'bound to be seen by the Labour movement and the whole country as a policy of despair, representing an admission of the failure of our economic policy', and once again suggested that 'we must now seriously consider an explicit commitment to a protectionist strategy for industrial reconstruction and a return to full employment' (ibid). However, at the Cabinet meeting the following day, Healey restated the argument that if Britain were to

continue living beyond its means to the extent of 5 per cent of Gross Domestic Product (GDP) per annum, the government would inevitably face a sterling crisis that would force it to 'adopt the policies appropriate to a siege economy, or they would have to borrow from the international institutions, and possibly the United States, on terms which would to a considerable extent dictate policy to be followed' (TNA CAB 128/56, CC (75) 16th Conclusions, 25 March 1975). In order to add extra weight to his argument, Healey once again noted that import restrictions were out of the question, not least because they would impose severe cuts in living standards on the British people and critically damage Britain's prospects for Borrowing overseas (ibid). When Cabinet resumed in the evening, it was agreed that Barnett should conduct bilateral discussions with spending ministers in order to decide the makeup of the package (TNA CAB 128/56, CC (75) 17th Conclusions, 25 March), and by the second week of April the Cabinet had reached agreement on cuts of just under £900 million for 1976-77 (TNA CAB 128/56, CC (75) 19th Conclusions, 10 April 1975).

Conclusions

In this chapter it has been shown that the size of the sterling balances had made British economic policy particularly susceptible to changes in overseas confidence in its macro-economic management, and that sterling guarantees in the 1960s were initially thought to lack credibility, and once put in place in 1968, had served to increase the balances rather than contribute to their orderly run-down. It has also shown that Britain was a principal advocate of the extension of the oil facility into

1975, which provided a condition free buffer for the government in the event confidence broke decisively, and that the Treasury believed that a decisive re-orientation of economic strategy was required in order to preserve the confidence that was required so Britain would be able to continue to finance its deficit and avoid a catastrophic diversification of overseas sterling.

It has also been shown that whilst the Treasury considered a number of ways of correcting the balance of payments directly, it strongly favoured reductions in public expenditure and government intervention in the wage bargaining process in order to preserve confidence. These preferences were strongly reflected in the expenditure cuts included as part of the April Budget, when, despite the objections of the TUC and Tony Benn, who wanted to see increased public expenditure to maintain employment coupled with import restrictions and borrowing to cover the deficit, the Chancellor argued that overseas opinion and financial markets had made it inevitable that expenditure had to be cut, and that any alternative course would force Britain either to withdraw from the world economy, with associated consequences for the British standard of living, or borrow from abroad, with conditions that would dictate austerity measures.

Chapter VI

The sterling exchange rate, the £6 pay policy, and the oil facility loan, April – December 1975

In the previous chapter it was shown that Britain's foreign reserves were vulnerable to wavering confidence in the sustainability of economic policy because of the size of the sterling balances, and that as a result of this the Treasury had advocated a decisive reorientation of economic strategy that considered a broad range of options, but settled on the need for the government to reduce public expenditure and intervene in the wage-bargaining process. It also showed that despite resistance from the TUC and the left of the Labour Party, it was able to begin making cuts in public expenditure in the April Budget by arguing that any other course would either be disastrous for confidence, the standard of living of the British people, or the government's ability to make its own economic policy.

This chapter will show how agreement on the need for policy measures that ran contrary to the principles of the Social Contract continued throughout 1975, and shows how they began to be implemented through the process of *preference shaping* depoliticisation. It begins by showing that a number of economic indicators were still a concern for the Treasury on confidence grounds, and then demonstrates how a slide in the sterling rate was used in order to argue that there was no alternative to introducing a £6 per week flat rate pay limit, despite the fact that the Treasury wanted the pound to fall for reasons of competitiveness and had refused to allow the

Bank of England to intervene substantially in the foreign exchange markets in order to achieve this. Finally, it will show that in the absence of a substantial improvement in Britain's external financing prospects, prudence encouraged the government to apply for loans from the IMF's oil facility and first-credit tranche, and that by emphasising the importance of avoiding further external financing crises resulting from lapses in confidence on the grounds that their outcomes would be worse than immediate retrenchment, it was possible to secure agreement to further cuts in expenditure for the February 1976 white paper in December.

The economic indicators

The levels of public expenditure and the extent of the PSBR in the 1970s had three broad economic implications for public policy-making stemming from their impact upon confidence. Firstly, the scale of public expenditure financed by monetary expansion had a negative impact on confidence because of its contribution to inflation. Of itself, this was especially problematic for Britain in light of the scale of the sterling balances, because large public expenditures financed in this way were seen to be actively eroding the value of sterling assets. Secondly, public expenditure was seen to pre-empt the use of resources by the private sector, which made the achievement of balance of payments equilibrium seem more remote. Lastly, the size of the PSBR had implications for the cost of Britain's debt servicing, which was increasingly seen to be unsustainable given the inability of British industries to rationalise.

Despite these implications, at a political level, the significance of the PSBR for the real economy was doubted, and in general discussion[1] at Cabinet on 10 April, it was noted that the concept had become 'a fetish, forming a barrier to the realisation of sensible policies' (TNA CAB 128/56, CC (75) 19th Conclusions, 10 April 1975). However, the Treasury was quite clear that the PSBR had implications for both the real economy, and for confidence. In a note by officials circulated to Cabinet, it was recorded:

> many of the lending transactions that contribute to it […] can have an important influence on the liquidity of the private sector, and so can affect spending and external capital flows. Secondly, the financing of a large borrowing requirement can pose problems for monetary management, which again have implications for the real economy and external outflows (TNA CAB 129/183, C (75) 61, 19 May 1975).

Finally, the paper noted, the PSBR 'has come to be considered by outside observers as an indication of the Government's budgetary stance, and so can be critical to confidence' (ibid).

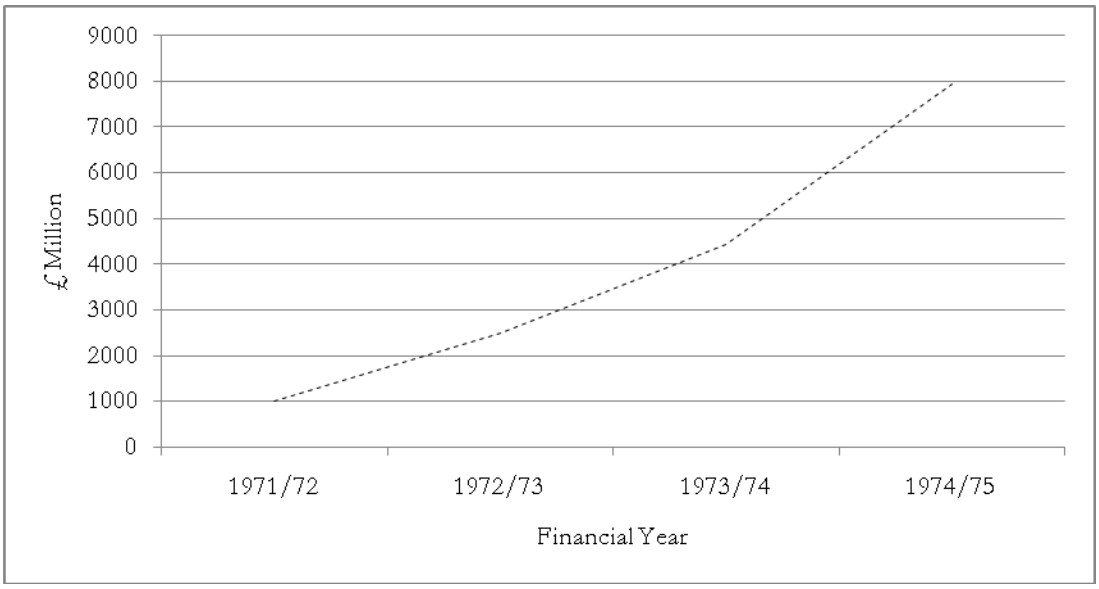
The path of public expenditure in the UK however, did not appear to be prudent, and aggregate expenditure virtually doubled from £27.4 billion in 1972 to £54.5 billion[2] in 1975 (CSO, 1977, 52). Perhaps more significantly from the point of view of market opinion, expenditure on investment had stalled relative to expenditure on

[1] The minutes do not make it clear which Cabinet member made the specific point in this instance.

[2] Figures rounded upwards to the nearest £0.1 billion.

consumption from 1973 onwards, with investment increasing by under £4 billion between 1973 and 1975, whilst spending on consumption rose by nearly £9.5 billion (ibid, 54). These figures did nothing to quash market suspicions that Labour governments were profligate spenders and lacked control over the public purse. Monetary expansion was also a concern, as figures for M3 rose from £2 billion in 1971-72 to £6.8 billion in 1973-74, before falling back to £3.5 billion in 1974-75 (ibid, 52), and as figure VI.1 below shows, the PSBR had virtually doubled fiscal year on fiscal year between 1971-72 and 1974-75. By this stage, the PSBR had reached nearly £8 billion, and it was noted in a Treasury paper that 'the UK's external debt is currently accumulating at a rate roughly equivalent to the value of a full year's North Sea Oil production in 1980 at 1974 prices' (TNA T 354/414, External Financing in 1975, 22 January 1975).

Figure VI.1, PSBR 1971-72 – 1974-75, £ million (not inflation adjusted)



Source: CSO (1977) *Economic Trends,* Number 279, London: HMSO, 52

Inflation had also continued unabated since the election of the Labour government in February 1974, and continued to contribute to the erosion of the real value of sterling

assets held abroad. As such, it continued to act as an incentive to diversify out of sterling. Wages had risen by nearly 5.5 per cent between February and June 1975, (CSO, 1977, 2), whilst as figure VI.2 below shows, the RPI had increased by 24.2 per cent on the same quarter of the previous year before the end of the first half of 1975.

Figure VI.2, Retail Price Index 1974-75, 1970 average = 100

		RPI	Percentage Increase*
Year	Quarter	All Items	All Items
1974	1	138.8	12.85
	2	147	15.84
	3	150.7	17.00
	4	157.5	18.24
1975	1	167	20.32
	2	182.7	24.29
	3	190.7	26.54
	4	197.3	25.27

Source: CSO (1976) *Economic Trends,* Annual Supplement, Number 2, London, HMSO, 96-7

*** Percentage increase on same quarter of previous year (my calculation)**

In light of these indicators, and despite the fact that the Labour government had recognised the balance of payments as a prior claim on resources and announced plans to cut expenditure programmes in 1976-77, the figures for public expenditure, the PSBR, monetary expansion and inflation, continued to dampen confidence. In order to address them the Treasury would need to be able to make strong cases that the reductions in public expenditure and government intervention in the wage bargaining process that it had advocated in December 1974 were justified. On the issue of incomes, the prevailing exchange rate strategy provided just such an

opportunity, as the Treasury argued that incomes policy was absolutely essential because of the depreciating pound, despite its preferences to see it fall.

The sterling exchange rate

Pressure on sterling had emerged late in 1974, and in light of unresolved questions about the appropriate exchange rate strategy, between 13 December and 24 January, the Bank of England had spent $377 million on intervention in the foreign exchange markets to support the rate (TNA T 358/207, Hedley-Miller to Folger, 24 January 1975). The rate remained under pressure throughout January, however through further selective intervention the Bank was able to stabilise the rate at an effective depreciation of 22 per cent below Smithsonian, or a spot rate against the dollar of $2.38. However, further pressure emerged in anticipation of the April Budget, and in its aftermath, the Treasury's exchange rate strategy gained a coherence that demonstrated its intentions to allow the rate to fall and conceal its failure to act decisively to prevent the slide, in order to justify the need to introduce an incomes policy.

Pressure on sterling re-emerged in the week prior to the April Budget, when on the morning of 7 April, the transactions of one middle-Eastern seller pushed the rate down to $2.38. At first, the pressure appeared to be insubstantial, and stabilised after a $5 million reserve switching operation, however by the early afternoon the Bank had used a further $18 million in this way, and requested authorisation from the Treasury for the authority to commit up to $50 million in the markets to prevent any

sudden depreciation (TNA T 358/207, Note for the Record, 7 April). The Treasury granted the Bank a discretionary authority in this amount, however its interventions in the market proved to be insufficient, and on 8 April sterling began to slip against the dollar and other currencies, falling to £2.37 by 10.15 am. On the grounds that it was thought to be undesirable for there to be a sharp slide in the rate immediately prior to the Budget, a further $30 million was authorised for reserve switching operations to hold the rate (TNA T 358/207, Note for the Record, 8 April 1975).

These flurries on the exchanges were a concern for the Treasury in so far as it was reluctant to see a sudden deterioration in the sterling rate that would unleash the sterling balances, however whilst it had rejected the possibility of depreciating sterling by 20 per cent, it nevertheless remained the intention to achieve a 10 per cent depreciation over the coming year. This was to be achieved by relying to the maximum extent possible on 'autonomous factors to depress the rate so that the main responsibility for depreciation is seen to lie elsewhere than with HMG' (TNA T 358/207, Walker to Mitchell, 11 April 1975). The Treasury had also forecast how this would be expected to proceed throughout the spring, noting that the uncovered interest rate differential would narrow from over 4 per cent to around 2 per cent, and that the dollar had shown signs of strengthening. In addition to this, it was felt that market apprehension would build in the run up to the referendum on the EEC, beginning around 23 April, and on this basis, Treasury policy was to intervene parsimoniously in order to stabilise the rate at an effective depreciation of 22 per cent below Smithsonian until this pressure emerged (ibid).

This appraisal of the situation proved remarkably accurate, as pressure on sterling again emerged on 22 April, just over one month before the referendum. In response to this pressure, the Bank had committed $50 million before 11.30 am in order to dampen suspicions that it was the government's intention to let the rate fall as had been reported in the media, and which appeared to be confirmed by reductions in interest rates (TNA T 358/207, Barratt to France, 22 April 1975). In response to the pressure the Governor of the Bank had requested $200 million to assert control over the markets, which the Treasury agreed to on the condition that spending in the exchange markets should be conducted on a prudent basis, given that as 'it is indeed our policy to get the rate down […] we ought not to slog away spending money to try and stop this happening' (ibid).

Whilst these early developments showed that the Treasury's attempts to get the rate down with relative stealth over a twelve-month period appeared to be on course, as the end of April approached the Bank had been spending increasing amounts in the markets to defend the rate, provoking Treasury concern that the use of the reserves was no longer being exercised prudently. On 25 April, with the effective depreciation expected to hit 22.7 per cent, the Bank had already used $105 million of the $200 million approved by the Treasury on 22 April, and the Bank indicated that it was likely to request authority to exceed the $200 million already agreed (TNA T 358/207, Mitchell to Hedley-Miller, 25 April 1975). When Derek Mitchell was informed that the Bank had already spent $40 million on the day, he made it clear that he expected the Bank to make contact with him before intervening in the event of further disquiet in the markets, and expressed his hope that 'this move to keep the

Bank under control will not be frustrated by parallel approaches to us, e.g. from the Governor' (ibid).

The Bank and the Treasury therefore had different positions with regard to what constituted a desirable scale of intervention, and this was borne out at a strategy meeting in early May. Examination of the figures showed that between 21 April and 2 May, $304 million had been spent in defence of the rate, including $188 million on 2 May alone (TNA T 358/208, Note of a Meeting, 5 May 1975). The Governor's view was that the need for this stemmed from the fact that the UK's prevailing rate of inflation indicated to the markets that some measure of depreciation was inevitable, and he argued that 'if the market got the impression that the authorities were intervening merely to smooth the depreciation it was probable that the rate would fall substantially' (ibid). On the other hand, Derek Mitchell noted that there was a real possibility that Britain could lose a substantial amount of its reserves in any decisive attempt to halt sterling's decline, and Douglas Wass agreed that 'there need not be a commitment to massive intervention when [sterling] reached a particular level' (ibid). Wass then proposed that the Bank be granted authority to use up to $100 million per day for smoothing operations, and whilst the Governor put the case for $250 million, the Chancellor came down on the side of the Treasury, authorising the Bank to use $100 million per day in smoothing operations, up to a maximum of $250 million (ibid).

As the Governor had feared, and in light of its exchange rate strategy, as the Treasury had hoped, the amounts authorised proved insufficient to end further

speculation on sterling, and in the morning of 13 May, the Chancellor agreed to increase the Bank's authority to intervene with up to $400 million (TNA T 358/208, Hedley-Miller to Wass, 13 May 1975). The result of this decision was that by 3.30 pm the sterling rate stood at $2.30, with the Bank's expenditure on the day reaching $229 million (ibid). This figure continued to increase throughout the afternoon, and by the end of the day, $313 million of the $400 million authorised had been used (TNA T 358/208, Note for the Record, 13 May 1975). The remainder of this money had been used by the end of the following day, leading to a further request from the Bank for authority to use $100 million for the purposes of 'parsimonious intervention' (TNA T 358/208, Note for the Record, 14 May 1975).

Douglas Wass (2008, 133) notes that in general, the Treasury's view was in line with that of the Governor, although there was unease about whether attempts should be made to hold sterling to any fixed parity and the fact that the size of reserves would not permit any large scale support of the exchange rate. He notes that the different views of the Treasury and the Bank 'did not, in 1975, give rise to any material policy differences' (ibid, 134). However it is difficult to see how the views of the Treasury, which were strongly against using the reserves to support a given parity in order to achieve depreciation, and those of the Bank, which wished to use the reserves for this purpose, could be any more disparate. This is especially brought out by the extent to which the Treasury felt the need to remind the Bank that spending the reserves to support the rate when it was government policy to secure depreciation was counter-intuitive, and its reluctance to authorise the use of the foreign reserves for such purposes.

In the context of the disagreement between the Bank and the Treasury on the aims and appropriate scale of market intervention, pressure on the rate and the scale of intervention contributed to the end-month reserves figures falling from $7,132 million for April to $6,491 million for June, but given that this was less than $300 million lower than the figure for January (see Bank of England, 1977, table 23; TNA T 354/416, Reserves Objectives, 11 August 1975),[3] it is clear that the situation was not critical, and the exchange rate, despite peaking at over $2.40 in February and March, had only fallen from $2.34 on the first Friday of January to $2.28 on the second Friday of June (see Bank of England, 1975, table 27). Nonetheless, the Treasury used the situation in order to advocate policy change. Mary Hedley-Miller in the Overseas Finance Division noted:

> There has developed an expectation that the Government is "going to act". For as long as this expectation is disappointed, 25 per cent [below Smithsonian] will not be regarded by outside observers and operators as

[3] Wass (2008, 134) discounts the monthly, published reserves figures for 1975 as a reliable indicator. He notes that they 'do not give any indication of the size of the intervention' because there were inflows as various borrowers drew on their lines of credit from time to time, but moreover because 'the Treasury occasionally "doctored" the true reserves figures by switching from spot to forward transactions or by timing the drawings on external loans' (ibid, 134), however he cites no documentary evidence giving examples of when this occurred or to what extent, which creates the impression that his analysis reflects a selective approach to the kinds of indicators deemed of importance.

> sustainable. If the exchange rate accordingly is going to be pulled down by market forces, mere money, as opposed to policy change, will not succeed in offering a sufficient opposing force (TNA T 358/208, Hedley-Miller to Wass, 11 June 1975).

The Treasury continued to associate the relatively modest slide in the rate with a lack of overseas confidence in British counter-inflation policy. On 18 June Derek Mitchell wrote to the Governor of the Bank, enclosing a paper that discussed the question of whether continued intervention in the foreign exchange markets 'would have any real value or whether it would simply mean throwing away the reserves', indicating that he was inclined to the latter view (TNA T 277/3056, Mitchell to Richardson, circulated to PCC as PCC (75) 65, 18 June 1975). The paper noted that the primary case for intervening in the market was that the changing portfolio preferences of major sterling balance holders could force the situation to breaking point. This position seemed strengthened given that the Kuwaiti ambassador had indicated that 'Kuwaiti policy could change substantially if the dollar rate depreciated to $2.20' (ibid), which appeared to represent the threat of a major diversification out of sterling. On the other hand, the paper argued that it was unclear intervention of even $500 million would be sufficient to hold the rate, and that a different approach was required. On this basis, the conclusion was reached that 'until action is taken on inflation that external opinion regards as adequate, the exchange rate is bound to be subject to chronic bouts of selling pressure and to go on falling' (ibid).

The slide in the exchange rate therefore, was not only favoured by the Treasury as an end in itself, but also provided the government with an opportunity to argue that the decision to continue with purely voluntary forms of collective bargaining was no longer in its hands because it was not credible in the eyes of sterling holders on whom the government's broader economic strategy was dependent. This was especially convenient in light of the Treasury's preference for a return to incomes policy that it had expressed in December 1974, and the long-standing contingency planning that had begun at that time and remained unresolved on the grounds that officials had not managed to find a scheme that would be effective and politically acceptable. The appearance of crisis in the foreign exchange markets attributed to a lack of counter-inflationary credibility had, as Wass had predicted in December 1974, provided the opportunity for the government to depoliticise the issue of incomes policy.

Counter-inflation strategy

As part of its contingency planning, the Treasury had identified three potential ways of coping with Britain's inflationary conditions in December 1974, each of which carried some degree of political or economic risk. The first suggestion was implausible, and involved taking no action on inflation and simply living with it. The second suggestion was to allow unemployment to increase to diminish the relative bargaining power of workers. Finally, it was suggested that the Treasury could design and implement a new incomes policy (TNA T 277/3053, PCC (74) 3, 10 December 1974). The official assessment discounted the first two options, the

first on the grounds that it would create an economic crisis of such an extent that it could 'lead to reform of the currency' (ibid), and the second because the increase in unemployment would create a political crisis that could lead to the defeat of the government (ibid). Incomes policy was therefore felt to represent a credible economic solution with a manageable political downside.

On 8 January three proposals for a new incomes policy were presented to the Treasury PCC. The first involved the sharpest break with the Social Contract, and would impose a two-month freeze in wages, which would be followed by a statutory pay norm that would be set below the rate of increase of the cost of living (TNA T 277/3053, PCC (75) 2, 8 January 1975). The second scheme was similar in the sense that it would impose a statutory pay norm that would be set at below the rate of increase in the cost of living, however it would avoid the initial pay freeze by making payments on account to those groups of workers who would otherwise have had settlements during the first two-months of the policy (ibid). The final scheme proposed to use direct controls on pay that were limited to delaying powers similar to those used in the incomes policy of 1966, to work in tandem with tax measures designed to stop firms from granting excessive pay increases in the first place (ibid).

Despite the trade unions' long-standing aversion to incomes policies, the government began referring to pressure on sterling as a justification for incomes restraint. On 15 January it was noted that the government had 'decided that the position on the foreign exchanges, coupled with the damage which inflation is doing to the whole of our national life, now make it necessary to introduce forthwith effective measures to

limit the growth of incomes' (TNA T 338/314, Posner to Hopkin, 15 January 1975). It was argued that the sterling position made it 'essential to aim at a reduction in the rate of inflation to about 10 per cent by the early autumn of 1976'[4], although the Treasury's view was that even this might be too much of a stretch for a purely voluntary policy (ibid).

However, the potential efficacy of a statutory policy was questioned from within the Home Finance Division, where officials did not believe that resort to a statutory pay policy was the only option the government had for breaking into the wage / price spiral. It was noted that statutory policies were often no more than a crude disguise for traditional deflation, and that 'as so often in the past, the Treasury's reaction to this situation is likely to be to try and cut real incomes even if this is not what the situation requires, and try to overcome a financial crisis by doing damage to the economy' (TNA T 357/424, St. Clair to Couzens, 16 January 1975). Instead, it was suggested that the desired effects could be achieved through a drastic cut in or abolition of VAT, drastic reductions in the rate of Corporation Tax, and the use of a more extensive system of subsidies in order to keep the prices of nationalised industries' products as low as possible (ibid).

This scepticism about the efficacy of incomes policy was also shared at the political level, and the Chancellor remained unconvinced about the possibility of implementing a scheme of this kind without provoking confrontation with the

[4] Wass (2008, 105) recalls that this figure was based on 'the rather arbitrary assumption of the minimum that would stand any chance of acceptance.'

unions. Even in response to a proposal from the Secretary of State for Prices in early February, which involved the application of a norm but did not rule out continued collective bargaining and direct action on prices, Healey noted that it was unclear whether the application of a norm could be presented as consistent with present policy (TNA T 357/425, Note of a Meeting, 13 February 1975). The Prime Minister echoed this view at Cabinet two weeks later, reporting that MES had agreed that for the time being the government's involvement in wage bargaining would remain limited to leadership, coupled with the insistence that 'the TUC guidelines should be honoured in the spirit as well as the letter' (TNA CAB 128/56, CC (75) 10th Conclusions, 27 February 1975), despite the fact that this had proven wholly ineffective in the past. Lever was also unsure about an incomes policy that would lead to a contraction of aggregate demand by reducing real incomes, and he described it as an attempt to 'avoid an exchange crisis by policies of self-mutilation' (TNA CAB 197/50, Lever to Wilson, 26 March 1975). He argued instead for action along similar lines to those proposed by Wilson at Cabinet in February, which recognised that it was important to tackle the 'evil' of inflation, but also noted that contraction of the economy should be avoided in favour of 'acting vigorously to make the social contract more effective', and that any necessary incentives for industry should be provided at the cost of public, not private consumption (ibid).

Amongst ministers therefore, there was a wide-ranging acceptance that something needed to be done about inflation, but this was coupled with uncertainty about how an incomes policy could be made to operate without unduly damaging the economy and antagonising the trade unions. However, during May, the Treasury made a

strong case associating sterling weakness with the lack of confidence of overseas opinion in counter-inflation strategy, which argued that without an incomes policy there would be catastrophic consequences for the pound. On 14 May, PCC received a paper that once again argued it was time for the government to make a choice between living with inflation, allowing unemployment to increase, or introducing a new incomes policy (TNA T 277/3057, PCC (75) 55, 14 May 1975).

One again, this choice was presented as if there were no choice at all. In response to the suggestion of taking no action on inflation, it was noted:

> If "living with it" came to look like enduring a long period of double figure inflation, the situation might well become unstable socially and politically as well as economically. People would lose faith completely in the Government to exert any control over inflation and there would be a progressive loss of faith in money as a store of value […] the currency would eventually be destroyed, both internally and externally (ibid).

The option of using increased unemployment as a weapon against inflation was also discounted as a suitable keystone in counter-inflation strategy, as whilst it could have an important role to play in controlling wage increases, it would be insufficient on its own to have the desired effect, even if it were allowed to rise above the one million mark, which would also cause a significant degree of political discontent (ibid). On this basis, a subsequent Treasury paper concluded that 'the majority of us feel […] that the objections to a non-statutory no-norm policy are too strong to make it acceptable' (TNA T 277/3055, PCC (75) 56, 14 May 1975).

The £6 pay policy

Having presented the government with a 'non-choice' in light of the bleak prospects associated with alternatives to incomes policies, the Treasury also set about examining potential different forms of incomes policy. This included highlighting the difficulties of implementing tax-based incomes policies such as that proposed by the New Zealand economist, Peter Elkan. The Elkan scheme was 'a scheme to tax earnings in the whole economy in excess of some norm as a general surcharge on tax liability and recycle the proceeds in some subsidisation of the price level' (Wass, 2008, 110). The Short Term Economic Policy Group (STEP) noted that the premise was a simple one: 'since employees are taking too much from employers, they should be required to give the excess back' (TNA T 277/3076, STEP (75) 16, 25 June 1975). However, the apparent simplicity of the scheme concealed a more complex political and economic reality, based around the fact that it would require workers to pay a tax, described as a 'Pay Adjustment Factor', to their employers. This would no doubt be unpopular in itself, however, it was also the case that as this was 'not, and does not look like an ordinary tax […] the alleged preservation of free collective bargaining would be limited from this standpoint' (ibid). The use of taxation in an incomes policy was also inherently problematic, and it had been established back in February that before any tax could be levied it would be necessary to establish liability (TNA T 357/425, Note of a Meeting, 13 February 1975), and Wass (2008, 108) notes that on this basis, the Inland Revenue 'were strongly opposed to the idea of a tax on incomes additional to incomes tax.'

However, despite these concerns about the acceptability and practicability of an incomes policy, the TUC's position on the matter had begun to shift, and Michael Foot, who it has been suggested was recognised within the trade union movement as 'an honest and reliable interlocutor' (Flinders and Buller, 2005, 535; see also Harmon, 1997, 103), was able to report to MES that in his discussions with union leaders, it was increasingly accepted that there was a 'need for more widespread commitment to the pay guidelines' (CAB 134/3930, MES (75) 30, 21 May 1975). This softening of approach within the TUC was reflected by Len Murray's engagement with Denis Healey, Michael Foot, and Cabinet Secretary, Sir John Hunt, on an initiative designed to reduce the rate of inflation to 15 per cent by the end of the year, which would involve either the application of a general percentage norm, a threshold style system, or a flat rate (TNA PREM 16/342, Note of a Meeting, 4 June 1975). Discussion of the benefits of a flat rate policy had also occurred in the Downing Street Policy Unit between Bernard Donoughue and press officer, Joe Haines, who had made the case that for acceptability's sake, any incomes policy should be simple. 'Everybody', he argued, 'would understand what they could buy with £5 or £6' (Donoughue, 1987, 63). However, the flat rate policy was accredited to the initiative of Jack Jones of the TGWU within Whitehall, and the £6 flat rate idea was described as the 'Jack Jones formula' in Prime Ministerial briefs of 19 June (TNA PREM 16/342, Hunt to Wilson, 19 June 1975).

Throughout June, in tandem with the TUC's softening attitude, the Chancellor's position on incomes policy had also been hardening, and when he reported events in the foreign exchange markets to the Cabinet on 12 June, he took the opportunity to

use sterling to justify the need for a new incomes policy, noting that pressure on the pound had occurred 'against a background where British wage settlements were being made at four times the level of settlements in West Germany, and where British inflation was likely to run at more than double the rate in our principal competitor countries. There was an urgent need', he went on, 'for a new incomes policy' (TNA CAB 128/56, CC (75) 27th Conclusions, 12 June 1975). By 20 June, Wass (2008, 112) notes that Healey had made up his mind and 'gone out for a full-blooded Incomes Policy.'

However, at Cabinet that day, it was heard that 'the TUC were extremely unlikely to accept [a figure of 10 per cent] and even if they accepted it would find it almost impossible to ensure compliance' (TNA CAB 128/56, CC (75) 29th Conclusions, 20 June 1975). However, Healey was not deterred, and again invoked the external situation in order to make the political argument. He informed his colleagues that 'the economic situation of the country required the Government to be more drastic in its action than has been suggested', and that this meant keeping 'wage increases below 10 per cent, or a flat rate of £5' (ibid). The argument was also gaining broader acceptance. Shirley Williams, for instance, also noted that time was of the essence, and that a 15 per cent norm would not be acceptable because 'the country could not afford a wages increase norm higher than 10 per cent' (ibid). As a result, the Prime Minister noted in his summation that the meeting had produced a relative consensus on the need to swiftly arrange an incomes policy that could deliver a norm of 10 per cent, whilst making every effort to achieve this without resort to statute (ibid).

This was the crux of the issue. Despite agreement at the official and ministerial levels of the urgency of introducing a credible new pay policy, the problem of securing TUC support remained. These difficulties were borne out at a meeting with the TUC later in the day on 20 June, when the Chancellor once again emphasised the need to introduce an incomes policy because of pressure on sterling, whilst failing to reveal that it was the Treasury's intention to let the rate fall. He argued that failure to secure a 10 per cent norm would be disastrous for confidence and would fail to stop major sterling balance holders from carrying out their threats to diversify (TNA PREM 16/342, Note of a Meeting, 20 June 1975). Len Murray however, informed the meeting that 'he would not like to think that the TUC were being framed for a policy that they could not deliver' (ibid), whilst Hugh Scanlon of the Amalgamated Union of General Engineering Workers, frankly noted that 'as far as his own union was concerned, it could not go along with anything that implied a reduction in the standard of living of its members' (ibid). Jack Jones saw no better prospect for the success of such a tight incomes norm, suggesting that 'the prospect of anything less than 20 per cent was remote' (ibid).

However, just as the foreign exchange position had provided a convincing case for introducing an incomes policy of some kind to ministers and the TUC alike despite Treasury preferences for depreciation, on 30 June a further slide in the pound occurred which forced the issue of incomes policy to a swift conclusion. The pound had fallen 4 cents against the dollar on the day, closing at $2.18, which was below the threshold that the Kuwaiti and Saudi Arabian monetary authorities had indicated

was the limit of their tolerances, and both had suggested they would diversify their sterling holdings imminently (TNA T 358/209, Note of a Meeting, 30 June 1975). As such, Derek Mitchell advised that the government should make 'a very early announcement of incomes policy' (ibid).

This possibility was a discussed at Cabinet the following day, where it was agreed that the Chancellor would address the House of Commons in the afternoon with a statement designed to demonstrate the government's determination to get inflation down to 10 per cent by the third quarter of 1976, and that if a satisfactory voluntary agreement could not be reached, the government would be prepared to legislate (TNA CAB 128/57, CC (75) 31st Conclusions, 1 July 1975). Both Donoughue and Haines expressed concern to the Prime Minister that the Cabinet was 'being faced with an attempt by the Treasury to stampede it into a statutory pay policy', and that the proposed announcement was 'a straightforward announcement of such a policy' (TNA PREM 16/343, Donoughue and Haines to Wilson, 1 July 1975), however, the statement to the House went ahead as planned despite these objections.

Healey informed the Commons that if 'no agreement can be reached which meets these conditions, the Government will be obliged to legislate to impose a legal requirement on both public and private sector employers to comply with the 10 per cent limit' (Hansard, 1 July 1975, col. 1190), and Donoughue (1987, 67) notes that this paved the way for the rest of the summer to be spent agreeing the precise details with the TUC, arguing that the statement demonstrated that 'the famous Treasury "bounce" technique had been launched, with the Bank of England as a powerful

ally.' However, as Pliatzky (1984, 130) notes, this interpretation is objectionable on the simple grounds that it 'is another instance of talking about the Treasury as though the Department was somehow separate from its Ministers and could operate without them.'

Nor was it the case, as Flinders and Buller (2005, 535) have argued, that the £6 pay policy was simply the result of 'the convergence of interests of a small number of personalities for a limited period of time [that] allowed these "agents" to overcome the obstacles inherent within Britain's industrial relations institutions for a short time.' It is clear that the Treasury successfully manipulated the appearance of the external situation by presenting a slide in the pound as the result of a lack of confidence in British counter-inflation policy, despite the fact that it had been in favour of depreciation and limited intervention in the foreign exchange markets so it could occur. This argument was used at both official and political levels to make a decisive case, and resulted in a situation in which the TUC accepted that there was no alternative to an incomes policy because of market conditions. However, incomes policy was not the limit of the Treasury's aspirations for credibility, which also involved much tighter control over expenditure and a reduction in the PSBR.

Public expenditure

Like incomes policy, the Treasury had held preferences for cuts in public expenditure and a reduction in the PSBR since December 1974, however given the government's commitments under the Social Contract, expenditure issues were

highly sensitive, especially in light of the TUC's response to the April 1975 Budget. It had suggested that the principal theme of the measures had been to 'reduce the amount of money that the public sector would otherwise require to borrow', which would in turn 'increase the already growing level of unemployment' (MRC MSS.292D/560.1/13, Econ Ctee 8/1, 14 May 1975). In light of these feelings, reductions in public expenditure remained politically difficult, and the government addressed the matter in two ways: firstly, through the application of cash limits, and; secondly, by justifying cuts from the February 1976 Public Expenditure White Paper with reference to an external financing crisis, which led the government to draw from the first credit tranche of the IMF and the 1975 oil facility.

The most significant problem relating to public expenditure the government faced was the inadequacy of the system of planning and control that had stemmed from the Plowden Report, which was known as the Public Expenditure Survey Committee (PESC) system. As Wass (2008, 8-9) notes, PESC planned public expenditure 'in terms of the prices ruling for the items to be purchased at the time of the annual survey' during 'a regular annual drill […] in Whitehall.' One of the principal weakness of the PESC system was the lack of incentive that it provided for planners to be cost-effective, because as planning occurred in volume terms, no matter how much programmes were overspent, money would be forthcoming to make up the shortfall. This means that under inflationary conditions, 'the Treasury was asked, in effect, to underwrite the inflationary element in departmental spending' (ibid, 8).[5]

[5] On the weaknesses of PESC, see also Wright (1977, 143-4), Pliatzky (1984, 132), and Barnett (1982, 78).

The system was not only weak in theory, but had also shown to be inadequate by the outturn figures for public expenditure in comparison to planned expenditure. Pliatzky (1984, 131) has described the Treasury's attempts to keep public expenditure within limits during this period as a kind of Sisyphean task, in which it attempted to 'push public expenditure downhill, only to find it roll back up again to an even higher point.' However, he also notes that there were other factors at work in accounting for the rises in expenditure above the planned amount. He argues that 'it would have been astonishing if expenditure in 1974-75 had turned out as it had been planned three years earlier, with a U-turn and a change of government and the social contract in between' (ibid, 132). This implies that his view was not simply that the system needed reform, but that policy changes were also required. Nevertheless, it was the system that gained notoriety, firstly, for allowing public expenditure for the financial year 1974-75 to run at £5,000 million more than planned, as revealed by Wynne Godley to the Expenditure Committee of the House of Commons, and the following year, allowing expenditure to run at a level £1,600 million more than planned, eclipsing the £1,100 million cuts the Chancellor had made in his April Budget (ibid, 131-2).

Whilst Browning (1986, 70) records that the Treasury argued that the increases were accounted for 'mainly by policy changes which it had not seemed worthwhile to announce specifically', it was well aware of these systemic shortcomings, and as early as August 1974, it had been noted that because 'a programme of activity, or the defined aims of policy, are agreed in physical terms […] unless a change of policy is

agreed, the spending department gets pay and prices rises "for free'" (TNA T 353/145, Cash Limits, 15 August 1974). It was also recognised that this opened up the system to accusations that it was 'either positively feeding inflation or at least doing nothing to improve it', and that planning in cash terms would seem to have the advantage of promoting prudence and efficiency on the part of programme managers (ibid).

Despite the politically neutral appearance of introducing a scheme of cash limits across a broad range of expenditures, its reliance on the Treasury's ability to make an accurate prediction about the rate of inflation in the coming year meant that Treasury officials were reluctant to introduce it immediately. This is because making predictions about the rate of inflation would represent a gamble with potentially unsettling consequences that could undermine the whole basis of the system. For instance, if the limits were set too high, the incentives for programme managers to spend wisely would be lost, whereas if they were set too low, 'the pressure for some interim relief may be beyond containment and the system is brought into disrepute (for once allow the first fixed to be exceeded and no Department will ever believe in their immutability again)' (ibid). Even more significantly from a political point of view, and given the prevailing uncertainties about the rate of inflation, with limits set too low it was argued that 'the government would be risking *unpredictable and unplanned* cuts in its policies' (ibid, original emphasis).

The PCC shared this initial assessment of the difficulties of rolling out a system of cash limits when the issue of public expenditure control was discussed in February 1975. Nonetheless, it also suggested that the political difficulties that might result from the implication that the target volumes of some programmes might not be reached 'might be more defensible in a crisis situation' (TNA T 277/3054, PCC (75) 32, 25 February 1975), and here, just as was the case with incomes policy, it was clear that the Treasury's preference for depreciation could help a potentially unpopular policy measure gain acceptance. By the beginning of May, head of the Public Sector side of the Treasury, Sir Douglas Henley, was fairly certain such a crisis would be forthcoming, and noted that any action taken to limit its effects would inevitably involve adopting some form of cash control on public expenditure (TNA T 331/950, Henley to Pliatzky, 5 May 1975). Finally, by 19 May and in the same context of the Treasury's preferences for sterling depreciation that had helped it to get the issue of incomes policy back on to the agenda, the Chancellor informed his Cabinet colleagues that the Treasury had been instructed to begin examining the practicalities of planning public expenditure in cash terms (see TNA CAB 129/183, C (75) 63, 19 May 1975).

The decision to introduce a system of cash limits on two-thirds of voted government expenditure and local authority expenditure over which central government had no control was part of the Chancellor's statement on counter-inflation policy on 1 July (Hansard, 1 July 1975, col. 1190), and Barnett (1984, 77) notes that the introduction of cash limits 'was probably the most important change [on the public expenditure front] for very many years'. However, it is important not to overstate their

importance as part of short-term economic strategy. Barnett (ibid, 68) himself acknowledges that the statement on cash limits was 'short and fairly weak', and as Pliatzky (1984, 134) notes, 'cash limits could not in any event be introduced before the next financial year.' As such, whilst the Treasury's preference for depreciation and its refusal to allow the Bank to intervene substantially in the foreign exchange markets had allowed for inadequacies in the systems of wage determination and expenditure planning to be addressed by arguing that the markets would allow no other alternatives, the Treasury still believed that a substantial reduction in public expenditure was called for.

This was reinforced in light of the fact that despite the perception of the cuts in the April Budget as a step in the right direction, the Fund's managing director expressed a view that 'the proposals were less convincing than he had thought' when he was informed that the proposed reduction in the PSBR was by comparison with the 1975-76 forecast, and that when compared with the current year there would be an increase of £1 billion (TNA T 354/415, Note for the Record, 2 April 1975). In light of its preferences for public expenditure cuts, which were shared by the IMF, the Treasury began making a case for further reductions. This was based around the fact that there had been a deterioration in the rate of growth of GDP, which no longer looked likely to reach 3 per cent, and the fact that the acceptable timeframe for the correction of the balance of payments had been significantly shortened because of the extent of Britain's external indebtedness and the erosion of its credit rating (TNA T 277/3055, PCC (75) 49 (revise) 8 May 1975). These more pessimistic assumptions indicated that there would be a significantly reduced amount of

resources available for domestic personal consumption, which led the Treasury to conclude that if the government wished to keep the tax burden relatively close to 1974-75 levels, 'a very substantial cut would be required in public expenditure for the year 1979 – perhaps rather more than £3 billion at 1974 prices' (ibid).

This view was presented to the Cabinet on 22 May, in what Wass (2008, 119) describes as a 'long and argumentative' meeting. Whilst there was no prospect of the Cabinet agreeing to specific cuts at the meeting, Healey asked that ministers be prepared to identify cuts of £3,000 million in the PESC exercise so that when the time came, the government would have a range of options (TNA CAB 128/56, CC (75) 25th Conclusions, 22 May 1975). However, there were substantial dissenters. It was argued in general discussion[6] that because the measures would cause increased unemployment, government tax revenue would be reduced and the overall savings would be much less than the cuts proposed, and that as such it would be wiser to plan public expenditure in a full employment context (ibid). Benn also argued that there was 'a wholly feasible alternative policy based on import controls – which the Government would be compelled to bring in within a year in any case – combined with increased investment in the context of fuller employment' (ibid), but Wilson concluded the meeting by acknowledging the absence of consensus, whilst noting that 'only by asking officials to proceed with the expenditure survey on the basis put forward […] could they ensure that they would have available sufficient options later in the year should major cuts have to be made' (ibid).

[6] The minutes do not make it clear which Cabinet members specifically raised these points.

Securing agreement to plan for cuts should they be needed however, was one thing. Getting the cuts implemented was quite another, and this was a high priority for officials. The Treasury believed that 'a suitably chosen set of expenditure measures would help to give a much needed boost to the government's international reputation and creditworthiness', and that a well judged package would show 'that of their own volition they had taken a firm decision to put the economy right, and to subordinate purely political commitments to this overriding need' (TNA T 277/3056, PCC (75) 68, 25 June 1975). The external financing prospects offered just such an opportunity for the government to argue convincingly that its credibility amongst those overseas needed such a boost, when in July it was noted that funds may be needed before the end of the year to keep the sterling situation under control, and that 'only the IMF is capable of providing [finance] on the scale and terms which we are likely to need' (TNA T 354/415, Barratt to Wass, 30 July 1975).

External financing and the IMF loans

The possibility of drawing on the oil facility and the first-credit tranche was discussed in principle between Treasury and Fund officials in Washington D. C. on 14 and 15 August. The Fund once again expressed concern about the levels of the PSBR and DCE, and requested information about what measures the UK proposed to keep them down, however on the grounds that the drawings Britain intended to apply

for were for all intents and purposes condition free,[7] the most important thing to come out of the meetings was the fact that the Fund staff were not sure that Britain could show a demonstrable need to borrow from the oil facility, and noted that the ability to show a loss of reserves would alleviate this problem (TNA T354/416, Cassell to Fogarty, 18 August 1975).

Despite the Fund's initial impression that Britain did not need to draw on the oil facility, a review of the external financing prospects by the Overseas Finance Division in October suggested that Britain would have to acquire between £100 million and £900 million over the coming six months. It also argued that the higher figure was equally as likely as the lower, and that as such it was 'a matter of simple prudence that we should set out now to fill the gap (or the larger part of it) by a drawing of £575 million […] on the IMF oil facility' (TNA T 354/416, Mitchell to Wass, 15 October 1975). This view was supported by projections for future market and bilateral borrowing, and net sterling inflows, which were judged to be poor. As figure VI.3 below shows, if these sources of finance were not supplemented, it was predicted that Britain would suffer a loss of reserves of £502 million over six months, and on this basis, it was argued that 'it would seem imprudent to allow for

[7] Despite this, in discussions about the content of a possible letter of intent, UK officials were surprised to find the Fund's suggestions 'liberally peppered with "ceilings", "limits" and "targets"', however after noting that this kind of language appeared inappropriate for a low-conditionality drawing of the kind under discussion, managed to get 'most, but not all, of the offending words removed' (TNA T 354/416, Cassell to Fogarty, 18 August 1975, 3).

any further rundown as a deliberate element in external financing' (TNA T 354/416, External Finance: Prospects and Policy, 15 October 1975).

Figure VI.3, Overall Financing Prospect, £ million (not seasonally adjusted)

	Second Half 1975	Current Six Months*	First Half 1976
Financing Requirement (a)	113	-606	-725
FINANCING			
Foreign Currency Borrowing (b)	319	414	324
Net Sterling Flows (c)	-710	-310	-50
Total Financing (d) ((b) + (c))	-391	+104	+274
Reserves Loss ((a) –(d))	-278	-502	-451

Source: TNA T 354/416, External Finance: Prospects and Policy, 15 October 1975

*** Fourth quarter of 1975 and first quarter of 1976**

There were also concerns about the timing of any approach for a loan from the oil facility because it was available for the calendar year only, and because any UK drawing would have implications about the resources available for others considering drawing on the facility. As such, the managing director indicated that the UK should reach a decision by 26 October at the latest, and it was on this basis and the fact that should Britain not draw in 1975 resources would be lost, and not a critical external financing need, that the Treasury felt that an application to the Fund should be made at this time (ibid).

Therefore, it was on the basis that the external financing position was potentially difficult, but not imminently critical, and because the IMF resources would be lost to Britain once and for all at the end of the calendar year, that Healey held exploratory discussions with Witteveen on the prospects for a UK drawing at the beginning of November. By this stage, he had decided that he wished to draw on both the oil facility and the first credit tranche as a demonstration that Britain was 'firmly embedded in the international monetary system' (TNA T 386/69, Note of a Working Dinner, 3 November 1975). In these discussions, Healey informed the managing director that he was committed to tackling inflation with the £6 pay policy, however Witteveen continued to express concern about the size of the PSBR (ibid). On this matter, the Chancellor was once again reassuring, noting that the imposition of cash limits would add the effective control over public expenditure that had been lacking, and that he was aiming for a further cut of £3.75 billion at 1975 prices in the 1976 Public Expenditure White Paper that would affect targets for 1978-79 (ibid).

On 6 November, the Chancellor revealed to Cabinet that he intended to draw on both the oil facility and the first credit tranche on the grounds that Britain's external creditworthiness had still not improved enough to allow for market borrowing (TNA CAB 128/57, CC (75) 46th Conclusions, 6 November 1975). The intention to apply carried with it a number of implications, none more so than the fact that it represented the use of Britain's final unconditional sources of borrowing in the international monetary system. Therefore, despite the TUC's assertion that it had 'deep concern over the Government's arbitrary decisions in the public expenditure field over the last year', and its view that 'further cuts in public expenditure

concerning these services will be regarded as an intolerable attack on the living standards of working people and a fundamental breach of the social contract' (MRC MSS.292D/560.1/14, Econ Ctee 1/2, 8 October 1975), the government appeared to have maximum incentive to act to restore confidence if it was to have any chance of avoiding conditionality applied by the Fund as a result of needing to draw on the higher tranches in 1976.

Healey used this argument in support of cuts in the 1976 Public Expenditure White Paper at Cabinet on 13 November. He argued that Britain must show itself to be moving towards external balance because:

> it might well prove impossible in the interim to borrow overseas in order to finance the current account deficit, and the Government would then be forced to borrow from international institutions on conditions which would almost certainly include public expenditure cuts even more severe than those now contemplated (TNA CAB 128/57, CC (75) 48th Conclusions, 13 November).

To avoid such a situation, he argued that it would be necessary to cut public expenditure by £3,750 million in 1978-79 (ibid).

Barnett (1984, 80) notes that in light of Healey's threat of resignation over the issue, 'there was probably never any doubt we would achieve our target', however agreement was not reached easily. By 28 November Barnett had concluded his bilateral discussions with spending ministers, and a Cabinet paper was circulated informing ministers that savings totalling £2.6 billion had been agreed, leaving a further £1.15 billion to be found (TNA CAB 129/186, C (75) 137, 28 November

1975). In light of this, Douglas Henley wrote to Edmund Dell's Private Secretary to make the point that in his view 'the Chancellor should secure the whole of the £3,750 million […] not £3,600 million, £3,500 million or £3,400 million', and interestingly, given the relatively light conditionality associated with the loans Britain had applied to the IMF for, noted that this 'could make the difficult task of negotiating an acceptable letter of application for the IMF drawings less severe if the Chancellor can claim a major success on the expenditure cuts' (TNA, T 385/33, Henley to P.S. Chief Secretary, 3 December 1975).

The government had therefore made two related arguments for agreeing substantial cuts for 1978-79 from the 1976 Public Expenditure White Paper. Firstly, it had argued that Britain faced an imminent external financing crisis that required it to borrow from the IMF, because confidence was too weak for it to borrow elsewhere. Secondly, it argued that if even more substantial cuts were to be avoided in the future, Britain would have to restore this confidence by demonstrating rectitude. On this basis, Cabinet agreed to a further £1,033 million of cuts in its meeting on 11 December (TNA CAB 128/57, CC (75) 55th Conclusions, 11 December 1975), and in so doing created a situation in which the IMF executive board could not only approve the IMF loan, but could do so having 'commended the UK authorities for their political courage' (de Vries, 1985a, 466).

*

Conclusions

At the beginning of 1975, the Treasury had clear preferences for a return to formal incomes policy in order to tackle inflation, and for cuts in public expenditure to help bring the balance of payments into equilibrium at a faster rate and preserve overseas confidence, which were initially frustrated by political objections arising out of the government's commitments under the Social Contract. However, by the end of the year, it had made considerable progress on implementing both, and did so by suggesting that 1975 had been year of two crises – firstly in the foreign exchange markets as sterling fell in the spring and the summer, which it argued had made it absolutely necessary to agree an incomes policy and impose cash limits on public expenditure, and; secondly, in external financing, which it was argued, made it absolutely necessary to apply to the IMF, and therefore to cut public expenditure in 1978-79 in order to bolster Britain's creditworthiness amongst a rapidly shrinking pool of potential lenders.

However, this chapter has shown that 1975 was a year of two 'non-crises'. Firstly, it has demonstrated that the fall in the exchange rate that had occurred at the beginning of the year had been desired by the Treasury on the grounds that it would help improve the competitive position of British industry, that the Treasury had prevented the Bank of England from intervening decisively in the foreign exchange markets to arrest the slide, and that it had not resulted in substantial losses from the foreign reserves relative to their position at the beginning of the year. Despite these preferences, the fall in the rate was used as evidence that confidence in British

counter-inflationary policy was dangerously low, and used to justify the introduction of the £6 pay policy and cash limits on public expenditure, to which there had been substantial political opposition. Secondly, it has shown that the external financing difficulties at the end of the year were only anticipated, and based on forecasts subject to a wide margin of error. In light of these indicators, the application to the IMF was made not on the basis of need, which the Fund itself initially expressed doubts over, but because access to these resources would be lost if not drawn by the end of the calendar year. However, by presenting the application as a response to a further deterioration in confidence, the government was able to argue that it was absolutely essential for large cuts in public expenditure programmes to be agreed for 1978-79 if Britain was to restore confidence and avoid being forced to take even more drastic action in its search for further finance. By the end of 1975 therefore, the government's preferences for orthodox policies, and its intention to use strategies of depoliticisation to deliver them, was increasingly clear.

Chapter VII

Engineering depreciation, the 22 July measures and the application to the IMF, January – September 1976

In the previous chapter it was shown that by the beginning of 1975, the Treasury had strong preferences for incomes policy and public expenditure cuts, but had faced political opposition from the left of the Labour Party and the TUC. However, it had also recognised the fact that an impression of external crisis had the potential to help justify policies of retrenchment, and as a result was able to use a slide in the exchange rate that it believed was inherently desirable to secure ministerial and union agreement to a formal incomes policy in all but name, and had identified a potential problem for financing the external deficit in the upcoming year. This was used in order to justify a drawing from low-conditionality IMF facilities, and promoted the impression that should confidence not be restored, Britain would be forced to adopt more severe austerity measures, which helped to secure agreement for extensive cuts in the February 1976 Public Expenditure White Paper. It was also shown that during preparations for the drawing the Fund questioned Britain's need for the loan in terms of reserves loss, and that a principal reason for approaching the IMF was because funds available from the oil facility would be lost at the end of the calendar year.

This chapter demonstrates how the Treasury continued to manipulate perceptions of the external situation in order to secure further domestic retrenchment. It will show

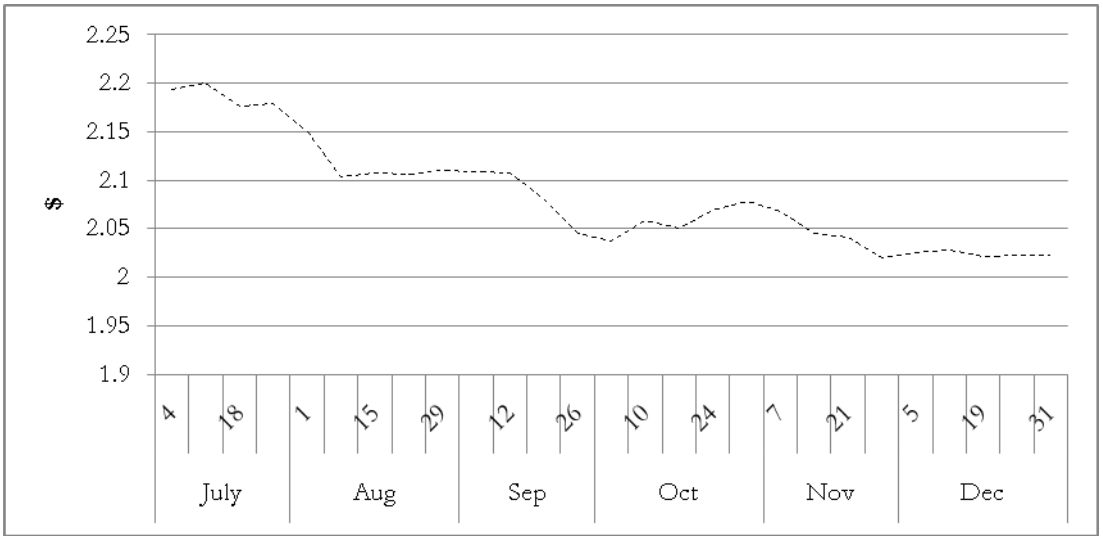
that whilst there were still sizeable sterling balances, the Treasury continued to favour further depreciation of the exchange rate and believed the risk of extensive diversification was tolerable if the rate could be brought down by 'autonomous forces.' As a result, when the pound came under pressure in early March, neither the Treasury nor Healey were concerned because it consolidated the need for incomes policy, and when the G10 suggested Britain take a short-term stand-by in June, ministers were provided with the strongest possible justification for further public expenditure cuts on confidence grounds if they wished to avoid a conditional drawing on the Fund. Despite securing these cuts in a package of measures announced on 22 July, they were not as substantial as officials had hoped, and it was once again argued that an approach to the IMF was absolutely essential on the grounds that there were no plausible alternatives given the continued need to finance the external deficit.

Depreciating sterling

As figure VII.1 shows, throughout 1975 sterling had fallen from $2.20 in the middle of July to a rate between $2.05 and $2.10, around where it stayed from October until the end of the year. Nevertheless, despite the achievement of a substantial depreciation, 1976 saw the Treasury once again actively engaged in discussions about the appropriate level for sterling in terms of the competitiveness of British industry. However, this project continued to present familiar difficulties because of the scale of the sterling balances, which were still over £7 billion in 1975-76 (Bank of England, 1977, table 19/1), and the size of the foreign reserves, which had fallen

from $6.2 billion in the first quarter of 1975-76 to $5.8 billion in the second quarter (ibid, table 23). The outcome of these discussions reflected the belief that 'the pound, at above $2, had been overvalued from the point of view of the competitiveness of British industry', and as such, within the Treasury there was a strong and widespread belief that further progressive depreciation was required in order to offset rising domestic industrial costs (Pliatzky, 1984, 143) despite the fact that the governor of the Bank of England had reservations about attempting to manipulate the currency downwards by market intervention (Burk and Cairncross, 1992, 22)

Figure VII.1, Sterling / Dollar spot rate, July – December 1975



Sources: *Bank of England Quarterly Bulletin*, compiled from 1975, table 27, 1976a, table 28 and 1976b table 29

As early as the middle of January, Treasury officials had noted that there was good cause to act to weaken the effective exchange rate by taking action on the MLR in order to maintain competitiveness (TNA T 382/2, Walker to Hedley-Miller, 13 January 1976), and in the middle of February, PCC heard the argument that not only would it be necessary to continue borrowing overseas until North Sea Oil came on

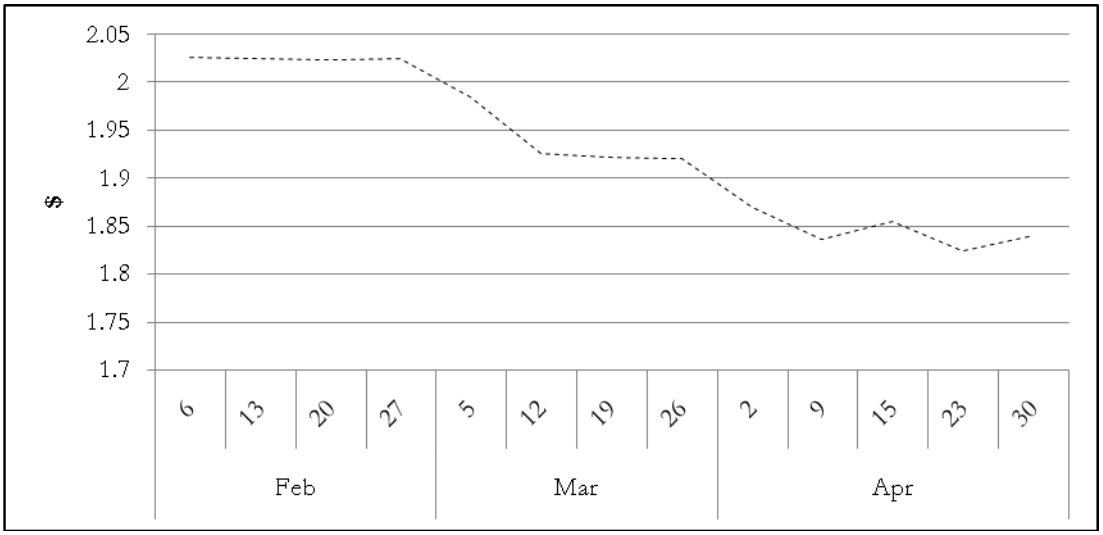
stream, but that an improvement in competitiveness would be required. At a meeting on medium-term economic strategy, the committee was informed that 'if we are seeking to achieve our objectives for both unemployment and the balance of payments a depreciation of about 20 per cent […] would be required' (TNA T 277/3175, PCC (76) 6th Meeting, 16 February 1976). Whilst the prevailing view was that Healey was unlikely to believe that the economic prospects were bleak enough to justify such a severe depreciation of the pound, the Permanent Secretary concluded that it would be unwise to count on some exogenous factor helping to improve prospects, and that the dilemma between improving competitiveness and scaling down the full employment objective could not be avoided on the grounds that 20 per cent was not likely to be achievable because of political objections, both at home and abroad (ibid).

With the rate at $2.02 on 20 February (Bank of England, 1976b, table 29), these figures indicate that the desired sterling rate was around $1.60, if both the government's balance of payments and full employment objectives were to be achieved. This view was confirmed at the following meeting of PCC on 18 February, however this target was tempered on practical grounds because it was noted that such a large depreciation would provoke an unfavourable reaction from the sterling balance holders, would open up Britain to retaliation from foreign competitors, and that if the government was unable to conceal its role in engineering the slide, aggravate trade union leaders and jeopardise agreements on the second round of incomes policy. Despite the belief that it was desirable for the exchange rate to fall more quickly, the extent of depreciation thought to be feasible over the

first half of the year was 10 per cent, and it was also noted that if this could be achieved with relative stealth, it would once again be possible to rally the TUC's support in defence of the pound (TNA T 277/3175, PCC (76) 7th Meeting, 18 February 1976).

The most significant policy change with regard to the sterling exchange rate in the context of continuing parsimonious intervention for smoothing purposes only, was a reduction in the MLR by a quarter of one per cent on 5 March 1976. This occurred after the Bank of England had sold pounds in order to cream off dollars on the previous day and to prevent a rise in the rate caused by a short-lived demand for sterling. That day the pound fell below $2 for the first time, breaching an important psychological barrier, and as figure VII.2 below shows, continued to fall, going below $1.85 at the beginning of April.

Figure VII.2, Sterling / Dollar spot rate, February – April 1976



Source: Bank of England (1976b) *Bank of England Quarterly Bulletin,* 16 (3), table 29

Browning (1986, 72) adroitly captures the orthodox interpretation of this policy change, noting that the Bank's actions contributed to market opinion that believed British authorities were selling on a falling market in order to deliberately force the rate down, which seemed to be confirmed by the interest rate cut. He notes that these events can be interpreted in two ways: firstly, that the Treasury and the Bank of England had failed to react in a timely fashion to ongoing events in the foreign exchange markets, or; secondly, that this represented a failure in a planned strategy to depreciate sterling to about $1.90. Either way, he concludes that 'the impression was given, and remains, that the Bank of England and the Treasury between them could have handled the affair better' (ibid, 96). Burk and Cairncross (1992, 22-3) also share this view, arguing that because the rate did not stabilise at around $1.90, the Treasury cannot be said to have achieved its aims, and Pliatzky (1984, 143) likewise notes that 'nobody had wanted or bargained for the slide in the exchange rate which now took place and could not be halted.'

These accounts however, significantly overstate the extent to which ministers and officials perceived the events in the foreign exchanges in March as indicative of crisis or policy failure. Whilst the Bank of England noted that 'a quite exceptional amount of guidance has been necessary for agencies, radio and television', which advised that the Bank had been in the market to an undisclosed extent, but 'discounted any talk of an engineered "devaluation"' (BE 3A 38/4, GLBM to McMahon, 15 March 1976), the Treasury's continued pursuit of depreciation led to an entirely positive account of sterling's depreciation immediately after the slide began. PCC was informed on 11 March:

> In the morning of the previous Thursday sterling had been particularly strong and in accordance with agreed tactics the Bank had creamed off dollars into the reserves to prevent the rate rising […] There was heavy selling pressure in the afternoon and the view formed that the Bank was selling on a falling market though this was not the case. On Friday there was a change in MLR which was largely the result of market forces. This confirmed the view that HMG were trying to get the rate down (TNA T 277/3175, PCC (76) 14th Meeting, 11 March 1976).

The Permanent Secretary went on to describe the resultant fall in the rate as a fortuitous event, but noted that due to the sophisticated understanding of the UK's exchange rate strategy amongst foreign observers, it was becoming increasingly difficult to conceal the ways in which the desired depreciation could be achieved without unleashing the sterling balances (ibid). As such, he noted that whilst any overt measures to bring the rate down were still to be avoided, it would be necessary to 'extract as much advantage as possible out of the present situation […] and not allow the rate to creep up' (ibid).

The account that the Chancellor gave to his Cabinet colleagues on the same day was not as forthcoming with regards to giving ministers an informed view about the details of the strategy for sterling. His comments were prefaced by informing other Cabinet members that no public comments should be made about the rate without his express permission, and after the receipt of his clearance for any proposed remarks, ministers should still be aware of the degree to which a careless statement could exacerbate the situation (TNA CAB 128/59, CC (76) 9th Conclusions, 11 March

1976). Healey then noted that the slide in the pound had occurred in a context in which Britain had not intervened in the foreign exchange markets other than to smooth the rate since the adoption of floating rates in 1972, and that the fall had ultimately been triggered by 'an unfounded rumour that Nigeria was selling her sterling [which] led the market to conclude the Government was trying to bring the rate down [and was] reinforced on Friday 5 March, when the Minimum Lending Rate was reduced by one-quarter per cent (a change which it was beyond the Government to prevent after lunchtime on Thursday)' (ibid). He furthermore added that reports on the British economy by the OECD suggesting that sterling needed to fall by 5 per cent had added to the cautious feeling about the British government's intentions for sterling amongst market actors (ibid).

A week later the Chancellor reported the situation to his colleagues in MES. In advocating the continuation of a medium-term economic strategy focussed around the operation of a tight incomes policy and a depreciation of the currency, Healey noted that the approximate 4.5 per cent fall in the rate over the previous few days was not a matter of concern. In his view, 'it would for the present be wise to take any opportunity that offered to let the pound sterling float downward' (TNA CAB 134/4048, MES (76) 6th Meeting, 17 March 1976), and that the events on the foreign exchange markets had been 'accidental, but fortunate' (ibid). Healey also noted that the scale of the pound's fall was nearly half of what the Treasury deemed necessary for the first half of 1976 (ibid), however, as shown above, it would have been more accurate, given the government's balance of payments and full employment

objectives, to have described the fall of 4.5 per cent as 50 per cent of the depreciation deemed to be *feasible,* but only 25 per cent of that deemed *desirable*.

As the slide continued the Treasury advised the Chancellor that it would be prudent to draw on the stand-bys agreed with the IMF the previous December. At a meeting with the overseas executive director of the Bank of England, Kit McMahon, on 20 April, the Bank was advised that the Treasury was 'now minded to recommend to the Chancellor that steps should be taken forthwith to draw the first credit tranche' (TNA T 381/15, Barratt to Jordon-Moss, 20 April 1976). The following day, the Chancellor's Principal Private Secretary, Nick Monck, was copied into a minute from the Overseas Finance Division noting that:

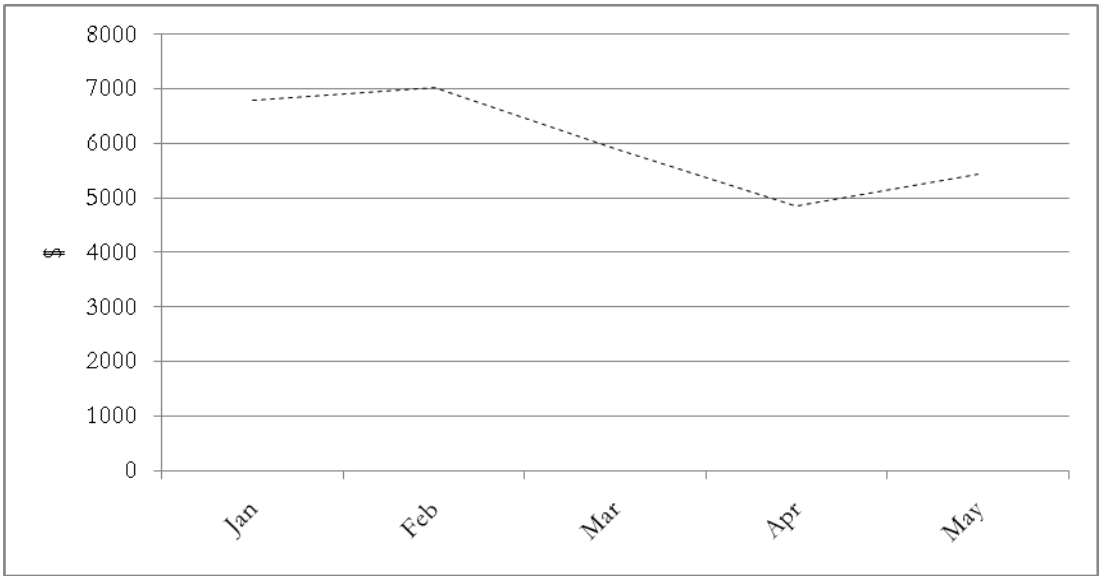
> Immediately after the Budget, there did not seem to be the necessity to rush at once into a drawing in the interests of reducing actual net currency losses during April. But with recent further losses, and with no immediate prospect of new developments which might change the mood of the market, it seems sensible now to make arrangements for an early drawing (TNA T 381/15, Littler to Jordon-Moss, 21 April 1976).

In light of this, on 22 April the Chancellor agreed to the proposal to draw SDR 200 million under the first credit tranche agreement (TNA T 381/15, Monck to Littler, 22 April 1976), and the remainder of the SDR 700 million had been drawn from the Fund by 12 May (see de Vries, 1985a, 466).

Nevertheless, there was still no undue concern from the Treasury about the path of the exchange rate. Indeed, Britain continued to enjoy the benefits of an ongoing

depreciation attributed purely to market forces, one official noting that 'the present sterling crisis, like the one last year, is helping incomes policy in the short run [and] the chances of getting a satisfactory "bargain" with the TUC this summer is improved' (TNA T 378/21, Britton to Posner, 26 April 1976). Indeed, on 12 May, when the final drawings were made from the low conditionality stand-bys from the Fund, Sir Bryan Hopkin wrote to Wass noting that the recent falls in the exchange rate had been entirely welcome, and that in combination with promising signals from the TUC on the second round of incomes policy, it offered 'the prospect of a marked and sustained improvement in competitiveness' (TNA T 378/21, Hopkin to Wass, 12 May 1976). The IMF's executive board also felt that there was little cause for concern about the sterling rate, noting that the market's interpretation of events in the UK had been entirely irrational and had contributed to sterling becoming undervalued, which was being addressed by a rise in the MLR to 10.5 per cent (IMF EBM/76/65, 23 April 1976).

Figure VII.3, Foreign Reserves, January – May 1976, end month



Source: Bank of England (1977) *Bank of England Quarterly Bulletin*, 17 (2), table 23

However, despite the fact that the fall in the rate had been entirely welcome, and remained short of what the Treasury deemed desirable in terms of the government's employment and balance of payments objectives, it had still been forced to manage the practical aspects of the depreciation, namely by ensuring that the exchange rate strategy was not so transparent as to threaten the incomes policy or unleash the sterling balances. This had required the Treasury to authorise the Bank's use of the foreign reserves in order to conceal the extent of official complicity in the depreciation, and as figure VII.3 above shows, the level of the foreign reserves showed a steep decline from a figure around $7 billion at the end of February throughout March and April, reaching a nadir of below $5 billion before being bolstered by the drawings on the IMF stand-bys in May.

The Medium Term Assessment, public expenditure and the June stand-by

In light of the fact that the Treasury and the Chancellor viewed the depreciation in sterling at the beginning of the year as inherently desirable, of more immediate concern for the Treasury were the implications for policy of the Medium Term Assessment (MTA). The MTA was forecast on the basis of realistic assumptions that the PSBR would peak at £12.3 billion in 1977, or 10.3 per cent of GDP, only falling to £8 billion, or 4.8 per cent of GDP by 1980 (TNA T 277/3177, PCC (76) 35, 25 May 1976). These figures suggested a strong financial case for further public expenditure reductions on confidence grounds given the importance of borrowing for the overall medium term strategy for financing the balance of payments, however other predictions in the MTA suggested that it would not be possible to make as

strong a case on resources grounds, with GDP predicted to grow by over 4 per cent in 1977 and 1978 and by over 3.5 per cent in 1979 (ibid). The conclusions therefore were that the MTA 'provided no justification for overturning the general strategy on public expenditure' (TNA T 277/3175, PCC (76) 22nd Meeting, 14 June 1976), although some members of the committee did believe the case could be made by arguing that it would be 'important to err on the side of making available more resources than necessary' in order to ensure there would be sufficient room for export led growth (ibid).

The fact that the MTA did not provide a decisive resources based justification for further expenditure cuts which could be used to bolster the strong financial arguments was problematic from the government's perspective in light of the fact that it remained clear that there was a continuing need to moderate the public sector's claim on resources in order to meet the demands of external financing until North Sea Oil came on stream. This was especially the case given that the Cabinet had felt it was easier to justify cuts to the TUC if and when it could be shown that there was pressure on resources. However, when the increasing demands being made on the contingency reserve were discussed at Cabinet during April and May, it was once again pressure on the sterling rate, despite preferences for depreciation, that were used in order to make the case for resisting further claims by spending departments.

At the second Cabinet meeting of Callaghan's administration, Barnett had revealed that with only one month of the financial year passed, the contingency reserve had

only £93-142 million remaining that was not subject to firm or agreed bids, and he noted that 'if all the other claims on the reserve were accepted, then public expenditure would be out of control' (TNA CAB 128/59, CM (76) 2nd Conclusions, 29 April 1976). He noted that the associated difficulties with making offsetting savings meant that it would be preferable to simply resist any new claims than it would be to make new reductions (ibid), and the Chancellor informed his colleagues that it was essential for action to be taken, because:

> There was a serious danger that foreign confidence would collapse if the Government allowed the public expenditure limits which they had set themselves to be exceeded […] and all of this meant that the Cabinet must resist to the maximum extent possible any additional claims on the contingency reserve (ibid).

Despite the accepted difficulties of fostering acceptance for new cuts, a meeting on expenditure commitments between public finance officials from spending ministries and the Treasury on 4 May noted a general acceptance 'that no programmes could be sacrosanct in these circumstances' (TNA T 371/87, Jones to Pliatzky, 4 May 1976). Furthermore, it was the Treasury view that officials from other departments had not limited their sympathies on public expenditure difficulties to suggestions of imposing moratoriums on capital building projects, increases in fees and charges and reductions in subsidies. Officials had also proposed a 1 per cent reduction in cash limits, a negative supplement for the Rate Support Grant, and the postponement of Regional Development Grants, which the Treasury had not considered on its list of possible savings (ibid). More significantly however, it was noted that officials 'did

not want to rule out savings that would require legislation and there was even a willingness to recognise that transfer payments, e.g. pensions and unemployment benefit might have to be cut in real terms as part of a general reduction in living standards' (ibid).

The acceptance of the need to make politically tough expenditure decisions by a broad range of officials was a further significant step away from the Social Contract in terms of economic priorities. However, whilst the Chancellor advised the Cabinet that if the scale of excesses in local authority expenditure were to become public knowledge there would be serious damage to British credibility, he argued that at the current time he did not personally feel that it would be appropriate to make further cuts in expenditure, but that as a bare minimum it would be necessary to demonstrate that the White Paper targets were going to be met on the grounds of overseas confidence (TNA CAB 129/189, CP (76) 15, 14 May 1976). He noted:

> There is a considerable body of opinion, not merely among our political opponents, but also among those in the financial sector on whose confidence we depend both at home and abroad, which believes that we ought to be cutting public expenditure this year; and that if we fail to do this of our own free will, we will sooner or later be compelled to do so by the force of circumstances (ibid).

The financial case for cuts therefore clearly resonated at the political level given that confidence in Britain's medium term economic strategy was essential if it was to be able to continue borrowing to finance the deficit, however, given the resources case

projected by the MTA, it looked as if making an overwhelming case to Cabinet on the basis of financial arguments would be difficult. However, the proposal by the G10 to extend a $5.3 billion stand-by to the UK for six months in light of the slide in sterling provided British officials and ministers with the opportunity to use the external financing constraint it imposed in order to lock Britain in to multilateral solutions to its difficulties and therefore help nullify support for the left's AES. It also had the added benefit of making resources cases against cuts seem irrelevant in comparison to financial cases for them because of the implications of a scenario in which Britain were to be unable to repay in December.

Healey (2006, 427) recalls that he was able to get the June credit without difficulty, however Burk and Cairncross (1992, 44) are correct to note that he had been 'disingenuous when he insisted that there were no strings attached to the stand-by.' As Hickson (2005, 89) explains, a bilateral loan of this kind would normally be made available for 'a period of three months, renewable indefinitely at three-monthly intervals', and that as such, application of the strict time limit should be interpreted as a strategic aspect of the United States' foreign economic policy in order to force Britain under Fund conditionality in December. However, meetings concerning the arrangement of the loan do not indicate that a majority of officials were against short-term financing, and show that some key actors, including Healey, already fully accepted the need to borrow from the IMF in 1976, and that American suggestions for an accelerated approach to the Fund were rejected principally on political grounds.

On 4 June, when various proposals to ease the management of sterling were discussed, there was considerable support from British officials for courses of action that involved immediate drawings on the conditional tranches of the Fund, or a contingent liability to do so should Britain be unable to repay any short term credit received. At a meeting with the Prime Minister, Healey reported that his discussions with Lever, the Bank of England, and the Treasury, had led to the proposal of three potential courses of action.[1] The first was favoured by the Governor of the Bank, and involved an immediate application to the Fund which would inevitably have conditions attached to it with regards to expenditure, and the Chancellor felt that it was this aspect of the strategy that had appealed to Richardson (TNA PREM 16/832, Note of a Meeting, 4 June 1976). The second option was to try and ride out the crisis on the basis that sterling was now undervalued, and that given time, it would inevitably float upwards. The Chancellor reported that this was the view of Sir Douglas Wass (ibid). The final proposal was to activate a $3 billion swap with the Federal Reserve Bank of New York and the EEC, which would allow the British authorities to intervene effectively, and contained a contingent liability to go to the Fund. The Chancellor noted that this was his favoured view, and that of Harold Lever (ibid).

Therefore, both the Chancellor and the Bank were in favour of accepting either direct or contingent Fund conditionality at the beginning of June, and Healey also informed Callaghan that in his view, there could be 'no doubt that they would need to cut public expenditure next year' (ibid). In response, the Prime Minister said that

[1] Notes of these meetings can be found in BE 2A 77/1.

for the short term at least, the government should hold to its position of emphasising the importance that existing public expenditure targets were met, and make no reference to additional cuts until after 16 June and relevant Cabinet discussions. He noted, 'there would be a dilemma next year about public expenditure and the PSBR […] but there was no need to say anything more at the moment' (ibid). However, British plans to arrange a stand-by were overtaken by the initiative of Jelle Ziljstra, the President of the Netherlands National Bank and 'the "head prefect" within the central banking community' (Wass, 2008,198), although Wass suggests that this initiative was probably the result of a suggestion to Ziljstra made by Arthur Burns. On 4 June he telephoned the Bank 'to enquire informally of the governor whether it would be helpful if an attempt was made to mobilise substantial backing for sterling' (BE 2A 77/2, Governor's telephone call with Ziljstra to confirm G10 standby, 4 June 1976). Richardson informed him that he had 'precisely the same thought in mind and had been planning to call Dr. Ziljstra and his other European colleagues that afternoon' in order to mobilise $1 billion funds from the Europeans to supplement $2 billion that could be mobilised through the FRBNY swap (ibid).

However, when the Chancellor met with Edwin Yeo on the following day, there was a suggestion that Britain should make an accelerated approach to the Fund, to which Healey responded by saying he could accept no more than a contingent liability to take such action, on the grounds that the 'whole relationship between the Government and the Unions would be jeopardised' (TNA T 381/10, Note of a Meeting, 5 June 1976). However, the Chancellor also informed Yeo that he wished to make public expenditure cuts for the financial year 1977-78 on the grounds that

this would make Britain eligible for borrowing from the higher tranches of the Fund, although he hoped that in the event such cuts were made that this would be unnecessary (ibid). In the short term however, it was his aim to have access to 'a very large sum of money, since the larger it was the less likely it would be to use it' (ibid). In light of the initiative by Ziljstra, Healey was able to announce to the House of Commons on 7 June that a $5.3 billion stand-by had been arranged, and that 'if any drawing on them could not be repaid by the due date, Her Majesty's Government would be prepared to seek further drawing from the International Monetary Fund' (Hansard, 7 June 1976, col. 915).

Wass (2008, 350) notes that the June stand-by 'was an initiative of the Chancellor of the Duchy of Lancaster' and that 'there was very little involvement by the Treasury or by the Bank at working level.' He goes on to note that 'experts in those institutions had, throughout the period 1974-76, insisted that the only worthwhile credit the UK should seek should be medium- or long-term' (ibid, 350). 'They did not', he suggests, 'want to face the refinancing problem which short-term credit presented' (ibid, 350). However, whilst the loan was undoubtedly arranged hastily, did not receive the kind of extensive contingency planning that the Treasury undertook in other policy areas, and British officials clearly held a range of views on the desirability of short-term credit, they do not appear to have made the kind of vigorous substantive objections that Wass' account implies. As such, the six-month time limit applied to the June stand-by should not unquestionably be seen to represent a condition enforced on a reluctant or ignorant UK government; it is clear that the conditions were accepted in full knowledge that there would be every

possibility that Britain would have to cope with the fullest extent of Fund conditionality later in the year. In this respect, the June stand-by formed an important part of a holding strategy that allowed the government to negotiate political constraints to public expenditure cuts that it thought were necessary on confidence grounds regardless of any resources case against them, and in light of the sense of urgency that conditions attached to the G10 facility implied for creating an impression of rectitude in British policy, the Treasury was able to play a strong hand it its advocacy of further fiscal measures in July.

The case for retrenchment: Treasury orthodoxy

Momentum for further expenditure cuts gathered at a political and official level throughout June, as Britain drew on the $5.3 billion stand-by, making it more important that action was taken in order to restore overseas confidence in sterling if there was to be any prospect of avoiding a conditional Fund drawing. However, because of the degree of aversion to expenditure cuts in the left of the PLP, achieving them required a good degree of political manoeuvring, and in the days immediately following the announcement of the June stand-by, the Chancellor continued to express his objections *in principle* to any further cuts. At the Ministerial Committee on Economic Strategy (now re-initialled EY) on 7 June, he reported the situation to his colleagues. Healey noted that in the previous week sterling had been under great pressure, and that this had been coupled with pressure from the City, the opposition, the IMF, and the Bank of England, to introduce immediate cuts in public expenditure, but that he had so far been able to resist them

because the statement issued by the central banks that had provided the loan had associated sterling's weakness with disorderly market conditions, and noted that the pound was now at an unjustifiably low level (TNA CAB 134/4025, EY (76), 5th Meeting, 7 June 1976). A similar message was relayed to the Cabinet on 10 June, with Healey emphasising that he had 'resisted pressure to make immediate cuts in public expenditure and that 'he had no intention of cutting public expenditure in the current year' (TNA CAB 128/59, CM (76) 8th Conclusions, 10 June 1976).

However, at both meetings, the Chancellor's statements on his principles about public expenditure were augmented with a realistic appraisal of what would be necessary *in practice*. This diverged considerably from the ideal scenario, and reflected the established Treasury preferences for reducing the PSBR by making cuts in public expenditure. In the course of discussion at EY it was argued that despite his ability to resist immediate calls for cuts in current expenditure, so far as the exchange rate went, the figure of $1.70 was to be regarded privately as 'a figure as a minimum level below which the rate should not be allowed to fall, even at the cost of adjusting economic policy' (TNA CAB 134/4025, EY (76) 5th Meeting, 7 June1976).[2] The Chancellor also informed his colleagues that there would need to be a reduction in the PSBR for 1977-78, either through increases in taxation or reductions in expenditure (ibid), and at the full Cabinet meeting, Healey noted that 'Ministers would need to consider the level of expenditure in future years when the

[2] This was despite the assertion earlier in the year that the desired rate for sterling, if both the balance of payments objectives and the full-employment objectives were to be obtained was around $1.60.

report of the Public Expenditure Survey was available in July' (TNA CAB 128/59, CM (76) 8th Conclusions, 10 June 1976). On 15 June, general discussion at EY once again reflected the view that 'it might well be necessary to cut back on other demands of the economy – eg from public expenditure – to make room for exports' (TNA CAB 134/4025, EY (76) 6th Meeting, 15 June 1976). Furthermore, the recognition of the necessity for further cuts was clearly shown by the fact that it was noted that should it become necessary for Britain to go to the Fund, 'this should be after, and not before, the adoption of policies which they would require' (ibid).

The Treasury also believed that further cuts in public expenditure were necessary for 1977-78, and at PCC on 21 June, Douglas Wass noted that they had become inevitable on financial grounds, but that it would be necessary to make 'a very strong case, which went beyond asserting merely that our creditors would demand it.' This was because there was likely to be substantial resistance as unemployment was already high, and it would be argued that a more politically acceptable way of cutting the PSBR would be to increase taxation (TNA T 277/3175, PCC (76) 24th Meeting, 21 June 1976). His case therefore centred around three key points. The first was that external creditors wanted to see the PBSR cut, and wanted to see this achieved through public expenditure cuts; secondly, he noted that pressure on resources in the manufacturing sector may arise during the year and that action should be taken pre-emptively as the opportunity presented itself, and; finally, that any delay would either mean the whole burden would have to fall on taxation, threatening the pay policy, or that expenditure cuts would have undesirably disruptive effects (ibid). However, the main case for public expenditure cuts

remained the extent to which the medium term strategy was dependent on borrowing in order to finance the deficit, and PCC noted that a reduction in the PSBR would 'improve the UK's chances of obtaining further finance from the IMF [and ease] the difficulty of financing so large a PSBR in 1977-78' (TNA T 277/3175, PCC (76) 25th Meeting, 23 June 1976).

Despite the accepted view that a reduction in the PSBR through public expenditure savings was desirable, there was less unanimity of opinion on the size of any potential package. Leo Pliatzky argued that 'it was very doubtful whether the Cabinet could agree on cuts amounting to more than £1 billion, which would do real damage to the fabric of the public services' (ibid), but it was noted that there was a real possibility that this would not be sufficient on either confidence or resource grounds. Alan Lord, Head of the Treasury's National Economy Group, argued that 'in order to free resources for the upturn, a £2bn cut in public expenditure would be desirable', which could be adjusted through taxation if the deflationary effects proved to be too great (ibid). Sir Derek Mitchell also said that size of 'the desirable cuts was nearer to £2bn than to £1bn', as did Russell Barratt from the Overseas Finance Division, who noted that 'there was a real risk that the IMF and the markets would judge that cuts of £1bn were inadequate, with the result that the government would be forced to take further action in disorderly conditions' (ibid). Lord Kaldor went even further than this, writing in a note to Denis Healey that he felt that the 'announcement of £1 billion expenditure cuts for 1977/78, however composed, will come as an anti-climax', and argued that with the addition of a tax element, the package announced should 'be in the range of *£3 billion plus* for 1977/78' on the

basis that 'it is much better, if an announcement is to be made, to announce a programme of action which is *bigger* than expected rather than one which (even if it is believed to be genuine) is *smaller* than what people think is necessary' (TNA T 364/17, Kaldor to Healey, 1 July 1976, original emphasis).

With support for an increasingly large fiscal package emerging from the Treasury, Sir John Hunt wrote to the Prime Minister to advise him that the stand-by facility arranged in June had only bought time, and that without being 'seen to be taking the necessary action the next sterling crisis could well be upon us well before the expiration of the stand-by period' (TNA PREM 16/833, Hunt to Callaghan, 24 June 1976). He furthermore advised Callaghan that recently produced forecasts had indicated that a cut in the levels of public expenditure would be prudent, but that because irrational market opinion believed that the PSBR was too high, resources cases for or against cuts were becoming increasingly irrelevant because sterling would remain vulnerable until these views were changed by a substantial reduction (ibid). The gathering support for further public expenditure measures therefore required a further round of discussions of economic strategy at the full Cabinet level in order to make the case, however, this also required making a substantial case against alternative strategies involving import controls, notably the AES.

The case against retrenchment: the AES

The AES had emerged from the ideas of Stuart Holland expressed in *The Socialist Challenge*, which argued that Britain's economic crisis was a result of the state's

failure to fundamentally restructure the relationship between capital and labour in a structural context in which there had emerged 'a new mode of production [which] divorced macro policy from micro structure' (Holland, 1975, 14). Writing of the Labour government of 1964-70, he argued that 'its capacity to control the economy was always in question', and suggested that the rise of multi-national firms had locked the economy in to an irreversible trend towards monopoly because the government lacked the means to manipulate the distribution of resources and investment towards a truly social-democratic national interest (ibid, 29-30). As such, a fundamentally revised approach to managing the economy was required, which would have to restructure the power relationships governing the way in which investment decisions were made.

The most coherent accounts of the AES that appear in the published literature did not emerge until the 1980s, and argued that the success of the strategy required a fundamental restructuring of the state's key institutions, including the police, the armed services, and the civil service, as part of an expansion of the role of the state in economic management by changing the character of Britain's ties with the world economy (Rowthorn, 1980, 88-90). Francis Cripps (1981, 93) also noted that the strategy would require the 'overthrow of the Establishment of top civil servants, managers and professionals', whilst the London CSE Group (1980, 22) agreed that it would be necessary to reorganise 'production and the regulation of class conflict that is inherent in our economic system.' Most significantly for day-to-day management of the economy however, it was believed that the expansion of the economy alone would simply exacerbate the tendency to import commodities, and that 'given the

depth of the problem it is inconceivable that higher exports alone can be sufficient, and something must therefore be done about imports' (Rowthorn, 1980, 93). A rejection of the liberal approach to free trading was understood to be the key that would give Britain's 'geriatric' industries space enough to be run-down whilst new industries were given time to establish themselves on the basis of sufficient investments to make them internationally competitive (London CSE Group, 1980, 96-7).

However, in government there was a long standing scepticism about the potential efficacy of direct measures to correct the balance of payments on principle, with Harold Lever noting in November 1975 that 'the liberalisation of international trade is not just a philosophical aspiration bequeathed to us by Victorian professors of political economy. It is plain common sense' (TNA CAB 197/50, Lever to Wilson, 20 November 1975). Even whilst acknowledging that the imposition of selective import controls would result in the government being 'warmly applauded by many of our supporters, as well as by chauvinistic opinion which always welcomes a nationalistic gesture' (ibid), he noted that there were three strong objections to import restraint. Firstly, he argued that controls would do little to help employment in the short-run. Secondly, the prospect of retaliation would lengthen the recession and make it more difficult to improve the standard of life for the British people. Lastly, he argued that access to international lines of credit would be severely limited, which would in turn reduce the prospects for achieving domestic reflation in the immediate future, (ibid).

The Chancellor of the Exchequer also shared these views, and had noted at the beginning of January that import controls would be slow to take effect and that their eventual success would be entirely dependent on the acquiescence of others, which could not be guaranteed. Furthermore, the suggestion that the imposition of generalised import controls would help the British balance of payments was dependent on the assumption that British industry would undertake the required rationalisation when it was equally likely that it would simply allow industries to ease up behind a wall of protection unless it could be guaranteed that they would be in place for up to five years (TNA CAB 134/4048, MES (76) 12, 29th January 1976). The Chancellor made a similar case in an MES paper of 12 March, which questioned the assumptions of the AES with regards to its benefits for the efficiency of British industry (see TNA CAB 134/4048, MES (76) 32, 12 March 1976), and in May, a paper was circulated to EY arguing that the kind of import restrictions implied by such an alternative strategy represented 'a step back to the kind of controlled economy we had after the war', and would contribute to the creation of a 'psychology of shortage' (TNA CAB 134/4025, EY (76) 19, 27 May 1976).

At EY on 15 June, Healey once again presented a critique of the AES, which was formed of five points. Firstly, he argued that import controls would produce only small effects in the first two years when Britain was likely to be in greatest difficulty; secondly, they would not be acquiesced in by those overseas; thirdly, they would prove to be an additional burden to domestic industrial capacity because they would require a diversion of production from exports; fourthly, it would not be certain that British industries would take advantage of the protection that import

controls afforded them, and; finally, because they would have to remain in place for at least four years, there was a risk that the potential change in government would result in industrialists lacking faith in the continuation of the policy (TNA CAB 134/4025, EY (76) 6th Meeting, 15 June 1976). Nonetheless, in spite of these criticisms, as the debate over a possible public expenditure package intensified throughout the summer, it was the issue of cuts versus protection that was at the centre of discussions.

The 22 July measures

Whilst the Treasury had identified a strong case for public expenditure cuts on financial grounds, which was accepted by the Chancellor after being aired at various committees, and had produced an array of arguments against import restrictions which were also subscribed to by Healey, it had not yet made the case with sufficient force in order to convince the more left-leaning Cabinet members that its arguments were robust.[3] On this basis, Tony Benn circulated a paper to Cabinet dated 2 July arguing that powerful financial institutions were demanding the proposed public expenditure cuts, that they would harm Labour's supporters by raising the level of unemployment, and that because of the lags involved, would have the most severe

[3] The trade unions had also expressed concern about the government's policies. At the beginning of 1976, it had been noted that 'many trade unionists would become disenchanted with the Social Contract and the approach to industrial strategy and improved economic performance if unemployment reached the levels forecast' (MRC MSS.292.D/560.1.15, Econ Ctee 4/2, January 1976).

consequences in the year directly preceding the general election (TNA CAB 129/190, CP (76) 43, 2 July 1976). He argued that the resources based case for cuts was not convincing, and that whilst there was the prospect of bottlenecks emerging in some industries, these would be best dealt with on a selective and direct basis rather than through across the board cuts which would bear no correlation to industry's needs (ibid). In addition to direct, selective assistance to industry, Benn proposed the government should 'strengthen its capacity to restrict inessential imports, both by preparing to introduce compulsory selective measures and by negotiating import ceilings with major importers and foreign suppliers', and increase taxes on imported commodities including alcohol, tobacco and oil (ibid).

However, despite criticising the Chancellor's proposals for cuts at Cabinet on 6 July, the Prime Minister noted that 'whether on resource grounds or for confidence reasons, there seemed to be a majority in the Cabinet which favoured an early statement by the Government of action to reduce next year's public sector borrowing requirement' (TNA CAB 128/59, CM (76) 13th Conclusions, 6 July 1976). In anticipation of a full discussion of the measures, and the opportunity for other members to circulate their own papers to Cabinet on the matter, it was clear that Tony Benn did not cut an isolated figure, with the Secretary of State for the Environment, Peter Shore, suggesting that the arguments that had been made against import controls may have been overstated. Without proposing an alternative as detailed as that of Benn, he noted that a measured approach to creating a package that would reduce Britain's dependency on foreign borrowing whilst commanding support for prices and incomes policies at home was the most appropriate solution,

and that under the circumstances, 'the situation of deficit, falling reserves and high unemployment precisely fits the terms of Article XII of the General Agreement of Tariffs and Trade and Article 108 of the Rome Treaty and would justify in international economic law the imposition of general restraints on imports' (TNA CAB 129/190, CP (76) 49, 13 July 1976).

However, Healey once again employed familiar arguments against import restraint, and argued that because Britain had drawn on the $5.3 billion stand-by there was no alternative to cutting expenditure if confidence was to be restored to a sufficient degree to enable Britain to avoid a conditional Fund drawing. He wrote:

> The $5.3 billion standby credit which we secured at the beginning of June has barely given us breathing space. I have had to draw a substantial amount from this standby in order to create the market conditions in which we can take the necessary decisions in an orderly way […] The rate has been steadier in the last fortnight […] mainly because of the belief that we shall be announcing important policy decisions concerning public expenditure and the PSBR for 1977/78 by the end of this month. If such an announcement is not made or is found to be inadequate, then sterling will again come under pressure on a scale which we cannot be confident of resisting even if we use all our present resources (TNA CAB 129/191, CP (76) 52, 13 July 1976).

Failure to undertake this action, he argued, would mean that in a worst case scenario, Britain would have to draw on the IMF simply to repay the June stand-by, which would leave it with no lines of credit available to finance the deficit in 1977 and

1978 at all, which, he argued, would mean that the IMF would undoubtedly enforce measures 'beyond those that would be announced this month' (ibid).[4]

On this basis, Healey was adamant that it would be critical to get the PSBR down to around £9 billion, or 6.5 per cent of GDP. This implied a reduction of £1.5 billion from the forecast level, and he suggested that because real take home pay had fallen by approximately 5 per cent since the first quarter of 1975, it would be undesirable for a significant amount of this to come from tax increases. This meant at least £1 billion would have to come from public expenditure in order to satisfy foreign opinion that British policy was moving in the correct direction and prevent outcomes that were expected to be even worse for all concerned (ibid). When the Chancellor put this case to Cabinet, Shore argued that there still had been 'no argument to show that cuts of £1,000 million would be sufficient to re-establish confidence in our economic policies [and] the package would therefore be a first instalment only and that was what made it so unacceptable' (TNA CAB 128/59, CM (76) 15th Conclusions, 15 July 1976). However, despite allowing others the opportunity to put their views to Cabinet formally, there was no extensive debate about the adoption of an alternative strategy at the meeting, and in summation the Prime Minister said that

[4] Healey made the same arguments at a meeting with the TUC on 14 July, noting that 'early action was required to prevent a run on sterling because if a run did occur it could use up the stand-by credit and force Britain into borrowing from the IMF […] and would almost certainly force more severe expenditure cuts', although the TUC responded by saying that there should be 'no rush to cut public expenditure' (MRC MSS.292.D/560.1/16, Econ Ctee 12, 14 July 1976).

the ‘criticism of the Chancellor’s strategy had not been matched by convincing arguments in favour of any alternative course: indeed all alternative courses would seem to involve public expenditure cuts of at least equal size [and] he did not accept the view that the present package was merely a first instalment’ (ibid). Furthermore, he did not believe that continuing discussion would yield a unanimous view, but that there was a clear majority in favour of announcing a PSBR target of £9 billion for 1977-78 and cuts of £1,000 million before the recess (ibid).

On 16 July the TUC rebuffed the Chancellor’s arguments by suggesting that ‘the confidence of sterling holders was not the only confidence that had to be considered’, that the ‘confidence of trade union members in their leadership was crucial to the success of the social contract policies’, and that it ‘did not believe that there was an economic case for cuts in public expenditure’ (MRC MSS.292D/560.1/16, Econ Ctee (S) 13, 16 July 1976). However, with the Cabinet considering the composition of a package of measures, the Treasury, the Chancellor, and the Prime Minister, had made a convincing case that public expenditure cuts were required because of the fall in the exchange rate and the conditions attached to the June stand-by. They argued that if the rate was not stabilised the conditions of the stand-by would otherwise force the government to adopt more severe measures as part of an IMF package, even though large sections of officials and economic ministers had been in favour both of the depreciation, and the recourse to short-term financing and the contingent implications for conditionality that came with it.

The Cabinet began its discussions of the makeup of savings on 19 July, and had agreed reductions of £952 million by 21 July, which, it was argued, would carry more conviction than a round £1,000 million cut in the sense that it did not appear to be an arbitrary attempt to appease market opinions, and looked as though the government had taken account of the arguments made by the TUC and other interests at home. As a result, Callaghan suggested that the Cabinet meet later in the day in order to discuss measures that could supplement the public expenditure element of the package in order to bring the PSBR to £9 billion, and make the final decision on the adequacy of the £952 million expenditure cut (TNA CAB 129/59, CM (76) 19th Conclusions, 21 July 1976).

Denis Healey then put a further proposal for supplementary measures to the Cabinet in a paper dated 21 July. He argued that 'there was a powerful feeling in the Party, which I am sure the Government share, that this month's package must at least be sufficient to do the job' (TNA CAB 129/191, CP (76) 56, 21 July 1976). On this basis, he proposed a 2 per cent surcharge on employers' National Insurance contributions to begin in January 1977, and argued that 'without the surcharge there is a serious risk that the package will prove insufficient' (ibid). This element of the package was the subject of greater Cabinet controversy than the public expenditure portion, because despite the acceptance in principle that meeting the PSBR target of £9 billion was desirable, the consideration of a tax element to supplement public expenditure cuts had not been taken into account when other decisions had been made. Tony Benn argued that 'the proposal completely transformed the context in which the Cabinet had discussed the proposals for cuts in public expenditure' on the

grounds that both 'the TUC and the Labour Party were prepared for a $1 billion package [and now] they were suddenly to learn that the Government's package was twice as big' (TNA CAB 128/59, CM (76) 20th Conclusions, 21 July 1976). He reiterated the view that the government had a protectionist alternative that had not been seriously considered, and in discussion it was argued that 'if the Cabinet had known that such a proposal might form part of the package, they might well have argued for a very different selection of public expenditure cuts' (ibid).

Nevertheless, these arguments did not carry sway with the Cabinet because time had become a critical factor in decision making. It was noted that there was 'a general public expectation of a statement the following day […] and it simply was not possible now to go back again over all the ground which the Government had covered in the last four meetings (ibid). The meeting therefore ended with the Prime Minister's assertion that whilst the addition of the tax element would create opposition, he did not think it would strain relations with the trade unions to breaking point. As such, there was a majority within the Cabinet that believed that 'if action were to be taken, it should be on a large enough scale to avoid any likelihood of further trouble in the autumn, and that there was therefore a balance of opinion in favour of imposing the surcharge on employers' National Insurance contributions' (ibid).

One issue that was not resolved during discussions of the July measures however, was the adoption of a monetary target, which had long been an ancillary

consideration for British officials. In March, the Bank had considered the significance of monetary aggregates, and noted that the out-and-out monetarist:

> simply asserts that a change will alter *pro rata* – though only after a long and variable delay – the flow of monetary demand […] he also asserts that since the volume of real output is to an large extent determined by non-monetary factors […] changes in the flow of monetary demand will, over time, be closely reflected in the inflation rate (BE C 40/1429, Targets for Monetary Policy, 19 March 1976).

The problem in so far as the Bank was concerned was that monetarists had no explanation of the mechanism through which changes in monetary demand were reflected in the inflation rate, or how it occurred in practice. The Bank noted that monetarists simply say that 'the facts […] prove that it does: you can rely on the lessons of experience and do not need to ask why' (ibid), but that 'most economists do not find this satisfactory as an intellectual stance' (ibid).

Despite this continuing uncertainty over the relevance of monetary aggregates, it had been recognised in April 1975 that a drawing from the higher tranches of the Fund would require a commitment to DCE, which the Chancellor did not believe would be a problem politically (see TNA T 354/415, Bridgeman to Gray, 22 April 1975). However the Monetary Policy Group noted that the establishment of targets for its constituent parts, including the PSBR and sales of public sector debt, would be difficult administratively and may require politically unsettling public expenditure cuts if they were to be met (see TNA T 354/415, MPG (75) 8, 30 April 1975). This remained the judgement in July, and explains the exclusion of a monetary target as a

publicly announced portion of the package (see TNA T 386/116, Bridgeman to Wass, 14 July 1976) despite the view of Sir Bryan Hopkin and Gordon Richardson that a target should be announced for confidence reasons (see TNA 386/116, Hopkin to Wass, 15 July 1976, TNA 386/116, Richardson to Healey, 21 July 1976 and BE C 40/1430, Richardson to Healey, 21 July 1976).

Although on balance it was thought best to exclude a target for a monetary aggregate from the July statement, the agreement of public expenditure cuts had paved the way for the Chancellor to address the House of Commons on 22 July announcing that although the recovery of the economy was expected to bring the PSBR down to £10.5 billion, 'given the economic prospect as we now see it […] the PSBR shall be reduced to £9 billion or less' (Hansard, 22 July 1976, col. 2012). He went on to tell the House that the government had avoided making mechanical cuts across all programmes, and emphasised the fact that the government had 'deliberately decided to maintain the social security benefits like pensions so as to provide the maximum support to those in need here at home' (ibid, col. 2013).[5]

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[5] Interestingly, despite his vocal opposition to the measures at the Cabinet meetings, Benn recorded in his diaries that although he was instructed by Callaghan to sit on the front bench during the statement and presumed that he looked as though steeped in gloom, he was 'sound asleep and […] didn't hear any of the Questions or Answers' (Benn, 1989, 600).

The IMF application

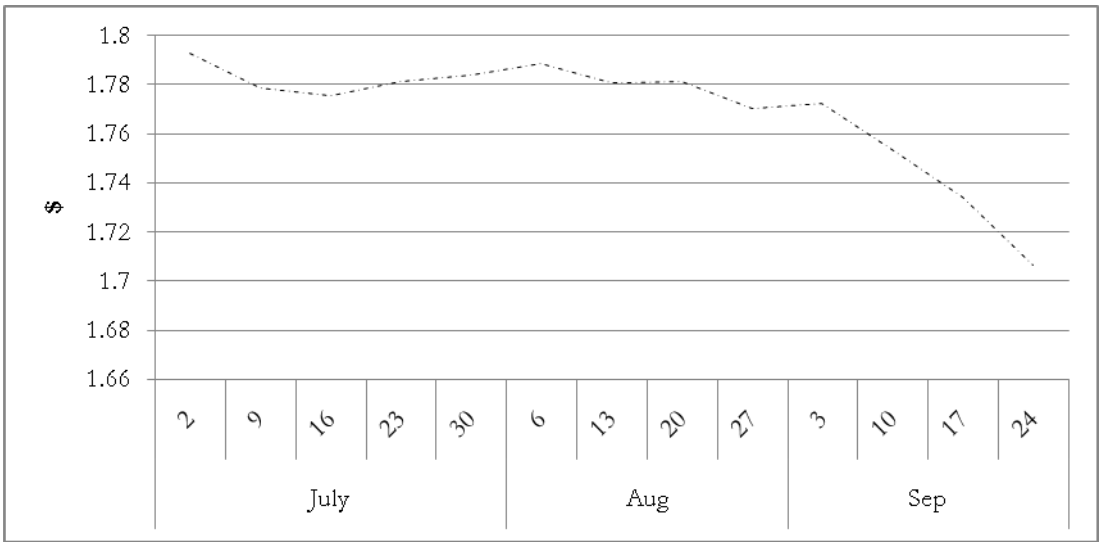
Having secured political agreement to a substantial package to reduce the PSBR to £9 billion by arguing that the weakness of sterling, Britain's obligations under the G10 stand-by agreement, and the inadequacy of alternatives had made the package absolutely essential, preparations for a Fund drawing began almost immediately. The IMF staff report from the 1976 Article VIII consultation had noted that 'there is no question that [British] economic strategy required a substantial reduction in the fiscal deficit but, because of high and still rising unemployment, there are different views about the timing of the action' (IMF SM/76/153, 7 July 1976).[6] This was clearly reflected in the political debate over the 22 July measures, but appeared to have been resolved with the Chancellor's announcement of the package to the House of Commons. However, on the day after the announcement, preparation for an application to the higher tranches of the Fund were already beginning within the Treasury, an official from the Overseas Finance Division writing to the Chancellor's

[6] At the Article VIII discussions on public expenditure, Finch from the IMF noted that all of the difficult decisions the government had made would be to no avail if further expenditure cuts in the region of £3 billion were not made, and Bridgeman from the Treasury noted that the difficulty they were having was to judge when they would have to occur (BE 6A 399/1, Note for the Record, 20 May 1976). On the Fund's closing statement, it was noted that the Fund had been predictable, and 'concentrated on the need to reduce the PSBR urgently', and that the size of the reduction required 'may be quite large' (BE 6A 399/1, Note for the Record, 26 May 1976).

Principal Private Secretary, noting that it would not be possible to turn the process into a charade, and that agreements would have to be made covering the balance of payments, the public finances and monetary aggregates (TNA T 381/15, Littler to Monck, 23 July 1976). He noted that when, not if, Britain became involved in negotiations with the IMF, 'the programme we present must be defensible' (ibid).

However, these preparations had begun despite the fact that there had been relatively few recent tremors in the foreign exchanges, and as figure VII.4 below shows, the sterling / dollar spot rate had remained relatively stable throughout July and August in a band between $1.76 and $1.80, with the reserves having fallen to $5,029 million by the end of August (Bank of England, 1977, table 23).

Figure VII.4, Sterling / Dollar spot rate, July – September 1976



Source: Bank of England (1977) *Bank of England Quarterly Bulletin,* 17 (2), table 29

This period of stability however, did not prove to be long lasting, and by early September pressure on the rate had re-emerged. At this time a paper was circulated to PCC arguing that there would be no feasible alternative to an application for the

conditional tranches of the IMF on the grounds that there was expected to be a large financing gap, with the current deficit forecast at $1.5 billion for the second half of 1976 and $3 billion for 1977, in addition to an increasingly large deficit on the structural capital account (TNA T 277/3178, PCC (76) 53, 3 September 1976). Of the three possible ways of financing the deficit – increasing sterling holdings, public sector borrowing, and drawings on multilateral facilities – it was argued that none had good prospects. It argued that despite the current large interest rate differential, it was unrealistic to expect any large inflows into sterling, and that public sector borrowing could 'be expected to meet only a part of the requirement and is forecast to decrease in 1977' (ibid). As a result, there was 'still a substantial gap in each period to be met by recourse to multilateral facilities or the reserves' (ibid). The paper concluded that the 'financing gap is too large to be bridged by market or Government borrowing either bilaterally or from the EEC; and we do not believe it is realistic to look for a renegotiation of the G-10 short-term stand-by.' Furthermore, it was noted that even if this were possible, 'it would entail going to the Fund early next year immediately before the Budget in even less propitious circumstances' (ibid).

Once again the Treasury displayed an awareness of the difficulties that would be caused by an autumn approach to the Fund. Firstly, there was no doubt that the IMF would want to see the UK commit to the adoption of policies it perceived to be 'safe', whereas for political reasons the government would want to avoid having difficult decisions with regards to economic-management placed at the centre of the public debate and subject to foreign conditionality (ibid). Nevertheless, the message

of the document was clear, and by now familiar: if the government did not take action of the kind suggested by the Treasury, ministers would simply be postponing the inevitable, and when the adjustment eventually had to be made, it would be more painful.

By 9 September, events on the foreign exchanges had served to consolidate the Treasury's argument, as an increasing amount of foreign reserves had been spent in defence of $1.77, and the Prime Minister made the decision that 'he did not favour continued heavy spending to defend the rate' (TNA T 277/3175, PCC (76) 31st Meeting, 9 September 1976). However, this reserves loss provided the Treasury with the justification for further re-prioritisation of economic policy objectives, as Wass informed PCC on 14 September that there was a need to emphasise two over-riding objectives, which were 'securing an improvement in the current balance and finding adequate sources of finance in the interim; [and] secondly, making the pay policy stick' (TNA T 277/3175, PCC (76) 32nd Meeting, 14 September 1976). The implications of this, he argued, were that the 'need to reduce unemployment and the industrial strategy would have to be put on the back burner for the time being', and this view was broadly shared by other members of the committee (ibid).

Leo Pliatzky went on to make the case that 'economically there could be no doubt that a major downward adjustment was still needed, including further reductions in public expenditure', but that there were major political barriers because 'even holding public expenditure at the current time was a sufficiently large problem' (ibid). In combination with the fact that 'the Chancellor was in any case hooked on a

money supply target' (ibid), the political difficulties of expenditure cuts made the possibility of a monetary package look more attractive, however, given the inevitability of negotiations with the Fund, the Overseas Finance Division noted that 'plainly further unequivocal deflation would be helpful' (ibid).

In early September therefore, the Treasury believed it was necessary to apply to the Fund, and there was also substantial opinion that further deflationary action was required, which could not be taken immediately because of the potential political consequences. However, the post-July package forecasts in the MTA showed that the measures had not been as effective as hoped, and that despite the reductions, the PSBR was projected to be £10.8 billion for 1976 and £9.9 billion for 1977 (TNA T 277/3179, PCC (76) 55 (revise), 15 September 1976), which was above the critical target for confidence the Treasury had identified in July. This served to consolidate the view that the external financing requirement was unmanageable and that further expenditure reductions would be required.

These forecasts would be a further dent to overseas confidence, and therefore served to damage Britain's creditworthiness, which was inherently problematic in light of the expected deficit on current account of £3 billion for both 1977 and 1978, which added a medium-term argument for going to the Fund to supplement the short-term arguments that focussed on the difficulties the government would face when the $1 billion already drawn from the G10 stand-by had to be repaid in December (ibid). The Overseas Finance Division therefore argued that not only was the Fund drawing essential in light of the immediate situation, but that Britain's medium-term

financing problems would remain, making the Fund drawing 'the indispensible key to further borrowing, whether from official or from market sources' (ibid). The argument that Britain had no prospect of financing its deficit over the coming two years without accepting the need to apply to the Fund carried with it several policy implications. Firstly, Britain would have to undertake not to introduce generalised import controls, but most significantly, it would have to make commitments to quantitative, quarterly targets for the PSBR and DCE, in order to get approval for the loan, which as a bare minimum would require it to meet the £9 billion PSBR target already announced (ibid).

Healey finally outlined the case for an early approach to the IMF in a paper for EY on 23 September. He outlined three principal difficulties for economic strategy with regards to external financing and the balance of payments. The most substantial of these was the fact that before support for the pound had been suspended on 9 September, intervention in the foreign exchange markets had reduced the level of foreign reserves to below $5 billion. Secondly, drawings of $1,030 million from the G10 loan would need to be deducted from this figure, and that for practical purposes the reserves were insufficient from the perspective that they were 'not even the equivalent to two months' imports' (TNA CAB 134/4026, EY (76) 41, 23 September 1976). Finally, Healey noted that the deficit on capital account was projected to be £3 billion for 1977, and on the basis of speculative projections, was not predicted to improve substantially throughout 1978 (ibid).

Healey's recommendation therefore was that an application to the IMF should be made in October for all of Britain's remaining entitlement under the Fund, with negotiations scheduled to occur in November before an initial drawing could be made in early December in order to repay the June stand-by before the end-month reserves announcement (ibid). He noted that it would be the government's aim to reach agreement with the Fund on the basis of existing fiscal and monetary policies, but that irrespective of how the negotiations with the Fund progressed, it would be necessary to pay close attention to monetary aggregates, and that it may be necessary to take further measures to tighten the money supply (ibid). Finally, it was noted that it was necessary for the government to consider 'the implications of further changes in fiscal policy (including the adverse effects on employment) against the implications of any possible alternative strategy' (ibid). On the basis of these arguments, EY agreed on 23 September that alternative courses of action should be considered as contingencies for the eventuality that negotiations with the IMF broke down, but that in the meantime, the Chancellor should be authorised to open negotiations with the Fund.

Conclusions

The agreement to apply to the IMF for a conditional drawing at the end of September concluded an important nine months for British economic strategy. This chapter has shown how, at the beginning of the year, the Treasury continued to favour the depreciation of sterling. It has also shown that the Treasury had clearly defined preferences for further cuts in public expenditure that were shared by the Chancellor,

and that the superiority of cuts over proposed alternative strategies was emphasised on the grounds that alternatives would limit Britain's ability to finance the deficit in the medium term because they would severely damage Britain's creditworthiness, expose Britain to retaliation from overseas competitors, and distort incentives to invest in domestic industries. Having made the case that there really was no manageable alternative to expenditure cuts, political objections were overcome at Cabinet level by arguing that the decline in the rate and the need to repay the short-term G10 stand-by had made it essential to restore confidence if there was any chance of a conditional Fund drawing being avoided, and allowed for the measures of 22 July to be agreed.

Finally, the chapter has shown that the 22 July measures were not as extensive as the Treasury had hoped, and that by early September there was strong official opinion that further deflation would be required, coinciding with pressure on sterling and a decline in the reserves. These events were used in order to make a robust case for going to the Fund, and which would undoubtedly require more measures of the kind the Treasury desired. Therefore, economic policy-making continued to be driven by the use of market rhetoric to conceal government preferences for the exchange rate and to overcome political objections to the public expenditure cuts desired in order to allow Britain to continue financing the deficit, and by arguing that any alternative course of policy would logically result in more severe austerity. However, the clearest example of the government using market rhetoric and multilateral institutions in order to make a convincing case that there was little alternative to its

preferred strategy of fiscal rectitude tied to multilateral borrowing was to come during the IMF negotiations in the final quarter of the calendar year.

Chapter VIII

The IMF negotiations, October – December 1976

In the previous chapter it was shown how the Treasury continued to favour the depreciation of sterling and reductions in public expenditure at the beginning of 1976, despite increasing trade union hostility to cuts in the previous year. It also demonstrated how, just as the sterling and external financing 'crises' in 1975 were used in order to legitimise the introduction of incomes policy and cuts in the 1976 Public Expenditure White Paper, the fall in the exchange rate in March and the contingent implication to go to the Fund attached to the G10 stand-by arranged in June, were convenient for the Chancellor in building a case for a further round of public expenditure cuts. This was made on the basis of the need to restore confidence for the purposes of financing the deficit, and effectively locked British policy in to a multilateral solution on the grounds that the alternatives were not feasible. However, it was also shown that the cuts achieved in July were not of the magnitude the Treasury had desired, and that the MTA forecasts were then cited as demonstrating an imminent need to make conditional drawings from the IMF.

This chapter will show how the views of the Treasury officials and the IMF were very similar, and demonstrates how the Chancellor and his officials were able to negate political opposition to a decisive round of public expenditure cuts and the introduction of monetary targets by associating the package with IMF conditionality. The chapter begins by reviewing reaction to the IMF application, and shows how an

alternative proposal to negotiate an arrangement to guarantee the sterling balances was treated as of entirely secondary significance by both the British Treasury and its overseas counterparts. It then reviews preparations by UK ministers and officials for the Fund's visit, followed by an account of the negotiations with the IMF, which is divided into three phases. In phase one, there appeared to be a significant degree of difference between officials of the Treasury and the Fund, however this reflected the different forecasts used by each team and the limited negotiating brief ministers had authorised. It also shows how the views of Treasury officials were similar to those of the Fund when revealed to their ministerial superiors. In phase two, attention turned to the ministerial level and concentrated on winning the political argument for the proposed measures. This involved once again making the case against alternative strategies, which was achieved by arguing that the logic of the financial markets would make even more severe austerity measures essential in the event the AES was adopted. Finally, in phase three, it was necessary to close the negotiating gap on the second year of the package, which was achieved by introducing contingent elements into the British commitments, and therefore required no substantive concession to be made either by British policy-makers or the IMF.

Reaction to the application and the sterling safety net

The turbulence on the foreign exchanges that had led to the Bank's withdrawal from the foreign exchange markets on 9 September and contributed to the decision to make an application to the Fund continued throughout the month. As the Labour Party Conference began on 27 September, at which the government was defeated on

its public expenditure plans, the Chancellor was preparing to travel to Hong Kong for a meeting of the Commonwealth Finance Ministers (Hickson, 2005, 101). However, as sterling fell to $1.63 on 28 September, Healey thought that the risk of travelling was too great, and 'decided to return from Heathrow as he did not want to be out of contact on his journey' (ibid, 101). In light of these events, Healey announced his intention to apply for the additional tranches of borrowing from the Fund on the following day, which led to a slight recovery of the pound to just over $1.66 (see Bank of England, 1977, table 29).

Edwin Yeo was particularly pleased with the Chancellor's decision to apply to the Fund, and telephoned Healey to congratulate him on 'announcing the application to the IMF and gave him his good wishes' (TNA T 381/16, Note for the Record, 29 September 1976). He also suggested that there had been a number of reasons why the exchange rate had improved, and would continue to do so. In Yeo's view, in the end, 'greed would overcome fear', 'the market had been heartened by the cancellation of the Chancellor's travel plans', and finally, 'the market had welcomed the announcement' (ibid). Reaction to the announcement however, was not universally favourable. Tony Benn (1989, 616) noted in his diary that 'the smell of 1931 is very strong in my nostrils', and when the TUC discussed the issue with government ministers on 16 October, it expressed concern that real factors in the economy were being de-prioritised in favour of simple monetary factors, and argued that the government should take 'resolute action in showing international financial institutions that they would not be forced into taking action deleterious to the UK's economic recovery' (MRC MSS.292D/560.1/17, Econ Ctee 3/3, 16 October 1976,

pages). Instead of taking the course favoured by those financial institutions, the TUC instead advocated an import deposit scheme, a review of the system of food subsidies, which was to be phased out, and the introduction of a two-tiered interest rate, which would provide a favourable rate to those borrowing to invest in British industries. 'A more imaginative approach was needed', it argued, 'as jobs were being lost in the immediate situation' (ibid).

It was precisely these kinds of representations, and their acceptance by the government, that the Governor of the Federal Reserve Bank of New York, Arthur Burns, believed was at the heart of the problem in British economic policy-making. On hearing of Britain's application to the IMF, he made it clear that he felt that there was still work to be done before British economic policy could be considered to be back on track. Kit McMahon noted that he had received a number of unsolicited comments from Burns on UK policy and sterling. He had been informed that Burns felt that 'there was no hope for us until we satisfied the world's financiers', and that 'Mr. Healey did not yet understand this unpalatable fact [and] an application to the IMF was no good – "Britain does not want another loan"' (TNA T 381/16, Comments on the UK and Sterling, 3 October 1976). Burns' prescription for Britain involved three elements: firstly, Britain should abandon 'all this nationalisation nonsense'; secondly, the government needed to 'give [its] people some incentive'; and lastly, he said it would be necessary to 'reduce "these awful public deficits"' (ibid). Furthermore, when McMahon attempted to explain the political difficulties that the Prime Minister and the Chancellor had been facing, and identified the progress they had already made, it was noted that Burns 'brushed [his] remarks

loftily aside, saying that we could not go on being "run by the trade unions" and that the British people, having a great fund of common sense, would respond and make any necessary sacrifices when they were shown the right policies' (ibid).

However, the progress that British policy had made since the end of 1974 demonstrates the extent to which the Treasury and the Chancellor had been working towards restoring the profitability of industry and reducing the public sector's claim on resources, but by gradual means borne of the need to recognise the potential for such policies to exacerbate social and political conflict at home. Harold Lever however, had come to the view that the arrangement of a safety net for the sterling balances was required, and would provide a lasting solution despite the fact that the Basle agreements of 1968 had proven to have exacerbated difficulties rather than contributed to an orderly run-down of the sterling balances. Significantly however, Callaghan also believed that a sterling safety net of some kind would significantly ease some of the problems of British economic management, because he 'had come to the conclusion that the reserve status of sterling had been the cause of instability in sterling when he had been the Chancellor of the Exchequer in the 1960s, and was also convinced that this was the cause of the current crisis' (Hickson, 2005, 150).

As figure VIII.1 below shows, the total of private and official sterling balances was over £7 billion at the end of March 1976, but had been subject to a steady run down throughout they year that was reflected in the slide in the value of sterling. In light of the problems caused by the sterling balances, the idea of arranging some kind of guarantee facility to reduce Britain's vulnerability to lapses of confidence in the

markets had been under consideration for some time,[1] but had been shelved on practical grounds, and the difficulties of arranging such a scheme were no doubt consolidated by the failure of the Basle agreements to help run the balances down.

Figure VIII.1, Sterling Balances, March – December 1976, £ million

		Official	Balances	Other	Balances	Total
Year	Date	Total	Oil Producers	Total	Oil Producers	
1976	Mar-31	4020	2623	3234	473	7254
	Jun-30	3099	1964	3223	444	6322
	Sep-30	2750	1541	3435	449	6185
	Oct-20	2561	1404	3325	467	5886
	Nov-17	2483	1397	3356	482	5839
	Dec-31	2639	1421	3484	497	6123

Source: Bank of England (1977) *Bank of England Quarterly Bulletin,* 17 (2), Table 19

At the end of May 1976, the Treasury had noted the view that 'if a medium-term credit facility could be negotiated, this would be well-worth having, and that if the making of an offer of new guarantees for official holders were a condition of getting it, this would probably be a price worth paying', but only if it was likely that the credit would have to be drawn (TNA T 381/5, Walker to Barratt, 24 May 1976). If not, it would simply lead to a further accumulation of overseas sterling as had occurred after 1968. It was also believed that the issue of arranging a safety net was delicate politically, because if it became 'known that HMG considered such a facility to be desirable or necessary but that negotiations had proved abortive', confidence would be further shaken with the potential to lead to a fast and disorderly run down

[1] Schemes of this kind had also been under consideration at the IMF since at least as early as May 1975 (see BE OV 38/121, Ryrie to Jordon-Moss, 19 August 1976).

of the balances with disastrous consequences for sterling. On this basis, it was suggested that any substantive discussion of a scheme of this kind should be delayed (ibid).

However, the Bank of England felt the problem of the sterling balances was a secondary problem, and that as such, the arrangement of a safety net for sterling should be considered as secondary to an application to the Fund. It June it noted that 'it is important to emphasise that [the sterling balances] are not the main cause of our exchange rate problems', and that 'movements out of the balances have not been a primary cause or a main component of recent outflows' (TNA T 381/5, Coping with the Sterling Balances, 4 June 1976).[2] As such, the Bank's view was that a safety net scheme was 'unlikely to be a practical one in the near future, or indeed until we have drawn substantially from the Fund' (ibid). The Bank also shared the Treasury's fears about the implications of discovery of negotiations of such scheme, arguing that a 'garbled leak could lead sterling holders to feel that something was being cooked up behind their backs', and that even if it did not prove impossible to secure the agreement of the United States and Germany to discuss such a scheme, it would be difficult to agree terms that did not prove to be too onerous (ibid). As such, when Derek Mitchell reported the prevailing views on the practicability of a safety net to the Chancellor's Principal Private Secretary, he argued that 'it would get us nowhere

[2] The breakdown in the period 5 – 18 March, when the slide began was: switching out of sterling, -$375m; transactions with UK residents, -$110m; sterling balances, -$180m; UK banks' external loans and sterling advances, -$100m; leads and lags, -$275m; residual, -$270m, total, -$1,350m (BE 3A 38/4, WJH to McMahon, no date).

to pursue ideas for funding at the moment', and that even if opportunities for informal discussions at a political level presented themselves, he believed it wise 'to advise even against this' (TNA T 381/5, Mitchell to Monck, 4 June 1976).

In anticipation of the announcement of the 22 July measures however, Harold Lever argued that the case against trying to make arrangements for a safety net had subsided. He suggested that the 'cuts would scarcely lessen the need for a safety net – only perhaps its urgency – and they would greatly strengthen our hand in asking for it' (TNA T 381/5, Lever to Healey, 9 July 1976). He furthermore argued that whilst the impending German and American elections represented obstacles to a swift agreement on the sterling balances, that they would not be insurmountable. Rather, he suggested that although 'Governments fighting election campaigns will be very reluctant to agree to any longer-term scheme which includes a financial commitment', he believed that the 'Americans and Germans can hardly refuse to discuss our ideas now, especially when they know that they cannot be expected to take up a firm position until after their elections' (TNA PREM 16/797, Lever to Healey, 15 July 1976).

The Chancellor however, did not share Lever's optimism. It was Healey's view that he did not 'think we should have any illusions about how far the ground could usefully be prepared ahead of the American and German elections', and that 'discussion in this area could all too easily misfire' (TNA PREM 16/797, Healey to Lever, 16 July 1976). The UK Executive Director to the IMF, William S. Ryrie, shared this scepticism about the plausibility of coming to an arrangement on the

sterling balances prior to the American and German elections and an agreement for a conditional drawing from the IMF. On 10 August he noted that he was 'sceptical about the viability of the safety net idea at present', on the grounds that the idea would 'have a heavy political cost and would use up funds needed for other purposes' (TNA T 381/6, Ryrie to Barratt, 10 August 1976). He also doubted that an agreement on a safety net for sterling would have less onerous policy implications for Britain than other courses of action. He noted that he had doubts about 'whether it is true […] that a safety net would involve no greater conditionality than drawing our remaining rights in the Fund', and that 'if the thing were negotiable at all […] it would only be on conditions which would be still more severe' (ibid).

The Overseas Finance Division put a similar view to PCC, noting that such a scheme would ease the external financing situation, but that it would not solve it. But furthermore, the support of the major nations on which its success depended would not be forthcoming 'unless we had already been to the Fund and had an agreed economic strategy' (TNA T 277/3179, PCC (76) 58, 13 September 1976). The Chancellor gave a further endorsement of this position in a note to Callaghan on 22 September when he bluntly stated that an agreement on the balances would be 'no substitute for an IMF stand by', and that his view was that Britain 'shall have to get the standby settled first: without this no additional facility stands a chance' (TNA PREM 16/798, Healey to Callaghan, 22 September 1976). Finally, on 6 October the Prime Minister noted that the idea should be temporarily shelved because 'he would not want to go against the Chancellor of the Exchequer's judgement' (TNA PREM 16/798, Note of a Meeting, 6 October 1976).

Reactions to the IMF application were therefore mixed. Whilst Edwin Yeo and Arthur Burns both believed it to be a positive step forward, Burns did not feel that it would solve any of the fundamental problems that faced Britain, which he believed were in the underlying philosophy towards economic management and the way in which vested interests in the UK had been co-opted into policy-making. The TUC was also disappointed because of the implications of further cuts, and both Harold Lever and Callaghan believed that the sterling balances were the cause of the problem, and could be negated with an arrangement of a safety net for sterling. However, there was a wide range of official opinion that did not believe this strategy to be plausible before agreement with the Fund, which was eventually accepted by political elites, and allowed attention to begin focussing on preparations for the Fund's arrival.

Preparations for the Fund's visit

At the highest ministerial level, preparations for the Fund's visit began with Callaghan's attempts to elicit statements of support from foreign leaders, most notably Gerald Ford and Helmüt Schmidt. On 29 September, the Prime Minister telephoned Ford in order to discuss the IMF loan and the conditionality likely to be associated with it, telling the President that within the UK 'there are strong pressures for an alternative that I believe will be bad for this country. But not only bad for this country, but bad for the Western world and our value as an ally and partner and we are putting great things at risk if this pressure on sterling continues' (TNA PREM

16/798, Note of a Conversation, 29 September 1976). Callaghan went on to explain that this made it essential that Britain was able to secure an early agreement with the IMF that did not involve 'too much haggling', and that after the agreement was made, it would be necessary to arrange 'some protection against the special risk that could arise from the possible withdrawal of the sterling balances' (ibid).

Ford was sympathetic to the situation in which Britain found itself, and said that he believed Callaghan's conference speech, in which he had publicly rescinded the commitment to full employment through the expansion of domestic demand, had appealed very strongly to him and members of his administration (ibid). In response to Callaghan's suggestion that Britain may no longer be able to 'take a long view about world interests, about Western interests and about Britain's role as a partner', Ford informed the Prime Minister that he and his administration would be 'strongly in favour of what you want to do through the IMF', and that hopefully this would include avoiding trade limitations (ibid). However, Callaghan was able to secure no specific commitment from the President on the kind of support that could be relied upon, other than Ford's reassurance that the United States would 'do what we can with the IMF on your behalf' (ibid).

At Chequers on 10 October, Callaghan also raised the issue of the IMF application with Chancellor Schmidt. Schmidt informed the Prime Minister that in his view, Britain faced two problems, which were its budgetary excesses and the sterling balances. However, he also said that he felt that Britain's present policies could not fail in conquering inflation, albeit at a cost of being left with two million

unemployed (TNA PREM 16/799, Note for the Record, 10 October 1976). Schmidt also revealed that as the German reserve currently stood at $38 billion, it would be possible for Germany to contribute around $4.5 billion to a safety net for sterling (ibid). However, the German view more generally on a sterling balances agreement was not reflected by his statement, as when Derek Mitchell met the State Secretary of the German Ministry of Finance, Karl Otto Pöhl, on 3 November, Mitchell was told that there was a political will to help Britain on the part of the Germans, but that it applied 'at present only to the passage of our application to the IMF' (TNA PREM 16/799, Meeting with Herr Pöhl, 3 November 1976). As such, German support for some form of safety net could only be counted on 'once we had completed negotiations with the IMF' (ibid).[3]

At an official level, preparations for the IMF negotiations focussed on the kinds of policy changes that would be required in order to restore confidence and ease the external financing difficulties. The economic policy options report presented to PCC by the macro-economic group on 25 October noted that according to 'normal standards of demand management, we are all agreed that there is no question of excessive demand on real resources at the present time', but that regardless of this fact, 'none of us believes that there is much chance of financing the external deficit – which means convincing both the Fund and the Market – without further fiscal

[3] Morgan (1997, 506-7) notes that some of Callaghan's Cabinet colleagues, including Benn and Dell, 'felt that the Prime Minister was pursuing his own, externally directed policy by using his links with Ford and Schmidt to bypass the IMF to direct attention to his own favoured project of funding the sterling balances'.

action' (TNA T 277/3179, PCC (76) 68, 25 October 1976). Furthermore, it was suggested that this fiscal action should take the form of public expenditure cuts for three reasons. Firstly, because the forecasts suggested that the fall in real take home pay in the coming year was already reaching the limits of political acceptability; secondly, that public expenditure problems would help to address the structural imbalances in the economy, and; lastly, that public expenditure reductions would do much more, pound for pound, than increases in taxation (ibid).

The importance of taking further fiscal action was also discussed at a meeting on 25 October after pressure on sterling had emerged in light of a *Sunday Times* article that had claimed that UK officials and the IMF had already reached agreement that a suitable rate for sterling would be $1.50. In a general discussion of the appropriate response to the renewed pressure on the rate, there was a general agreement that any scheme of import controls or import deposits would look like a panic measure, and that whilst they may later have a role to play in a broad package, they were not appropriate in the current situation (TNA T 378/22, Note of a Meeting, 25 October 1976). Gordon Richardson argued that it would be necessary to intervene substantially in the foreign exchange markets in order to stabilise the rate, but that this should be 'preceded by the announcement of a comprehensive package […] with a large public expenditure element' that should also be made before the conclusion of the IMF negotiations (ibid). This view was also shared by Derek Mitchell, who thought a further cut of £2 billion would be appropriate, although Leo Pliatzky indicated that he did not believe this would be possible in the current financial year because of the difficulties in securing Cabinet agreement for more cuts (ibid). The

conclusions that the Chancellor took from this meeting were important ones. He noted that whilst fiscal action was required, it was clear 'those who would lend us the large sums required would insist on policy measures', and on this basis, he 'accepted the majority view that they should aim to stick to the longer timetable, involving deferring announcement of fiscal action until after the IMF negotiations' (ibid).

Pressure on sterling and the demands of external financing therefore had the effect of shaping the Treasury's preferences for measures to restore confidence in the markets so that it could continue to finance its balance of payments deficit. This was also beneficial because it helped to restore the competitive position of British industry, and would help to justify cuts in public expenditure, freeing resources to be diverted to exports. However, it was also the case that the expectation of conditionality associated with a high credit tranche drawing from the IMF was recognised by the Chancellor to be a good reason for deferring action in the face of potential political objections. Into November, the Treasury and the Bank of England continued in their quest to restore confidence so it was possible to attract the required external financing, by once again arguing that nothing less than further fiscal action would satisfy the markets, which was reinforced by the predictions included in the Treasury's autumn National Income Forecast (NIF).

Douglas Wass (2008, 238-9) notes that gloomy predictions about the unemployment prospects were 'crowned by an even more sombre financial forecast', with the 'deterioration [in forecasts] ascribed to the slacker state of the economy and hence to

lower tax receipts and higher expenditure.' He notes that this had created the inevitable prospect that developments 'would cast a dark shadow over the forthcoming negotiations' (ibid, 239). The forecast circulated to EY noted that the July forecasts had assumed an annual rate of growth of GDP of 4.5 per cent for the eighteen months beginning in the first half of 1976, and that on this basis the outturn for the PSBR would have been £9 billion (TNA CAB 134/4026, EY (76) 54, 2 November 1976). However, it was noted that since July, 'the indicators have increasingly suggested that the economy is growing more slowly than we thought' as a result of the sharp depreciation in sterling and the fact that industry had not taken as much advantage as expected of the impetus its competitive position had been given by the slide in the rate, either in world markets or at home (ibid). In combination, it was reckoned that these two factors 'account between them for a reduction of some 2 [per cent] in the annual rate of economic growth' (ibid).

The new forecasts assumed that the increase in earnings for the 1977-78 pay round would be kept to 10 per cent despite the faster rise in prices, and that Britain would be able to meet all of its external financing needs without changes to policies and without a further slide in the sterling exchange rate other than that required to maintain competitiveness (ibid). GDP was expected to grow moderately, at a rate of 2.5 per cent until the end of 1977, whilst unemployment was expected to peak at 1.75 million at the end of 1977 before remaining flat throughout 1978. There was also expected to be a deficit on the current balance in 1977 of just over £1.5 billion, and a year on year increase in the RPI of 16 per cent up to the middle of 1977, before falling back to 8 per cent in 1978 (ibid). Most significantly however, 'higher

unemployment and higher interest rates mean that the forecast of the Public Sector Borrowing Requirement […] in 1977-78 has to be revised significantly upwards (from £9 billion to £11 billion)' (ibid). On this basis, it was noted that 'faced with this prospect, I do not think that it would be right to take no action, even if our creditors would allow us' (ibid).

The Treasury therefore believed that there was a case for action to be taken regardless of issues of confidence and credit-worthiness on the basis of its forecasts. However, these forecasts have been the subject of retrospective controversy. Healey (2006, 432-3) notes that the 'Treasury had grossly overestimated the PSBR, which would have fallen within the IMF's limit without any of the measures they prescribed', and that 'we could have done without the IMF loan if we – and the world – had known the real facts at the time.' However, as Burk and Cairncross (1992, 225), note, although 'some writers have suspected that the forecasts were deliberately steeped in gloom in order to procure those decisions […] there is no reason to think this was so.' Indeed, the documents reveal that the Treasury was remarkably forthcoming about the degree of error likely to be contained within its figures. In the forecasts circulated to EY for instance, the Treasury wrote in summation: 'uncertainties about the future development of the economy are much greater than usual. It is important, therefore, that the precise figures used in the new forecast […] should not be taken too literally' (TNA CAB 134/4026, EY (76) 54, 2 November 1976). Wass' (2008, 239) account reflects this, noting that 'the reliability of the financial forecast was open to a good deal of doubt', and that 'the team responsible for it made it clear that they had had the greatest difficulty in producing

an internally consistent set of numbers owing to the huge uncertainties surrounding the external outlook.'

It was on the basis of these forecasts, and in the full knowledge of the uncertainties contained therein, that Cabinet gave its approval for officials to begin contingency planning on the reduction of public expenditure levels for 1977-78 (see TNA CAB 128/60, CM (76) 28th Conclusions, 26 October 1976). At the PCC meeting on the contingency plans, it was noted that it made strategic sense for the Fund to make the opening bid and then to argue against it, because in so far as confidence was concerned, what really mattered was achieving a package that reflected the Fund's wishes (TNA T 277/3175, PCC (76) 37th Meeting, 26 October 1976). However, although both Bryan Hopkin and Leo Pliatzky felt that there would be no reason for the PSBR to be reduced to as low a figure as £9 billion, the general view was that the 22 July measures had not worked because the cuts 'were too small and too cosmetic', and that to 'introduce another package that failed to restore confidence would give us the worst of all worlds' (ibid). The conclusions of the meeting reflected Sir Douglas Wass' view, that 'it was of overriding importance that the Fund negotiations should be successful, that a fiscal package was probably unavoidable, and that it was highly important from the point of view of confidence that it should contain a large public expenditure element' (ibid). On 4 November, Derek Mitchell quantified his view of the scale of reduction in the PSBR required, noting that he believed the target should be closer to £8 billion than £9 billion, and that the majority of the reduction should take the form of public expenditure cuts (TNA T 381/17, Mitchell to Monck, 4 November 1976).

These views were also held by Kenneth Berrill in the CPRS, who argued that the projected PSBR of £11 billion was a strong argument for further deflationary measures, and that whilst this action would make the achievement of a third round of pay policy difficult and reduce the rate of growth in the economy, it was essential that Britain restore confidence (TNA PREM 16/836, Berrill to Callaghan, 2 November 1976). His conclusion was that there was 'clearly a great deal to be said for taking further deflationary action' in order to restore Britain's creditworthiness, ensure sufficient reserves for the support of sterling, and bring the date at which the balance of payments showed demonstrable improvement forward (ibid). However, his view was also sensitive to the political demands of the situation, and he noted that despite agreement that further deflation was required, 'we must present the case [against cuts] as though we really believed it and not that we half agreed that further deflation was appropriate and life-restoring' (ibid).

Phase one: the negotiating mandate and the forecasts

The Fund team arrived at the beginning of November, led by Alan Whittome, head of the Fund's European Department, with David Finch of the Exchange and Trade Restrictions Department, as his deputy. As shown above, by the time the Fund team arrived there was a substantial body of official opinion within the UK that believed a further substantial reduction in the PSBR was required in order to restore confidence on the basis of the autumn NIF. Despite these views however, the remit of British officials was limited, with Wass informing PCC that 'on no account should officials

express any view, except on his specific authority, about what policy changes were desirable. The discussion should be entirely technical and exploratory and on our side should be on the basis of "present policies"' (TNA T 277/3175, PCC (76) 38th Meeting, 2 November 1976). Given the degree of sympathy at an official level for further deflationary action, this can only be explained in terms of the presentational advantages that would come by having it appear that officials had fought valiantly against cuts.[4]

On 4 November, the Fund held preliminary discussions with British officials, and it was noted that 'it is plain – but not unexpected – that the team are under instructions to focus very heavily on the PSBR and public expenditure' (TNA T 381/17, Littler to Wass, 4 November 1976). However, Britain's opening presentation to the Fund was not delivered until 8 November, by which time the Fund team had had the chance to review the figures from the NIF, by which, it was revealed, the Fund team had been 'considerably shaken' (TNA PREM 16/800, Littler to Wass, 8 November 1976). Bryan Hopkin explained that whilst the forecasts were very disappointing, there were better prospects for the year ahead and that the main difficulty Britain faced was getting over 'the intervening period of extreme difficulty' (ibid). The Fund's

[4] Morgan (1997, 544) notes that 'it was widely believed that the British Government […] were deliberately allowing the IMF negotiators to hang around in London [to demonstrate] that the British Government did not intend to grovel or crawl before their foreign paymasters', and the documents reveal that there was a significant presentational element to this. However, it was not because British officials were powerless to resist IMF proposals, but because they largely agreed with them.

response was in partial agreement, and Whittome noted that the Fund 'fully endorsed the general strategy of seeking recovery through a shift of resources to the export and manufacturing sectors [and] could see no other acceptable strategy' (ibid). Nevertheless, this was clearly qualified by the view that the Fund 'doubted whether the problem was simply that of getting through a short period of difficulty' (ibid), and subsequently, Whittome presented his general view about the implications of the forecasts provided by the Treasury:

> He said he saw great difficulty in IMF insistence on action which would significantly worsen, for any long period, the already bad unemployment prospects. At the same time he did not think we could rely on the forecast balance of payments improvement as a reason for taking a relaxed attitude towards the PSBR and monetary prospects; his fear was that in these respects, the forecasts simply did not add up (ibid).

On this note, the discussion ended with those involved in no doubt that the IMF were concerned about the size of the PSBR and monetary aggregates as had been predicted. It was noted by the Bank that 'at this somewhat formal session, it was difficult to judge the way negotiations might go' (BE 6A 399/1, Note for the Record, 8 November 1976), but it was clear that in order to reach a satisfactory agreement, targets for both the PSBR and DCE would have to be incorporated into the package of measures. Whilst, as has been shown, this view was compatible with those of a number of high-ranking British officials, making progress with the Fund team was hampered by the limited negotiating mandate. Alan Whittome made a point of mentioning this in a conversation with Derek Mitchell on 9 November, when he

noted that 'he had detected that every one in the Treasury had clammed up on discussion of policy changes' (TNA T 364/50, Mitchell to Wass, 9 November 1976). Furthermore, he noted that if British officials and ministers were expecting the Fund to provide a prescription on their behalf, this expectation would be disappointed because the Fund 'did not see how they could produce a set of objective proposals, divorced from a political context which they well understood, and so run the risk of being accused of a total lack of realism' (ibid). Early in the discussions therefore, negotiations appeared to be approaching a stalemate, on issues of procedure, if not principle.

The progress that had been made between the two teams was then reported at PCC on 11 November, and in summary it was noted that the IMF team had thought a PSBR target of £9 billion would be too high, that a more appropriate figure would be in the range of £5-6 billion, and that it was 'worth risking over-kill – even at the expense of temporarily higher unemployment – in order to get the changes in economic behaviour that we needed to lay the foundations for a stronger economy in the medium term' (TNA T 277/3175, PCC (76) 39th Meeting, 11 November 1976). At a meeting with the Fund team that afternoon, Healey acknowledged that the tight negotiating brief of Treasury officials had limited the amount of progress that it had been able to make with the IMF mission (TNA T 364/50, Note of a Meeting, 11 November 1976), but suggested that it would only be possible to get the mandate for negotiations broadened 'if the IMF team could give some idea of the changes which they thought were desirable' (ibid). To this suggestion, Whittome responded with caution. He noted that 'it was no part of the Fund's role to impose policies on

member countries', even though 'the Fund's own constituency would not accept the prospect in the NIF' (ibid). As a compromise, Whittome agreed that he would return to Washington over the weekend and would aim to produce a recommendation for Healey, 'provided the Chancellor could give a personal assurance that this procedure would not lead to a pillorying of the Fund team for attempting to impose policies on the British government' (ibid). This demonstrates the extent to which there was a feeling, even amongst the Fund officials, that the staunch negotiating position of the Treasury was designed in order to set the Fund up as the architect of an enforced deflation. Given the preferences of British officials that had been revealed to ministers, there appears to be some truth in this.

In the meantime, whilst Healey waited for Whittome to return with his suggestions on 16 November, attention was turned to preparing the Chancellor's presentation for the upcoming EY meeting at which he would attempt to secure ministerial agreement for a broadened negotiating mandate. The Treasury's draft speaking note for Healey, prepared on 12 November, clearly demonstrated the official view that a substantial reduction in the PSBR was required. It noted that in meetings to date, the Fund had clearly shown a preference for 'a substantial reduction in the PSBR in 1977-78 and a further reduction from that reduced level in the following years', but more significantly, it was noted that 'their ideas are not by any means unreasonable' (TNA T 364/50, Draft Speaking Note, 12 November 1976). However, it was not suggested at this stage to acquiesce to a substantial reduction, but that 'as an opening gambit with the Fund, we should say that we judge a desirable PSBR for 1977/78,

given the constraints on policy and the damage to other objectives which might ensue from too strict a programme, would be about £9.5 billion' (ibid).

When Whittome returned to London on 16 November, he noted that the Fund had based its views on a suitable PSBR target on different forecasts to those used by the Treasury. This significantly eased the political constraints British policy-makers were facing, because, in the Fund's view, it was the outturn figure that carried the most importance. This made it acceptable for any reductions to achieve the desired target to be made from a figure of £10 billion rather than the £10.9 billion that the Treasury had forecast (TNA T 381/17, Note of a Meeting, 16 November 1976). This confusion over forecasting had therefore amplified the degree of difference in opinions between the Fund team and British officials – which were already congruent in terms of the kind of action that was required, and differed principally on what would be politically acceptable – and therefore closed the negotiating position between the British government and the Fund by nearly £1 billion, without there having been any substantive discussions about actual policies between the two parties.

At EY the following day, the Prime Minister noted that Treasury forecasts had been interpreted as on the high side, and that the IMF and the National Institute for Economic and Social Research would shortly be publishing more optimistic forecasts (TNA CAB 134/4025, EY (76) 19th Meeting, 17 November 1976), however, the possibility of carrying through a revised forecast into decisions on a fiscal package as had been implied on the previous day was not explicitly discussed.

The Chancellor simply 'stressed that it would be disastrous to agree a small reduction with the IMF by pressing them very hard if such a reduction did not also satisfy the market' (ibid). It was in this climate of uncertainty about which forecast would be used as the basis for any downwards adjustment of the PSBR that the committee authorised the Chancellor to explore a 'PSBR in 1977-78 lower than the £10.9 billion in the October forecast […] but they should refuse to discuss anything lower than £9 billion' (ibid).

However, whilst this seemed to imply that the government had accepted the possibility of achieving a £1.9 billion reduction of the PSBR, which implied a target of well below £8.5 billion if made from the Fund's forecast, the lack of transparency with regard to the point of departure continued to cloud the issue. When Whittome visited Wass on the following morning, he told the Permanent Secretary that 'he was still quite clear that he could not sell the sort of action we had in mind, even to himself, let alone the creditor countries', and noted that although the Fund was reluctant to barter over figures, it was its view that the PSBR for 1977-78 should be in the range of £8-8.5 billion, and that for 1978-79, DCE should be targeted at £5 billion, which implied a PSBR of £6.5 billion (TNA T 371/25, Wass to Monck, 19 November 1976). To this, Wass responded that he believed it 'important not to exaggerate unnecessarily the differences between us', but that he was having difficulties in forming a view about how to make progress without a firm idea of the quantitative conclusions the Fund had reached. However, he nevertheless 'accepted that, in principle, a two-year programme of the type they envisaged was a reasonable proposition' (ibid).

Despite this agreement that the Fund's proposals were of reasonable proportions, the negotiations continued to be frustrated by the Treasury's limited negotiating mandate. On 19 November, when Pliatzky informed Whittome that he had no authority to discuss the specific policy changes that would be required in order to reduce the PSBR by £3-4 billion for 1978-79, Whittome said that he 'wanted to see "serious figures" of what could be obtained from public expenditure' (TNA T 371/25, Note of a Meeting, 19 November 1976). However despite these frustrations, that evening, the Fund team received some reassuring news from the Chancellor, who said that he 'hoped that the quantum of fiscal action or the target levels for the PSBR would be decided on the following Tuesday', which would allow the government to talk to the Fund about more specific measures in the first week of December (TNA PREM 16/802, Note of a Meeting, 19 November 1976). The Chancellor also took the opportunity to present his view that any reduction in the first year of the package greater than £1.5 billion would threaten Britain's major NATO roles, and that a PSBR of below £9 billion would be difficult to justify, whilst the leader of the Fund team countered by saying that he would find it difficult to convince others at the Fund that this would be adequate (ibid).

By the middle of November therefore, it looked as if negotiations between UK officials and the Fund team were in deadlock because of the Treasury's inability to discuss specific policy measures and the Chancellor's reluctance to discuss a PSBR target of below £9 billion. However, substantial progress had been made in reconciling the two positions in a way that had conveyed significant presentational

advantages on any possible agreement. Firstly, the Fund had indicated that reductions would need to be made from a lower PSBR forecast than that implied by the Treasury's NIF, which reduced the gap between the two teams in terms of the size of fiscal reduction that would be required. Secondly, the strict negotiating mandate given to the Treasury created the impression that British officials were fighting valiantly against austerity measures, despite expressing views in private that showed a substantial degree of overlap with the Fund. But finally, and most significantly, the Chancellor's suggestion that Whittome make the first proposal from which the teams would work meant that the basis of any agreement would be one that had originated with the IMF, and not British officials. However, whilst this had the potential to act as a buffer between the government and the economic and social consequences of a deflationary package, it was still necessary for the Treasury and the Chancellor to win the political debate, and their attempts to do so began at Cabinet on 23 November.

Phase two: the political arguments

The beginning of Cabinet discussions opened up the opportunity for firm decisions to be taken on the measures to be adopted in order to secure the IMF loan. The Chancellor began by making the case for a reduction in the PSBR in a paper of 22 November, which argued that there was no alternative to agreeing with the Fund on such terms. The Chancellor wrote that, 'at the present planned levels of expenditure and taxation we shall face very severe financing problems over the next year or two', and that Britain's improved performance in the foreign exchange and guilt-edged

markets owed 'much to the fact that people know we have the [IMF] team here – and to the expectations which that has created' (TNA CAB 129/193, CP (76) 111, 22 November 1976). He furthermore noted that 'we cannot expect that confidence to continue unchecked, if we do not act fairly soon to meet those expectations' (ibid). He informed his colleagues that the Fund was 'looking for a PSBR of about £8.5 billion to be achieved particularly by means of public expenditure savings', and that his own view was that 'the broad scale of the action they now suggest is about right if we accept their view of the pattern of growth in the next two years' (ibid). As such, he proposed that the Cabinet authorise officials to discuss a fiscal reduction of £1.5 billion for 1977-78, rising to £2 billion for 1978-79 (ibid). During the meeting, Healey assured the Cabinet members that although 'the situation was very difficult […] it would be worse if the negotiations broke down' (TNA CAB 128/60, CM (76) 33rd Conclusions, 23 November 1976).

The Chancellor's proposal and his justification however, did not meet with the universal approval of the Cabinet, who remained unconvinced about the salience of his arguments about external financing, and were concerned about the implications for the relationship with the trade unions. The Foreign Secretary, Anthony Crosland, argued that 'the proposed reduction in the PSBR in 1977-78 could not be defended on any reasonable grounds' (ibid). In his view, there was unlikely to be any pressure on resources, and the demands of external financing were not likely to be as great as predicted in light of the fact that the National Institute for Economic and Social Research had already reduced their own PSBR forecast to £8.3 billion. In addition, he argued that 'in terms of the Social Contract, there was absolutely nothing to be

said for the proposal' (ibid). As an alternative course, he suggested that the government propose to the IMF that the PSBR for 1977-78 be reduced by £1 billion to £9.5 billion, made largely of cosmetic measures such as the sale of BP shares, and public expenditure cuts with no demand or employment effects. He furthermore argued that in negotiating this line, the Fund should be 'left in no doubt that the consequences of pressing for more could only be to drive the Government into a protectionist attitude' (ibid). This proposal met with considerable approval from the Cabinet, however at this stage, Callaghan took a middle ground, and in summation noted that 'many of the Cabinet at present felt that the scale of the public expenditure cuts at present proposed was too great to accept', and that the government should proceed on the basis of attempting to secure an agreement with the Fund on the basis of a PSBR for 1977-78 of £9.5 billion (ibid).

This demonstrated the degree of political difficulty in winning Cabinet support for proposals broadly accepted by officials and the Fund, which Callaghan relayed to the Fund later that day (see TNA T 364/50, Note of a Meeting, 23 November 1976). In response, Whittome said that the Fund's emphasis on the second year of the programme, when an upturn in exports should mean that adjustments would have to be minimal, was a demonstration of the Fund's recognition of the political constraints that the government faced. He also informed the meeting that 'it would be a defeat for the IMF if their advice led to a Government falling', but that nonetheless, 'to the IMF a PSBR of £9.5 billion for 1977/78 was not convincing because they were sure it would not appear convincing to the millions of bankers all over the world whose response to the purchase prices of sterling would determine

where the exchange rate went' (ibid). On the basis of these discussions, and without Cabinet approval, the meeting was concluded with the agreement that beginning on 24 November, the Treasury and the IMF would consider the implications of a reduction in the PSBR for 1977-78 to £8.5 billion, £9 billion, and £9.5 billion (ibid).

After these packages had been reviewed, the Chancellor advised the Prime Minister that the first programme, a reduction in public expenditure of £0.5 billion in 1977-78 and £0.5 billion in 1978-79, was seen by the IMF team to represent 'a manifest failure of policy to respond to the prospect before us' (TNA PREM 16/803, Healey to Callaghan, 25 November 1976). The second proposal, to reduce public expenditure by £1 billion for 1977-78 and £1.5 billion for 1978-79, also received no interest from the Fund team on the grounds that they saw it carrying the risk of failing to restore confidence in the markets, which would lead to further pressure on sterling emerging in the near future (ibid). The final package, of expenditure cuts of £1.5 billion for 1977-78 and £2 billion for 1978-79, 'whilst [bringing] us up to the Fund's suggested guideline for 1977/78', still fell 'some way short of the figures which the Fund team have been suggesting for 1978/79' (ibid).[5]

[5] The discussion of a package of £1.5 billion for 1977-78, rising in the following year, prompted Bernard Donoughue to note that the Cabinet seemed to be faced 'only by the choice between the suicidal extremism of the Treasury and the protectionist extremism of Mr. Benn' (TNA PREM 16/803, Donoughue to Callaghan, 25 November 1976), however Healey was adamant that the largest package was the most promising basis for an agreement with the Fund, which was absolutely essential (TNA PREM 16/803, Healey to Callaghan, 25 November 1976).

Cabinet was again updated on the status of negotiations on 25 November, and the Prime Minister invited his colleagues to circulate their own proposals in writing so that ministers would have time to consider them in advance of their meetings the following week (TNA CAB 128/60, CM (76), 34th Conclusions, 25 November 1976). It was argued that it was important to ensure that alternative courses were given a full exploration, although it was also noted that the alternative strategy was impracticable for the purposes of satisfying the Fund and the market (ibid), and that:

> The IMF had now abandoned the concept of a target for the PSBR in 1978-79, having been persuaded that the uncertainties in such a calculation were too great; and they were moving towards the concept of a target figure for the adjustment, which would be varied in relation to growth. It was suggested that if the target in 1977-78 were £8.5 billion, the carry-through of the expenditure cuts […] would mean that relatively little further expenditure savings would be needed (ibid).

Whilst this strategy would also face political difficulties, the Prime Minister informed the Cabinet that the time had come 'to decide which course was least unpalatable and least risky, and then seek maximum support for it' (ibid).

Healey put two papers before Cabinet, the first of which outlined the three packages that British officials had discussed with the Fund team and would form the basis of discussion (see TNA CAB 129/193, CP (76) 122, 30 November 1976). In the second, he made his argument for coming to an agreement with the IMF. In it, he noted that the argument for the fiscal adjustment was 'not simply that this is what the

International Monetary Fund […] require as a condition of a standby credit' (TNA CAB 129/193, CP (76) 123, 30 November 1976). He noted that the argument was also 'partly about finance, and particularly about external finance, and partly about the general direction of the economy and the pace at which it is progressing to our declared goals' (ibid). The external finance argument was that Britain continued to require £1 billion per annum in order to finance the structural deficit on capital account, and that it was a continuing necessity to be able to finance the tendency for sterling holders to convert their assets into other currencies (ibid). He therefore recorded that his judgement – 'reached independently of the Fund – is that there is a powerful case for a fiscal adjustment', which would act so as 'to reduce the PSBR to something like £8.5 billion in 1977/78 and perhaps to a similar figure the following year', coming 'largely, if not predominantly, through reductions in public expenditure' (ibid). Finally, he noted that whilst the proposals 'are not agreeable and will be difficult to sell to the Party and the TUC […] if there were a better or more viable set of policies [he] should propose them' (ibid).

Several of his colleagues, notably Tony Benn, Anthony Crosland and Peter Shore, however, were convinced that there was an alternative course that Britain could pursue that the Chancellor had not considered, in the adoption of the AES. In his own Cabinet paper, Benn outlined an alternative six-point plan for economic recovery, which included:

1. An immediate decision to introduce overall import quotas for manufactures so Britain would be able to survive without the IMF loan if necessary.

2. The immediate introduction of import deposits to cover the interim period before import quotas could be implemented.
3. The immediate enforcement of exchange controls.
4. The reintroduction of a Capital Issues Committee to channel investment into priority areas.
5. A lower interest rate for official holders of sterling as a secondary incentive to investment.
6. Taking reserve powers to introduce planning agreements and increasing the funding of the National Enterprise Board (summarised from TNA CAB 129/193, CP (76) 117, 29 November 1976).

On the basis of these policies, Benn believed that it would be possible to persuade the IMF, GATT, and EEC, that this was the correct set of policies for British recovery, and that because of the degree of international interdependence that existed it would be possible to negotiate the IMF loan on the basis of those policies (ibid).

Anthony Crosland's paper took a similar line. He argued that as there was no decisive case for cuts on resource grounds, and as confidence was the principal issue, it would also be necessary to consider the implications of a break in the Social Contract caused by further deflation (TNA CAB 129/193, CP (76) 118, 29 November 1976). He suggested that so long as Britain received the IMF loan, the market would believe that Britain had the means to control its economy, and that this would be possible on the basis of a £1 billion PSBR cut because:

> Our bargaining position with the IMF is in my view stronger than people realise. For if they push us to the point of a siege economy and the full

> panoply of import controls, this would gravely threaten the cohesion of the EEC, dangerously stimulate a move towards world protectionism, and bring into question the British contribution to the military defence of the West. Our very weakness brings us strength. If we keep our nerve, we shall find that the IMF cannot *not* afford to give us the loan (ibid, original emphasis).

Peter Shore's paper was not as confident about securing the IMF loan on the basis of an alternative strategy, but he nevertheless believed that the case against imposing direct controls on imports had continually been overstated. Significantly, he noted that new forecasts from the NIF suggested that import quotas would not create excess demand and force rationing in the UK, that there would be no case for retaliation under international law, and that although there was a possibility that such a path would risk de-railing the IMF negotiations, this was a risk the government was already taking (TNA CAB 129/193, CP (76) 124, 30 November 1976).

However, despite this ministerial support for a scheme of generalised import controls, either as a realistic approach to addressing British economic decline, or as a strategic bluff to induce the IMF to grant the loan on softer terms in order to avoid taking a dangerous step towards world protection, there was no new work commissioned on examining the feasibility of such a scheme. This work had been completed on 14 October in the form of two papers prepared by the CPRS on the cases for and against import controls, which had been prepared as 'lawyers briefs' for EY. These papers were simply re-circulated to Cabinet under new cover. The case for import controls was reliant on the argument that 'the present strategy is

clearly not working now, that it will not work over the crucial years 1977-80, nor yet again over the longer term', and that as such, 'protection by quotas is thus the only viable way of attacking the cause of Britain's long run economic decline and of laying the foundations for fast economic growth in the future' by closing the balance of payments gap, helping to avoid destabilising capital flows, and reducing unemployment (TNA CAB 129/193, CP (76) 116, 30 November 1976, Case For). The intuitive case for import controls however, was paired with a considered demolition of the practical implications in the case against.

In the case against it was argued that the alternative strategy 'ignores the practical implications of the immediate situation [and] disguises, or assumes away, a number of fundamental industrial and economic difficulties, which will in practice prevent it from achieving the results claimed for it' (TNA CAB 129/193, CP (76) 30 November 1976, Case Against). Firstly, it was argued that a system of quantitative restrictions would not work because it would not be possible to 'get all of the fences up fast enough to prevent a collapse of sterling', that such a scheme would be 'contrary to [European] Community Law', that Britain 'would certainly be exposed to retaliation by other countries', and most fundamentally, 'the whole philosophy behind our international policies – both political and economic – has been based on the assumption that our future lies in membership of the Atlantic Community' (ibid). Secondly, and from a purely industrial perspective, it was argued that 'protection would only succeed if industry organised itself to develop new and internationally competitive products and to launch new and major campaigns to sell them', and that

there was 'no reason to think that protection – even in the absence of retaliation – would produce anything of the kind' (ibid).

At Cabinet on 1 December, Benn spoke first in favour of his proposal. In his diaries, Benn (1989, 663) records that he said it was essential for Britain to reflate the economy if the government was to carry the labour movement, and noted that 'Mrs Thatcher would do it and in a way she would probably find it easier because no-one would suspect her of wanting to make it an entry point into a full siege economy' (ibid, 665). However, Fay and Young (28 May 1978, 33) note that Healey suggested Benn's argument amounted to calling for Britain to 'withdraw to the citadel, but only so long as we can slip out occasionally to borrow the money to buy the bows and arrows we'll need to shoot at the besieging armies.'[6] Second to speak was Peter Shore, on his more moderate approach, involving a £1 billion cut in public expenditure for 1977-78 and 1978-79 (TNA CAB 128/60, CM (76) 35th Conclusions), followed by Anthony Crosland – 'the third gladiator in the ring' (Benn 1989, 667) - who argued that a government statement threatening a siege economy would be enough for the United States and Germany to ensure that the IMF 'would act in such a way as to avert that possibility' (TNA CAB 128/60, CM (76) 35th Conclusions).

In general discussion, arguments against the imposition of generalised import controls were made on the basis that if Britain were unable to finance the deficit, it

[6] Morgan (1997, 548) likewise notes that 'Benn's paper was demolished as Callaghan had long intended.'

may be necessary to resort to such drastic measures as rationing, and that, whilst the IMF may make the loan available under those conditions, it was a risk that could not be taken on the grounds that 'if this proved wrong the country would be in a bankrupt situation' (ibid). After this discussion, Healey made his own case for agreement with the IMF. He argued that Britain had no alternative but to agree to the proposed action on the grounds that under any other conditions, market sentiment would not make it feasible for Britain to finance its deficit, save for printing money or increasing interest rates to a level that would severely undermine the affordability of credit for investment in British industry. The onus of Healey's argument was that: 'without the IMF loan the external deficit could not be financed, there would be no safety net for the sterling balances, no acquiescence by other countries in a scheme of import deposits, and no bilateral lending' (ibid).

The argument that Britain's dependence on market confidence for financing its external deficit had also been rehearsed within the Treasury as part of its contingency planning for the break-down of negotiations, and demonstrated just why the proposed alternative strategies were so undesirable. Firstly, it was noted that if 'the IMF talks were to break down […] a serious sterling crisis could be virtually taken for granted [which] could be self-perpetuating until the Government stepped in with strong measures to halt it', and any adoption of an alternative strategy would make this inevitable because it would be inherently incompatible with an agreement with the Fund (TNA T 364/50, Hudson to Isaac, 30 November 1976). Secondly, and significantly, 'there would be no question of using the reserves to support the rate', because after the repayment of drawings made from the June stand-by, the reserves

would be insufficient (ibid). The implications of such a course brought about by an '*unwillingness* by Ministers to reduce the PSBR', it was argued, were that:

> It would be paradoxical – though by no means inconceivable – if it turned out the only way to bring the crisis to an end was by introducing just the sort of policies that the Government had refused to introduce in order to secure the Fund loan (ibid, 3, emphasis added).

The argument that the only course open to the government was a large fiscal reduction had therefore been widely deployed at official and ministerial levels by the beginning of December, and played an important role in reducing the political opposition to the Treasury's and the Chancellor's preferred course of action, which was to make a large fiscal adjustment and agree with the Fund. However, Benn (1989, 678) recalls that Cabinet on 1 December concluded with Michael Foot objecting to the Prime Minister's summation, arguing that only a majority was in favour of continuing to negotiate with the Fund. He said that agreement was 'not unanimous and the Cabinet minutes always say "the Cabinet noted with approval the summing up of the Prime Minister." Well, we don't all approve of the summing up by the Prime Minister'. Despite this objection however, Callaghan argued that Foot could surely agree that there was a majority in favour of continuing the negotiation with the IMF, and this intervention allowed for the Cabinet minutes to report that a majority agreement had been reached in favour of pursuing the negotiations on the basis of a fiscal reduction (TNA CAB 128/60, CM (76) 35th Conclusions, 1 December 1976).

Phase three: finalising the package

Following the Cabinet meeting on 1 December, Healey met with Witteveen and Whittome, and attention turned to the potential phasing of the drawings that Britain would be able to make from an agreed IMF loan. Healey had identified a potential problem in the Fund's proposal to pay the stand-by in eight equal instalments in light of the fact that the G10 stand-by would have to be repaid on 8 December. He noted that if the IMF drawings would not be sufficient to cover repayments on the stand-by because Britain had only been able to make an initial drawing of £0.5 billion, there was a chance that Cabinet would not agree to a package of the size proposed (TNA PREM 16/804, Note of a Meeting, 1 December 1976). Witteveen however, said that this was a matter for the UK and the G10 to agree between them, although it was possible that some front-loading of the drawings would be possible depending on the size of agreed package (ibid).

On this note, attention turned again to the fiscal element of the agreement, and familiar arguments were repeated, with the managing director saying that a PSBR of £9.5 billion would be insufficient, and the Chancellor arguing that he was worried about swaying Cabinet when the package he had already proposed, including the sale of BP shares, would bring the PSBR down to £8.7 billion (ibid). Healey and the Fund team then went to meet the Prime Minister, who told Witteveen that if a £2 billion fiscal adjustment was the Fund's final word, then negotiations were at an end. If this were the case, 'he would lead Cabinet to a conclusion that the right course was to go for a protectionist economy and the introduction of quota restrictions on

imports forthwith' (TNA PREM 16/804, Note of a Meeting, 1 December 1976). In light of this, when the Fund re-convened with the Chancellor, Witteveen continued to press for another £0.5 billion cut for 1977-78, but eventually acquiesced to the Chancellor's proposal on the condition that the UK would be willing to go beyond a £1.5 billion reduction in the second year (TNA PREM 16/804, Note of a Meeting, 1 December 1976).

On the following day, Cabinet met to discuss the size of the package that it should agree in order to secure the IMF loan. The Chancellor began the meeting by relaying to other Cabinet members once again his view that the PSBR must be cut because it would not otherwise be possible to finance the deficit without severe inflation, or interest rates of such a high level that investment in British industry would be fundamentally damaged. The problem as it presented itself was, he argued, that 'potential creditors regarded the present PSBR as inconsistent with credit-worthiness', and that to change this, a reduction of £1.5 billion must be made, with £0.5 million coming from the sale of shares in BP (TNA CAB 128/60, CM (76) 36th Conclusions, 2 December 1976).

Callaghan then revealed his hand. He noted that whilst the package may create difficulties in carrying the Labour Party, he did not believe there would be an adverse reaction from the public at large because they were better informed on economic matters than they were often given credit for (ibid). This statement was crucial in carrying the Cabinet, and it was noted that 'the consequences for the Party and for the country would be very serious if it became known that proposals

supported by both the Prime Minister and the Chancellor of the Exchequer had been rejected by the Cabinet' (ibid). As a result, Callaghan was able to conclude that 'the majority took the view that in order to get the loan there should be adjustments of £1.5 billion in 1977/78 which the Chancellor had said should lead to one of £2 billion in 1978/79', and that although some members still thought that this was an unacceptably high price to pay, they were a minority, and that as such, the Chancellor should be authorised to put the proposal to the IMF (ibid).

Callaghan (1987, 440) noted of the Cabinet meeting on 2 December that he had 'recognised the package would have an adverse effect on some of the Government's supporters in the House', but that after each minister had had the opportunity to express their view in turn, 'it was obvious that there was a substantial majority for the Chancellor's proposal, although a minority found it unacceptable.' The question however, he felt, 'was whether Denis could get the IMF on board on the basis of the Cabinet's figure' (ibid, 440). Attempts at this reconciliation began that evening, when the Chancellor once again met with the Fund team, accompanied by Douglas Wass and Derek Mitchell, and informed the IMF staff members that 'the Government would be ready to take action which would reduce the PSBR from the revised forecast of £10.4 billion to £8.7 billion', and that the 'first item at the Cabinet next Monday afternoon would be to give formal clearance to the quantum of £2 billion for 1978/9' (TNA PREM 16/804, Note of a Meeting, 2 December 1976). This provoked some dispute about what Witteveen had agreed to at previous meetings, with the Chancellor noting that the managing director had agreed to a package of this size, but Whittome arguing that 'the Cabinet's position did not

represent the acceptable minimum for the fund' (ibid). This disagreement meant that the final matters of substance had to be deferred until Whittome could speak to Witteveen and report on his views the following day.

When the discussions resumed, Whittome reported that he had received a message in writing from Witteveen saying that he wanted a cut of £1.5 billion in 1977-78, and a substantial addition for the following year, which Whittome had interpreted as meaning about £3 billion (TNA PREM 16/805, Note of a Meeting, 3 December 1976). To this, Healey said 'that Dr. Witteveen could take a running jump', which prompted Whittome to offer a compromise package that involved Britain accepting a £1 billion package in the first year, if the Chancellor could agree to a £1 billion larger package for the second year (ibid). From this point onwards, Healey remained steadfast in his position, informing Whittome that whilst the second year was a little more open than the first, nothing more than £2 billion would be acceptable, and that he would not be able to fight with conviction for anything more (ibid). 'It was easier', the Chancellor suggested, 'to ask for sacrifices which would enable the country to stand on its own feet than to do so in order to get a foreign loan' (ibid).

The resolution to this situation however, was neither difficult nor technical, and lay in the application of a 'wait and see' approach. Whittome asked the Chancellor whether 'it would be possible to give a contingent undertaking to do more than the Chancellor had proposed to Cabinet in 1978/79, which would be linked to achieving a lower level of employment than was now forecast', to which Healey replied favourably so long as 'it was made strictly contingent on the IMF's optimistic view

of the economy and of the effect of the fiscal cuts being proved right' (ibid). With this agreement, the meeting ended uneasily, both parties expressing the possibility of meeting difficulties with its constituencies, but the basis of a final agreement was in place on terms that the Chancellor and the Treasury had deemed as necessary and appropriate from well before substantive negotiations with the Fund had begun.

By 5 December, Whittome had secured Witteveen's agreement to the Treasury's proposed formula, 'albeit reluctantly' (TNA PREM 16/805, Wass to Stowe, 5 December 1976, 1), however, the problem of carrying Cabinet still remained. In order to do so, Douglas Wass had written a powerful statement in favour of agreeing with the Fund by making the argument that there was no other feasible course of action. He noted:

> The announcement of the failure – or even the postponement – of the application for a drawing would be treated with dismay by the financial markets […] If the Government did not immediately announce a convincing package of measures to deal with the situation, sterling would become the subject of a major attack and the rate would fall. We should have no means of stopping it […] money and capital markets too would fall sharply and interest rates would rise autonomously […] this situation would be intolerable. We should have to take action to avoid a complete financial collapse (TNA PREM 16/805, Wass to Callaghan, 5 December 1976).

The action that would have to be taken in this event would involve cuts in public expenditure of up to £1,000 million, tax increases of £430 million, the sale of BP shares, and a scheme of import deposits that would contract the economy sharply

(ibid). The other only alternative would be to introduce the siege economy implied by the AES, and Wass felt that the objections to this course were so strong, and by now so familiar, that he did not need to go into them in detail. He simply noted that it 'would be a virtually irreversible step away from Europe and away from the system into which we have progressively integrated ourselves since the War', and that as such, the AES was not 'an immediate option in the event of a breakdown with the Fund' (ibid).

The Treasury had therefore consistently made the case that there were no plausible alternative courses of action in order to secure agreement with the Fund, and secure the public expenditure cuts it believed were necessary in order to stabilise sterling and restore Britain's creditworthiness so it would be able to finance the deficit until North Sea Oil came on stream and British industry was restored to competitiveness. In light of these arguments, when Cabinet met on 6 December, Callaghan informed members that it was now a matter of urgency to give shape to the fiscal package, and Healey noted that this involved immediate agreement of £1 billion cuts for 1977-78 and £1.5 billion cuts for 1978-79, which may later be revised dependent on the performance of the British economy by comparison to a growth rate for that year of 3.5 per cent (TNA CAB 128/60, CM (76) 37th Conclusions, 6 December 1976). The Cabinet spent the remainder of the meeting and two meetings on 7 December coming to an agreement on the shape of the fiscal package (see TNA CAB 128/60, CM (76) 38th Conclusions and CM (76) 39th Conclusions, 7 December 1976),[7] whilst

[7] In his memoirs, Callaghan (1987, 442) noted that these meetings were 'dreary' and 'like teeth extractions'.

in the Treasury, attention turned to negotiating the final wording of the letter of intent, including targets for DCE, which were finally agreed at £7.7 billion for 1977-78 and £6 billion for 1978-79, in the early hours of 13 December (TNA PREM 16/808, Monck to Stowe, 13 December 1976). Whilst it was the feeling of British officials that the Fund was 'trying to toughen up the monetary targets' in order to offset worries about the fiscal cuts they had accepted (ibid), agreement on these figures provoked none of the intense political debate that had accompanied the fiscal reductions, and the letter of intent was agreed without objection on 14 December (TNA CAB 128/60, CM (76) 41st Conclusions, 14 December 1976), allowing Witteveen to recommend to the executive board of the IMF that the UK be given the stand-by the following day (IMF EBM/76/165, 15 December 1976). The board then considered its decision, and reached the conclusions that 'the program now undertaken can provide a firm basis for the urgently needed change in past economic trends of the United Kingdom' (IMF EBS/76/519, 16 December 1976).

Conclusions

This chapter has presented a narrative of events from the middle of September until the conclusion of the IMF negotiations in December, and has demonstrated that throughout the final quarter of the year, the Treasury and the Chancellor continued their pursuit of further fiscal reductions by using market rhetoric, and ultimately, the conditionality of the International Monetary Fund, in order to navigate political opposition to the proposals and reconcile diverging views with their own. This process began with the argument that it was necessary to approach the Fund for a

conditional drawing because of the dire external financing prospects Britain was facing in light of pressure on sterling, and despite calls for an attempt to be made to seek an agreement to guarantee the sterling balances. The Treasury, supported by the timing of overseas elections, argued that not only would a sterling balances agreement not address the cause of the current difficulties, but that it was also implausible prior to any agreement with the Fund. In any event, it was argued that such a course would incur even more rigorous conditionality than an IMF drawing.

The autumn forecasts then allowed the Treasury to present a case for further cuts, despite the fact that it was widely acknowledged that the figures were highly uncertain. In light of pressure on sterling, these forecasts convinced the Chancellor of the case that further action was required, and he decided to delay the action because of the widely anticipated application of conditionality by the IMF as part of the terms of agreement. The IMF negotiations then proceeded through three distinct phases, during each of which the Treasury and the Chancellor strategically made the case that decisions about the size of the PSBR were effectively beyond the control of the government because of its need to finance the deficit, the absence of a plausible alternative, and the Fund's conditions, despite broad agreement with the Fund, at least in private, on the scale of the action required throughout the negotiation.

Chapter IX

Conclusions

The conclusion of the IMF negotiations marked the end of an eventful two years in government for the Labour Party, in which they had moved from their promises of redistribution of incomes and wealth and the preservation of employment, through several rounds of expenditure cuts and direct action to limit the rate of growth of incomes. All of these policies had been geared at restoring overseas confidence in the British economy so that Britain would be able to continue financing its balance of payments deficit in the medium-term, and correct it over the long-term by freeing resources for the export sector and letting the pound slide to help restore the competitiveness of British industry. All of these changes had occurred despite the Labour Party's manifesto commitments and political opposition from the labour movement and the left of the Parliamentary Labour Party. However, policy change was not, by and large, characteristic of uncertainty and indecision, or the disciplinary exercise of structural power over British policy-makers. Rather, it occurred in light of the consistent advocacy of the diversion of resources into export sectors of industry, public expenditure cuts, and robust counter-inflationary policies, by the Treasury and the Bank of England, and was achieved principally through the politics of depoliticisation.

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The depoliticisation of economic policy-making, 1974-76

This thesis has argued that policy change in 1975 and 1976 was not determined by the disciplinary exercise of structural power over British policy-makers in the form of IMF conditionality, or a process of social learning catalysed by external crisis, as many accounts of this period suggest. Rather, it has argued that market rhetoric and market rules, such as IMF conditionality, provided the government with the opportunity to pursue its preferences for depreciation, expenditure cuts and incomes restraint, whilst minimising political dissent through the politics of depoliticisation. This argument was constructed in a framework suggesting that states and markets should not be understood as analytically separate spheres that are able to impinge upon one another. I argued that such approaches misrepresent the nature of the relationship between state and market, and oversimplify a fundamentally complex social and economic environment that shapes the way in which governments form their policy preferences and devise their governing strategies. In the case of the 1976 IMF crisis, evidence for arguments based on the artificial analytical separation of states and markets has been presented in a superficially appealing way, however the simple identification of the public statements of the Labour Party with the government's preferences has amplified the extent to which policy-makers appear to have been influenced by external forces.

Most existing accounts of the crisis therefore suffer from theoretical and empirical weaknesses that this thesis has attempted to address. I argued that instead of perceiving of state and market in reified terms, the state should be understood as a

social form of the relations of capitalist production, and the class antagonisms inherent therein. Understood in this way, it is clear that the state's role is not that of a passive, neutral arbiter. Rather, the state must fulfil specific functions in order to manage the circuit of capital and maintain conditions for profitable accumulation within its boundaries. I also argued that the state's nature as a national manifestation of the social relations of production in relation to the global character of accumulation provides strong incentives for governments to devise strategies geared towards restricting expenditure and inflation to prevent capital from seeking more profitable outlets abroad, but do not determine them at moments of crisis. I then suggested that as policies of this kind frequently require social costs to be carried by the labour movement, governments often find it beneficial to employ governing strategies that depoliticise the consequences of austerity. Finally, I argued that the government's clearly established economic preferences from 1974-76 demonstrate that the state is not autonomous from the economy, but is conditioned to act in the general interests of accumulation by virtue of its status as a historical manifestation of the class struggle inherent in the social relations of capitalist production, and that the Wilson / Callaghan administration used market rhetoric, and ultimately IMF conditionality, to depoliticise the consequences economic policy retrenchment.

In order for a convincing case arguing that governing authorities have used the politics of depoliticisation in an attempt to minimise political dissent to be made, certain observations about the nature of depoliticisation as a governing strategy must be made. Firstly, it is necessary to identify and demonstrate the government's *preferences* for policies geared towards the general reproduction of the social

relations of capitalist production. This is problematic for contemporary studies of depoliticisation, because by their very nature, a government's preferences when employing a strategy of depoliticisation are not publicly revealed preferences. As soon as state managers reveal their intention to pursue economic objectives in this way, the issues are re-politicised, and the potential benefits of depoliticisation are lost. Therefore, access to primary documents is invaluable for establishing a credible case that state managers employed a strategy of depoliticisation. Secondly, for a convincing depoliticisation argument to be made, it is necessary to identify *intention* on the part of policy-makers. Without being able to demonstrate the intention to depoliticise the consequences of potentially unpopular policy changes, they cannot be described as part of a strategic attempt at governing the economy, and as such do not fit accepted definitions of depoliticisation.

The accounts of Steve Ludlam (1992) and Douglas Wass (2008) have played an important role in showing the depoliticisation hypothesis to be plausible with reference to the 1976 IMF crisis by demonstrating clearly and empirically the fact that policy changes had begun well in advance of the application of Fund conditionality. However, neither author makes the case explicitly. Ludlam offers the closest suggestion of such an approach in his assertion that the adoption of policies in accord with monetarist discourses was geared more at forming public opinion than theoretical conversion (1992, 723), however he stops short of suggesting that this was part of a fully formed governing strategy, and indeed with his focus on the ideational aspects of policies lends itself more to support of the social learning thesis than it does to the depoliticisation thesis. Furthermore, the fact

that primary documents on the crisis only became available under the thirty-year rule on 1 January 2007 means that demonstrating the government's intentions and understanding its full range of preferences would have made it difficult to make a convincing case for the depoliticisation thesis that went beyond mere assertion; such a case would have had to rely principally on assumptions about the unrevealed preferences of policy-makers.

Douglass Wass did not face the same practical limitations with regard to his access to a full range of sources, both because of his involvement in events and the declassification of government records, however his judgement was that the documents offer no evidence that a strategy of depoliticisation was employed. In fact, he argues to the contrary, that the documents reveal no underlying strategy to deal with the events of 1976 (Wass, 2008, 345). However, this conceals the extent to which, from 1974-76, economic policy preferences and the way in which they were implemented displayed a remarkable consistency, and reflects a continuing theme throughout Wass' account that selectively absolves the Treasury for responsibility for certain policy decisions at certain times on political grounds, draws on Wass' own undocumented impression of events, or justifies the selective dismissal of certain evidence.[1] Despite the author's intention to distance himself from the events therefore, there are a number of aspects of the work that suggest his interpretation of

[1] For example, his assertion that it was no place for the Treasury to question the adequacy of the Social Contract, his impression about the way in which policy would be made more collaboratively during the 1974 spring Budget, and his discounting of reserves figures. See pages 80, 114-5, 175 *fn*3 above.

events reflects, at least in part, an intention to defend the Treasury's role in policy-making during this period.

In contrast, this thesis has shown how policy changed in a way that accurately reflects the way in which state managers aim to act in favour of creating favourable conditions for accumulation within its national boundaries by capping public expenditure and using incomes policies to control inflation, whilst attempting to depoliticise these austerity measures in order to negate social antagonisms by attributing the necessity of such measures to the logic of the market and the rules of its institutions, which ultimately, in 1976, came in the form of IMF conditionality. This can be demonstrated by looking at the period 1974-76 in three stages.

In the first of the stages, between February and October 1975, it is possible to see the interests of labour reflected in the Labour Party's commitments to the redistribution of income and wealth and voluntarism in collective bargaining in *Labour's Programme 1973, Economic Policy and the Cost of Living,* and the 1974 general election manifestoes (see Labour Party, 1973; TUC / Labour Party Liaison Committee, 1973; Labour Party, 1974a and 1974b). However, it is also possible to see that the Treasury and key members of the core executive, including the Chancellor, also favoured the diversion of resources into exports and restoring incentives to British industries through reform of the price code, which came at the expense of the government's commitments to extensive social expenditure in the March Budget. The potential for measures that took decisive action to reduce British inflation and bring the balance of payments quickly into equilibrium to exacerbate

social conflict however, was also recognised, and policies were chosen and implemented with an awareness of the need to balance political and economic concerns.

The first phase of policy making however, was highly politicised and carried the possibility that a continuation of such a strategy would translate the beginning of an economic crisis into a political crisis. As such, in the second phase, there was a decisive re-orientation of economic strategy that demonstrated the extent to which state managers prioritised the demands of correcting the disequilibrium in the balance of payments, restoring British industry to competitiveness, and implementing a credible and decisive counter-inflation strategy. This was informed by the Treasury's experiences of managing sterling in a historical perspective, and its particular sensitivity to crises of confidence in the foreign exchange markets. In December 1974 the Treasury argued that it had no faith in current policies, and argued that it was necessary to limit the public sector's claim on resources by cutting public expenditure, allow sterling to depreciate for gains in competitiveness, and implementing a formal incomes policy to restrict the rate of pay increases in order to control inflation and sustain confidence in sterling investments. It was also recognised that implementing these measures may not be possible in the immediate context because of the potential they would have to provoke political unrest, but that an external crisis would open up possibilities for the government to rally support for policies of this kind. The documents relating to this period clearly reflect the preferences of state managers for pursuing policies geared towards renewing

conditions for accumulation, and their recognition of the potential for market rhetoric and rules to assist them in this endeavour.

Throughout 1975, the government successfully employed a strategy of depoliticisation in order to introduce an incomes policy, reform the system of public expenditure planning, and make public expenditure cuts, by justifying them with reference to two 'non-crises'. The first of these was in the foreign exchange markets. As sterling came under pressure, the Treasury and the Chancellor argued that the fall in the rate was the consequence of a fundamental lack of faith in British counter-inflationary strategy, and that if the slide was to be reversed, the immediate introduction of a credible incomes policy was necessary. This argument was made despite the fact that the Treasury also had clear preferences for depreciation of sterling, had been adamant that the reserves should not be spent on defending the rate, and so had contributed to the fall in the pound indirectly by authorising only parsimonious intervention for smoothing the depreciation. The second 'non-crisis' of 1975 related to the demands of external financing, when it was argued that Britain would not be able to attract sterling inflows or borrow bilaterally to finance the deficit, and that as a result, Britain should draw the first credit tranche and the oil facility loans from the IMF. It was argued that because Britain's creditworthiness was still poor, and because Britain was being forced to use the last unconditional facilities available to it, cuts from the 1976 Public Expenditure White Paper would be required otherwise Britain would be forced to go to the IMF for a highly conditional loan that would make even more severe cuts inevitable. However, this loan was drawn in spite of the IMF's doubts about Britain's ability to demonstrate

need on the basis of reserves loss when the approach was being discussed, and was eventually drawn largely on the grounds that an external financing crisis was possible, not imminent, and that funds available from the oil facility would otherwise be lost at the end of the calendar year. In combination, the manipulation of external confidence in this way offers strong evidence of state managers' intention to depoliticise economic policy-making.

In the final stage, throughout 1976, 'non-crises' increasingly translated themselves into real crises, but the strategy of using market rhetoric and institutional rules in order to justify acting on pre-existing preferences for further public expenditure cuts continued. This focussed on the argument that the degree of dependence implied by Britain's involvement in the global financial and political communities had made the adoption of any alternative strategy unworkable on the grounds that it would be necessary to accompany them with even more severe deflation – and possibly rationing, too – than those measures otherwise proposed. This strategy was employed twice, firstly, and ultimately with only moderate success, in July, and secondly, and more successfully, during the IMF crisis of December 1976 itself.

The context of the first round of public expenditure cuts was one in which the Treasury and the Chancellor continued to believe that a further depreciation in sterling was required, along with a further reduction in the PSBR to ensure that Britain would be able to continue financing its deficit in the medium-term and until British industry had regained its competitiveness and the balance of payments was supplemented by the revenues of North Sea Oil. Once again, the fall in the rate was

used in order to make further retrenchment seem inevitable on the grounds that confidence needed to be restored. This need was amplified by the short-term loan taken from the G10 in June, which allowed the argument that Britain had to make further expenditure cuts if it wished to avoid a harsher, conditional drawing from the Fund later in the year, to be redeployed in order to secure Cabinet agreement for the cuts in planned expenditure announced on 22 July.

These cuts, however, were not of the extent that officials of the Treasury or the Bank of England had desired, and in light of admittedly uncertain forecasts for the growth of the economy and the size of the PSBR, it was argued that an approach to the Fund was essential, in full knowledge of the conditionality that would be associated with this. It was also argued that any other attempt to stabilise sterling, such as through the arrangement of a safety net for the sterling balances, would be entirely secondary to a Fund loan and only achieved on more onerous terms. Further pressure on sterling in September and October demonstrated the extent to which the Chancellor was aware of the potential for the appearance of IMF conditionality to ease political objections to further cuts. At this time he acknowledged that it was clearly desirable to take further deflationary action, but that in light of the widespread expectation of conditionality, it was preferred to wait until after the negotiation to make any announcement. In this instance, the intention of the government to use market rules in order to justify retrenchment through a strategy of depoliticisation is demonstrated most visibly.

The IMF negotiation itself was also a sophisticated expression of a strategy in which the Treasury and the Chancellor presented events in such a way so as to create the impression to the population at large, and sceptics of its proposals within the Cabinet, that they had fought strongly against further deflationary measures, and that the size of the package eventually proposed had been demanded by the Fund. This began by refusing to discuss any figures for adjustment or policy changes with the Fund, and asking its officers to make the first proposals, with which, in private, British officials were broadly agreed. The political argument was then won once again by presenting alternative strategies and demonstrating the reasons why they would inevitably involve greater sacrifices than the course proposed by the Fund, either by forcing Britain towards bankruptcy, or contributing to shortages of consumer goods caused by import restraints.

What is clear from economic policy-making in Britain in the period 1974-76, is that policy-making was not characterised by uncertainty and indecision. Preferences for measures designed to improve the competitiveness of British industry, reduce the public sector's claim on resources, and tackle inflation, had in each instance been clearly designed and expressed prior to the onset of crises or the appearance of crises. The crises of 1975 and 1976 were then subsequently used in order to argue that decisions on politically contentious issues such as incomes policy, public expenditure, and the size of the PSBR, lay beyond the control of the government because of its dependence on overseas confidence. The clearly understood implications of Fund conditionality was the perfect justification of this position in December 1976, and far from representing an abject failure of the Labour

government's economic strategy and the disciplinary potential of market forces, in many respects represents the pinnacle of its economic statecraft.

Final remarks: not so 'new' Labour?

Evidence from British economic policy-making in the run-up to and during the 1976 IMF crisis therefore tends to reinforce the claim that it is beneficial to understand the state as *social form,* conditioned by the class antagonisms inherent in the social relations of capitalist production. There is also strong documentary evidence suggesting that state managers attempted to depoliticise difficult aspects of policy-making with reference to market rhetoric and ultimately, Fund conditionality. The topic, however, also leads to some new research questions about the 'newness' of New Labour, given the apparent similarities in statecraft between the Blair administration and the Wilson / Callaghan administration. The fact that New Labour has couched its governing project in the rhetoric of 'the third way' and the principles of social inclusion will remain unique. However, in light of suggestions that strategies of depoliticisation have driven the New Labour governing project and the argument presented here, there are clear signs that the differences between the Labour governments in the two periods are largely superficial; the statecraft of the New Labour governing project has clearly identifiable roots in the statecraft of 'old' Labour's last term in office. Given the historical emphasis of this study, it is not possible to make a definitive judgement on this issue here, and the acid test will only come with the availability of a wide range of documentary sources relating to policy-making under New Labour, but if the 'newness' of New Labour is not to be seen

simply as a cynical re-branding exercise allowed by the terminal decline of Britain's primary sectors and the rise of the information based industries during the Thatcher period, considerable work needs to be done in order to demonstrate this uniqueness with specific reference to Labour's time in office in previous eras. The conclusions of this thesis suggest that the principal things that are 'new' about New Labour in terms of they way it has identified its preferences and implemented them, and given the extent to which the population at large now seems so ready to accept the imperatives of globalisation as justification for the government's neglect of the demand side of the economy, are the significantly less volatile social climate within which it has governed (itself a legacy of the 'free economy and the strong state'[2] established in the Thatcher era), and its name.

[2] On the 'free economy and the strong state', see Gamble (1988).

Annex

Index of names and offices

Office relate to those held between 1974 and 1976 unless stated. Where only a year is given, office relates to the Civil Service Year Book entry for that year.

Allen, Sir Douglas,	*HM Treasury, Permanent Secretary, until spring 1974, Head of the Home Civil Service and Permanent Secretary to the Civil Service Department from Spring 1974*
Barber, Anthony P. J.,	*Chancellor of the Exchequer, 25 July 1970 – 4 March 1974*
Barnett, Joel,	*Chief Secretary to the Treasury*
Barratt, F. Russell,	*HM Treasury, Overseas Finance Division, Reserves and Development*
Benn, A. N. W. 'Tony',	*Secretary of State for Industry, 10 May 1974 – 4 August 1975; Secretary of State for Energy, 4 August 1975, 4 May 1979*
Berrill, Sir Kenneth,	*Central Policy Review Staff, Head*
Britton, A. J. C.,	*HM DHSS, Senior Economic Advisor, Economic Advisor's Office, 1975, HM Treasury, Senior Economic Advisor, Medium Term and Policy Analysis Group, 1976*
Burns, Arthur F.,	*Federal Reserve Bank of New York, Chairman of*

	the Board
Callaghan, L. James,	*Secretary of State for Foreign and Commonwealth Affairs, 4 March 1974 – 5 April 1976; Prime Minister, 5 April 1976 – 4 May 1979*
Carey, Peter,	*HM Department of Industry, Secretary (Industry)*
Cassell, F.,	*HM Treasury, Overseas Finance Division, International Monetary Division, Undersecretary (Economic)*
Castle, Mrs. Barbara A.,	*Secretary of State for Social Services, 4 March 1974 – 8 April 1976*
Couzens, K. E.,	*HM Treasury, National Economy, Deputy Secretary Prices and Incomes Division, 1975, Counter Inflation and Public Finance, 1976*
Crosland, C. Anthony R.,	*Secretary of State for the Environment, 5 March 1974 – 8 April 1976; Secretary of State for Foreign and Commonwealth Affairs, 8 April 1976 – 19 February 1977*
Dell, Edmund E.,	*Paymaster General, 5 March 1974 – 10 September 1976*
Donoughue, Bernard,	*Downing Street Policy Unit, Head*
Elkan, Peter,	*Independent Economist*
Finch, David,	*International Monetary Fund, Exchange and Trade Restrictions Department; member of negotiating team, December 1976*
Fogarty, C. W.,	*HM Treasury, Overseas Finance Division, Deputy*

	Secretary, International Monetary Division
Folger, M. T.,	*HM Treasury, Private Secretary (higher executive officer) 1975, Defence Policy and Materiel Group Principal, 1976*
Foot, Michael M.,	*Secretary of State for Employment, 5 March 1974 – 8 April 1976; Lord President of the Council, 8 April 1976 – 4 May 1979*
Ford, Gerald R.	*President of the United States of America, 9 August 1974 – 20 January 1977*
France, C. W.	*HM Treasury, Principal Private Secretary to the Chancellor of the Exchequer, 1974-75*
Godley, Wynne,	*Government Economic Advisor*
Haines, Joe,	*Downing Street Press Officer*
Healey, Denis W.,	*Chancellor of the Exchequer*
Heath, Edward, R. G.,	*Leader of the opposition, 4 March 1974 – 4 February 1975*
Hedley-Miller, Mrs. Mary E.,	*HM Treasury, Undersecretary, Overseas Finance Division, Reserves and Development 1975, Overseas Finance General Group, 1976*
Henley, Sir Douglas,	*HM Treasury, Second Permanent Secretary (Public Sector) 1975, Exchequer and Audit Department, Comptroller and Auditor General, 1976*
Hopkin, Sir Bryan,	*HM Treasury, Chief Economic Advisor*
Hudson, N. B.,	*HM Department of Industry, Head of Division,*

	South East Asia Department (Senior Economic Advisor)
Hunt, Sir John,	*Cabinet Office, Secretary of the Cabinet*
Jones, James L. 'Jack',	*Transport and General Workers' Union, General Secretary*
Jordan-Moss, Nick,	*HM DHSS, Deputy Secretary, Services Development Group*
Kaldor, Nicholas,	*Special Advisor to the Chancellor*
Kissinger, H. A.,	*United States Secretary of State, 22 September 1973 – 20 January 1977*
Lever, N. Harold,	*Chancellor of the Duchy of Lancaster*
Lord, Alan,	*HM Department of Industry, Deputy Secretary, Industrial Planning, 1975, HM Treasury, Second Permanent Secretary (Domestic Economy) 1976*
McMahon, C. W. 'Kit',	*Bank of England, Overseas Executive Director*
Marshall, J. A.,	*Cabinet Office Undersecretary*
Mitchell, Sir Derek J.,	*HM Treasury, Second Permanent Secretary, Overseas Finance Division*
Monck, Nick,	*HM Treasury, Assistant Secretary, Social Services Division I, 1975, Principal Private Secretary to the Chancellor of the Exchequer 1976*
Murray, Lionel 'Len',	*TUC, General Secretary*
Pliatzky, Leo,	*HM Treasury, Deputy Secretary, Public Sector B, 1974-75, Second Permanent Secretary, Public Services, 1976*

Pöhl, Karl Otto,	*German Ministry of Finance, State Secretary*
Posner, M. V.,	*HM Treasury, Deputy Chief Economic Advisor, Chief Economic Advisor's Sector, 1976*
Ramsbotham, Sir Peter E.,	*UK Ambassador to the United States*
Richardson, Gordon,	*Bank of England, Governor*
Ryrie, William S.,	*HM Treasury, Undersecretary, Public Sector B (Agriculture and Trade) 1975, IMF, UK Executive Director, 1976*
Scanlon, Hugh P.,	*Amalgamated Union of General Engineering Workers, General Secretary*
Schmidt, Helmüt,	*Chancellor of Germany, 16 May 1974 – 1 October 1982*
Simon, William,	*US Treasury, Secretary*
Shore, Peter,	*Secretary of State for Trade, 4 March 1974 – 8 April 1976; Secretary of State for the Environment, 8 April 1976 – 4 May 1979*
St. Clair, W. L.,	*HM Treasury, National Economy, Assistant Secretary, Prices and Incomes, 1975, Assistant Secretary Industrial Policy Group, 1976*
Stowe, K. R.	*Cabinet Office Undersecretary 1975, Principal Private Secretary to James Callaghan 1976*
Thatcher, Mrs. Margaret, H.,	*Leader of the Opposition, 11 February 1975 – 4 May 1979*
Walker, David A.,	*HM Treasury, Overseas Finance Division, Reserves and Development (Assistant Secretary)*

Walsh, H. G.,	*Cabinet Office, Principal Private Secretary*
Wass, Sir Douglas,	*HM Treasury, Permanent Secretary, from spring 1974*
Whittome, Alan,	*International Monetary Fund, European Department, Head; leader of negotiating team, December 1976*
Williams, Mrs. Shirley,	*Secretary of State for Prices and Consumer Protection, 28 February 1974 – 8 April 1976; Secretary of State for Education and Science, and Paymaster General, 10 September 1976 – 4 May 1979,*
Wilson, J. Harold,	*Prime Minister, 4 March 1974 – 5 April 1976*
Witteveen, H. Johannes,	*International Monetary Fund, Managing Director*
Yeo, Edwin,	*US Treasury, Undersecretary*
Ziljstra, Jelle,	*President of the Netherlands National Bank*

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